Walking the Line:

Common Pitfalls in Civil and Criminal Employment Tax Cases

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The Department of Justice and the IRS have announced a renewed emphasis on both civil and criminal payroll tax enforcement lawsuits. This article provides a short overview of what an employment tax case is and identifies reoccurring problems in representing clients with potential employment tax issues.

Overview

The term "employment taxes" is a shorthand reference to the Federal Insurance Contributions Act ("FICA") taxes that employers are required to withhold from their employees' paychecks and thereafter remit to the IRS on a quarterly basis.[1] Payroll taxes are reported on IRS Form 941, Employer's Quarterly Federal Tax Return. Because employers are responsible for withholding the taxes from their employees and paying those funds over to the IRS, payroll taxes can improperly serve as a short-term bridge loan which helps keep businesses afloat.

While there are no precise statistics on the number of payroll tax cases brought each year by the IRS, anecdotal evidence suggests that their frequency is on the uptick. One reason that the IRS has placed renewed emphasis in this area has been criticism by the Treasury Inspector General for Tax Administration ("TIGTA"). In a report issued in 2017, TIGTA noted that the IRS had identified 137,272 cases involving shortfalls between tax deposits reported on tax forms and deposits actually made, but the IRS only worked 17% of the cases.[2] The remaining 83% had a potential underreported tax difference of more than $7 billion. The report also criticized the IRS for case selection (i.e., not selecting the high-dollar cases) and failing to pursue repeat offenders.

Anecdotal evidence of the IRS's employment tax push can also be seen by the Third Circuit, which handed down two non-precedential opinions involving employment tax liabilities this year.[3] Further, Don Fort, the Chief of IRS-Criminal Investigations, stated that the IRS plans to expand its enforcement efforts in criminal employment tax cases.[4]

A host of scenarios could cause a company to land on the IRS's radar for failing to remain current with its quarterly payroll tax requirements (i.e., such as the cases referenced in the TIGTA report). A Form 941 could demonstrate that quarterly deposits are less than the amounts reported, the IRS may learn that a company has misclassified its employees as independent contractors, or employers may simply fail to file Forms 941. Audits may occur where an employer is sued for wage and hour violations or is the subject of an Immigration and Customs Enforcement raid. Some employers, like hotels and restaurants, may be flagged for a state sales tax audit. Finally, employees, business partners, or aggrieved ex-spouses may even inform on employers through the IRS's whistleblower program, which provides cash rewards to individuals who alert the IRS about tax fraud.

Given the large number of ways in which an employment tax case can arise, practitioners need to be aware when these issues are lurking in the background. Further, the thin line between a civil matter and a criminal matter makes providing straightforward advice challenging and requires practitioners to identify and navigate several difficult issues.

Civil Collection of Payroll Taxes Against Individuals

The Trust Fund Recovery Penalty ("TFRP") statute, 26 U.S.C. § 6672, titled "Failure to Collect and Pay Over Tax, or Attempt to Evade or Defeat Tax," provides:

> **General rule.** Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Under § 6672, a voluntary, conscious, and intentional act of paying the claims of other creditors, including the wage claims of employees, instead of paying over the trust fund taxes to the IRS constitutes a "willful" violation of the duty to pay over.

Oftentimes, the IRS quickly determines that the corporate entity which was obligated to collect and pay over employee taxes does not possess sufficient assets to pay the outstanding payroll tax liabilities. When that happens, the IRS will seek to collect payroll taxes from corporate officers or employees. The IRS can impose a TFRP against the individual(s) who are responsible for paying over the employee share of the payroll tax. The penalty is equal to the employee's share of the withholding, not the employer's share. Once imposed against the individual, the IRS can collect against the individuals assessed the TFRP. The penalty is imposed in addition to the company's liability although the Government does not collect twice.[5]

In *Brounstein v. United States*, the Third Circuit Court of Appeals wrote that "[a] responsible person acts willfully when he pays other creditors in preference to the [IRS] knowing that taxes are due, or with reckless disregard for whether taxes have been paid."[6]

IRS revenue officers, who are trained to collect employment and other taxes, typically conduct TFRP investigations. When conducting an investigation, the revenue officer will examine the following factors to determine whether an individual is a responsible person:

1. The authority granted to officers and employees in the employer's bylaws or similar documents;
2. The individual's ability to sign checks on the employer's bank accounts;
3. Whether the individual signed the employer's employment tax and other returns;
4. Whether the individual made payments to other creditors in lieu of the United States;
5. Whether the individual was an officer, director, or principal stockholder of the employer;
6. Whether the individual hired or fired employees; and
7. Whether the individual was in charge of the employer's financial affairs.[6]

More than one person can be a responsible person.[8] And, the responsible person may not be the ultimate owner of the enterprise.[9] It is not a defense to argue that the alleged responsible person did not have final authority to make payroll decisions.[10]

Revenue officers often cast a broad net when seeking to impose the TFRP. At the conclusion of a revenue officer's investigation, the officer will send notice of the IRS's intent to assess the TFRP against one or more individuals. This notice often includes a recommendation to assess penalties against anyone who signed a check or had any other input in making a decision to pay other creditors while employment taxes remained unpaid. Individuals receiving notice of the IRS's intent have 60 days to challenge the proposed assessment at the IRS's Office of Appeals. If the appeal is unsuccessful, then the taxpayer has an opportunity to challenge the penalty in federal court by paying one employee's tax liability for one quarter.[11] After making this small payment, the taxpayer can file a refund claim in either federal district court or the U.S. Court of Federal Claims ("COFC"). This contrasts with other tax refunds or penalties where the taxpayer must fully pay the liability before being able to file suit in either federal district court or COFC.[12] Given the low barrier to bringing suit, there are a disproportionate number of civil employment tax cases litigated in federal court. The putative responsible person then receives a trial with a de novo review of the IRS's TFRP penalty assessment.

A recent Second Circuit *case, Chai v. Commissioner*,[13] held that the Government bears the burden of production to show that the penalty was approved in writing by a supervisor. Although the *Chai* case applied to a different penalty, the logical underpinnings suggest that it applies to any penalty assessed against individuals including the TFRP. Prior to *Chai*, the IRS did not always obtain written supervisory approval to assess penalties. Thus, there will likely be an uptick in responsible person penalty litigation.

In addition to the TFRP penalties, the IRS may file a lawsuit in federal district court to enjoin the taxpayer from failing to file quarterly tax returns and/or make timely deposits.

Criminal Payroll Tax Violations

A civil case for failing to remit employee taxes can easily transform into a criminal case under 26 U.S.C. § 7202. Section 7202 – Willful Failure to Collect or Pay Over Tax – provides, in its entirety, as follows:

> Any person required under this title to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.

Section 7202 and § 6672 are virtually identical.[14] Case law interpreting both statutes demonstrates that the elements of the offenses are interpreted in tandem.[15]

There are many factors that can convert a civil case to a criminal case, including: pyramiding (i.e., incorporating new businesses), cash payroll, use of nominees (transferring title of the business to a relative who plays no role in the operations), and extended periods of non-compliance. Indeed, in some instances, if the company continues to withhold payroll taxes from its employees but continues to operate, the IRS and criminal prosecutors can consider the employer's actions to be theft.[16]

Given that the IRS focuses on the same criteria under § 6672 and § 7202, it is difficult as a practitioner to discern when a civil case will become criminal. Further, because payroll taxes accrue quarterly, civil cases can become criminal matters simply with the passage of time.

Practitioners need to exercise situational awareness to discern whether a client is facing civil liability, criminal liability or both. If the taxpayer's business is failing and the taxpayer is behind on a number of bills, the case will have little jury appeal as a criminal matter. However, if the taxpayer is paying a large number of personal expenditures or drawing a significant salary, the IRS may seek criminal charges. This is not ironclad of course, but it is a good rule of thumb.

As a final note, § 7202 only applies to the employee share of the taxes; therefore, restitution orders for this offense should be limited to the employee share of the payroll.[17] Oftentimes, the Government will charge another tax crime, like tax evasion, which covers both the employer and employee share.[18] By proceeding under a different statute, the IRS can avoid problems with collecting restitution and the correct calculation of relevant conduct under the federal sentencing guidelines.

Common Pitfalls

There are several pitfalls that trap accountants and lawyers who represent clients with employment tax issues.

1. The Privilege Trap: The Role of the Non-Attorney

The IRS has a practitioner privilege, 26 U.S.C. § 7525, which creates a privilege between non-attorney practitioners and their clients akin to the attorney-client privilege. The privilege applies only in noncriminal tax matters before the IRS and in federal court. Notably, this privilege does not apply in state court.[19] Nor does it apply to any nontax proceeding such as a matter before, for example, the U.S. Department of Labor. Thus, the non-attorney advisor who assists a company with its payroll tax issues has no privilege in a subsequent criminal proceeding.

Therefore, non-attorney practitioners who collect information from their client may be forced to divulge the information in testimony before a grand jury, in a criminal prosecution or even a state audit. Given the ambiguity between civil and criminal employment tax cases, non-attorneys' roles should be limited to acting within the scope of an otherwise pre-existing attorney-client relationship. Otherwise, the advisor may find himself/herself in a position of being forced to divulge statements that were made to him/her purportedly in confidence.

2. The Interview Dilemma: Civil Cooperation Versus Criminal Admissions

Shortly after the IRS commences a civil collection action, the revenue officer will attempt to identify the responsible person. IRS revenue officers are provided with a questionnaire, which they then use to depose the company representative. The questionnaire, which is referred to as the IRS Form 4180, Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes, seeks "yes/no" answers to questions directed to the subject of the investigation such as:

- Do you determine financial policy for the business?
- Do you authorize payments of bills?
- Do you authorize, sign or transmit payroll tax returns?
- Did you know payroll taxes were not being remitted?
- Did you authorize any federal tax deposits?
- What actions did you take to see that taxes were paid?

The revenue officer transcribes the responses on the form as part of an oral interview. IRS guidelines prohibit the revenue officer from mailing the form to be completed outside the collection officer's presence (although it may be completed by telephone).[20]

Practitioners should consider the long-term ramifications of agreeing to an interview with the revenue officer or signing an IRS Form 2751, Proposed Assessment of Trust Fund Recovery Penalty, even if the case appears headed for a civil resolution. IRS Form 2751 is signed once the responsible person reaches an agreement with the IRS. The Form serves as an admission that the signatory is the responsible person. For example, in *Thayer*,[21] the defendant signed a Form 2751. The Government used the signed Form 2751 as part of its proof in a criminal trial for violations of § 7202.

Even after the interview, the collections officer may continue to conduct an investigation into the identity of a responsible person. For example, the I.R.M. suggests that collection officers may interview third parties and summon bank records to ascertain additional facts that could be used to assess the penalty or initiate criminal charges.

Because there is oftentimes no meaningful distinction between a civil case and a criminal case, attorneys can be reticent to permit their clients to sit for a Form 4180 interview. Some practitioners will simply agree to the penalty, recognizing that a substantial civil penalty is better than permitting his/her client to sit for

an interview which may later serve as a key piece of evidence in a criminal proceeding.

In short, even attorneys whose clients have the purest of intentions may find that their cooperation has significant repercussions.

3. Cooperating with Collections

In nearly every case, the IRS is simply seeking to be made whole. The exception would be those cases where companies failed to file payroll tax returns or filed false payroll tax returns. But even in those cases, the IRS will refrain from assessing TFRP if the company pays the past due tax liability.

If the IRS assesses a TFRP, it will seek to collect the employee share of the past due taxes from an individual. Many times that individual simply lacks the ability to pay the company's debts in full immediately. The IRS will then consider several collection options. However, before the IRS weighs its options, it asks the taxpayer to complete a Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals. Form 433-A asks dozens of questions about the taxpayer's assets (previous and current), liabilities, income and expenses. The form is incredibly detailed and highly intrusive.

A few points to note about Form 433-A. First, it is signed under penalty of perjury. Providing a misleading statement on the Form 433-A can be a basis to bring a false statements or tax evasion charge. Second, Form 433-A has the unique effect of making every practitioner a witness to his or her clients' statements, so if the client makes false statements on the Form, the client may assert a reliance defense. Finally, any retainer paid to the practitioner must be identified on the Form 433-A. It is advisable to collect a flat fee when representing a client who completes a Form 433-A.

Conclusion

Counseling clients whose companies have significant payroll tax liabilities remains difficult. Practitioners need to be aware of these and other potential issues to avoid making their clients' situation worse.

NOTES:

[1] FICA taxes are separately imposed on employees and on employers. 26 U.S.C. §§ 3101(a) (imposing Social Security tax on employees); 3101(b) (imposing Medicare tax and Additional Medicare tax on employees); 3111(a) (imposing Social Security tax on employers); 3111(b) (imposing Medicare tax on employers). Federal unemployment tax, imposed by the Federal Unemployment Tax Act ("FUTA"), is imposed solely on employers. 26 U.S.C. § 3301. Employer FICA and FUTA taxes are taxed directly against the employer.

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Generally, employers are required to deposit federal income tax withheld and both the employer and employee portions of Social Security and Medicare taxes under one of three timing rules: monthly, semi-weekly, or daily – depending on the size of the payroll. Form 941 must be filed quarterly by April 30, July 31, October 31 and January 31 for the calendar quarters ending March 31, June 30, September 30 and December 31, respectively. Returns may be filed ten days late if timely deposits were made.

[2] https://www.treasury.gov/tigta/auditreports/2017reports/201740038fr.pdf.

[3] *United States v. Lynch*, 2018 WL 2411429 (3d Cir. May 29, 2018); *United States v. Commander*, 2018 WL 2386023 (3d Cir. May 25, 2018).

[4] https://www.forbes.com/sites/kellyphillipserb/2017/08/04/irs-introduces-new-crime-boss/#696f4a992e31.

[5] *Quattrone Accountants, Inc. v. I.R.S.*, 895 F.2d 921, 926 (3d Cir. 1990).

[6] *Brounstein v. United States*, 979 F.2d 952, 956 (3d Cir. 1992). *See* also *Collins v. United States*, 848 F.2d 740, 741-42 (6th Cir. 1988) (per curiam) ("It is no excuse that, as a matter of sound business judgment, the money was paid to suppliers and for wages in order to keep the corporation operating as a going concern – the government cannot be made an unwilling partner in a floundering business."); *Sorenson v. United States*, 521 F.2d 325, 328 (9th Cir. 1975) ("Employees to whom wages are owed are but a particular type of creditor.").

[7] *Vinick v. United States*, 205 F.3d 1, 6-8 (1st Cir. 2000); *Quattrone Accountants, Inc.*, 895 F.2d at 927. *See also United States v. DeMuro*, 677 F.3d 550, 561 (3d Cir. 2012) (stating that authority to discharge employees is "directly" relevant to whether a defendant had significant control over finances).

[8] *Barnett v. I.R.S.*, 988 F.2d 1449, 1455 (5th Cir. 1993) ("There may be – indeed, there usually are – multiple responsible persons in any company."); *Gephart v. United States*, 818 F.2d 469, 473 (6th Cir. 1987) ("More than one person can be a responsible officer of a corporation. Essentially, liability is predicated upon the existence of significant, as opposed to absolute, control of the corporation's finances.") (internal citation omitted).

[9] *Brounstein*, 979 F.2d at 956.

[10] *Id*. (holding that a corporate officer who "fails to pay over to the government withheld taxes when there are funds to do so is not entitled to prefer his own interest in continued employment over that of the government…."); *see* also *United States v. Crabbe*, 364 Fed. Appx. 412, 2010 WL 318399 (10th Cir. Jan. 28, 2010) (the defendant was held to be a responsible person under § 7202 where he was the vice president; had some control over financial affairs; unilaterally established a corporate bank account; had authority to distribute corporate funds, including by signing corporate checks; held a large share of the ownership interests; participated in firing at least one employee; and ostensibly had the authority as vice president to hire or fire others). *But see Erwin v. United States*, 591 F.3d 313, 320-21 (4th Cir. 2010) ("titular authority alone does not establish responsible person status. Rather, the proper inquiry focuses "on substance rather than form. The substance of the circumstances must be such that the officer exercises and uses his authority over financial affairs or general management, or is under a duty to do so, before that officer can be deemed to be a responsible person.") (citing *O'Connor v. United States*, 956 F.2d 48, 51-52 (4th Cir. 1992)); *Vinick*, 205 F.3d at 6-8 (same).

[11] *Steele v. United States*, 280 F.2d 89, 90-91 (8th Cir. 1960). In certain circumstances, the taxpayer can challenge the penalty in bankruptcy too.

[12] A plaintiff cannot demand a jury trial in the COFC.

[13] 851 F.3d 190, 222-23 (2d Cir. 2017).

[14] *See Slodov v. United States*, 436 U.S. 238, 247 (1978) ("Sections 6672 and 7202 were designed to assure compliance by the employer with its obligation to withhold and pay the sums withheld, by subjecting the employer's officials responsible for the employer's decisions regarding withholding and payment to civil and criminal penalties for the employer's delinquency.").

[15] *United States v. Thayer*, 201 F.3d 214, 219-221 (3d Cir. 1999).

[16] When an employer is unable to fully pay its employment taxes, the potentially responsible persons can reduce their TFRP exposure by designating employment tax payments as trust fund taxes. Otherwise, without such a designation the IRS will apply the payment first to the employer's share before then applying the excess to the trust fund taxes. Internal Revenue Manual ("I.R.M.") § 5.7.4.3(2). Unfortunately, however, the IRS's electronic deposit system does not allow employers to designate electronic payments. Designated payments need to be made by check with a cover letter instructing the IRS to apply the payment to trust fund taxes only.

[17] Restitution in tax cases is different than restitution in criminal cases. *Compare* 18 U.S.C. § 3663 with 26 U.S.C. § 6201(a)(4). The Tax Court recently curtailed the IRS's ability to collect interest on a Tax Court restitution order. *Klein v. Commissioner*, 149 T.C. No. 15 (2017).

[18] *See generally United States v. McKee*, 506 F.3d 225, 233-34 (3d Cir. 2006) (defendant charged with tax evasion for failing to pay outstanding tax liability).

[19] Pennsylvania has a narrower privilege that applies only to CPAs. 63 Pa. Cons. Stat. § 9.11a (1997). The privilege does not apply where there is a federal claim. *See Long v. H.D.J. Co*., 2004 U.S. Dist. LEXIS 11812 (E.D. Pa. June 14, 2004) (ordering records produced in response to a subpoena because the party issuing the subpoena had brought federal claims).

[20] I.R.M. § 5.7.4.2.4.

[21] *Thayer*, 201 F.3d 214 at 217 (3d Cir. 1999).