

# Employers Beware! Payroll Tax Violations Come With a Very Heavy Price

By Caroline D. Ciruolo, Kostelanetz & Fink



Caroline D. Ciruolo, former acting assistant attorney general of the U.S. Department of Justice's Tax Division, is a partner with Kostelanetz & Fink and a founder of its Washington, D.C., office. Ciruolo is president of the American College of Tax Counsel and chair of the ABA Tax Section's Civil and Criminal Tax Penalties Committee. She is a recipient of the IRS Chief Counsel Award and the ABA Tax Section's Janet Spragens Pro Bono Award, and she served as an instructor with the IRS Military Volunteer Income Tax Assistance Program at Ft. Meade in Maryland. Ciruolo serves as an adjunct professor at the Georgetown University Law Center and the University of Baltimore School of Law Graduate Tax Program. She has been recognized by *Chambers*, *International Tax Review*, *Best Lawyers in America*, *Super Lawyers*, and *The Daily Record's* Top 100 Women Circle of Excellence. ©2021 Caroline D. Ciruolo. All rights reserved.

*Note: A version of this article focused on criminal enforcement appeared in the ABA Criminal Justice Section's White Collar Crime Committee Newsletter, Winter/Spring 2021.*

In fiscal year 2020, the Internal Revenue Service (IRS) was responsible for more than 96 percent of the gross revenue received on behalf of the United States.<sup>1</sup> Employment taxes, including federal income tax actually withheld and paid over to the IRS, constitute over 70% of all revenue collected by the IRS.<sup>2</sup> Despite our strong system of voluntary compliance, the IRS estimates the annual gross tax gap—"the amount of true tax liability that is not paid voluntarily and timely"—to be \$441 billion.<sup>3</sup> Of this amount, \$81 billion is attributable to employment tax.<sup>4</sup>

Therefore, it comes as no surprise that civil and criminal employment tax enforcement is among the highest priorities of the IRS and the Tax Division of the U.S. Department of Justice (DOJ). The IRS and DOJ have increased civil and criminal employment tax enforcement since 2015 in an effort to educate, modify the behavior of, and hold accountable those employers who intentionally fail to comply with their employment tax obligations.

## The Basics

An employer is required to deduct and withhold income tax from wages.<sup>5</sup> As set forth on Form W-4, *Employee's Withholding Certificate*, the amount of income tax required to be withheld depends on a variety of factors. Employers are liable for the payment of amounts withheld, whether or not the employer collects the tax from the employees.<sup>6</sup>

In addition to federal income tax withholding (FITW), employers are required to withhold Federal Insurance Contribution Act (FICA) tax, which includes Social Security (Old-Age, Survivors, and Disability Insurance [OASDI]), Medicare (Hospital Insurance), and, where applicable, the additional Medicare tax.<sup>7</sup> Once employment taxes are withheld, the funds "constitute a special fund held in trust for the United States."<sup>8</sup>

Employers are also responsible for direct employment taxes, including a matching amount of FICA<sup>9</sup> and Federal Unemployment Tax Act (FUTA) tax.<sup>10</sup>

## The Deposits

Subject to limited exceptions,<sup>11</sup> if the employment tax liability equals or exceeds \$2,500 during the tax period for which the employment tax return is filed, employers must deposit FITW and FICA tax within several days of the payment.<sup>12</sup> All federal tax deposits must be made electronically.<sup>13</sup>

## The Returns

An employer who pays wages subject to FITW and FICA tax is generally required to file Form 941, *Employers Quarterly Federal Tax Return*, 30 days after the end of each quarter.<sup>14</sup> FUTA tax is paid and reported on Form 940, *Employer's Annual Federal Unemployment Tax Return*, which is filed by January 31 following the calendar year being reported.<sup>15</sup>

Each year, the employer must furnish accurate Forms W-2, *Wage and Tax Statement*, to each employee reflecting, among other things, wages paid and tax withheld. Copies of the Forms W-2, along with a Form W-3, *Transmittal of Wage and Tax Statements*, are filed with the Social Security Administration.<sup>16</sup> The failure to issue these forms can result in a civil penalty generally equal to \$250 for each statement.<sup>17</sup>

## Importance of Withholding and Reporting to the IRS

The IRS has established that tax compliance is much greater if income is subject to third-party information reporting and even higher when also subject to withholding. "[T]he net misreporting percentage (NMP) for income amounts subject to substantial information reporting and withholding is 1 percent; for income amounts subject to substantial information reporting but not withholding, the NMP is 5 percent; and for income amounts subject to little or no information reporting, such as nonfarm proprietor income, the NMP is 55 percent."<sup>18</sup>

## Civil Penalties

Employers that fail to make timely deposits of employment taxes during the quarter or fail to pay via electronic transfer face substantial civil penalties, which increase with the length of the delay.<sup>19</sup> In addi-

tion to the foregoing failure to deposit penalties, the failure to timely file required employment tax returns, or to timely pay any balance due reflected on those returns, can result in additional civil penalties under IRC §§ 6651(a)(1) and (2), respectively.

These civil penalties, and statutory interest on both the unpaid tax and penalties, add up quickly, and continued noncompliance exposes employers to both civil and criminal penalties and enforcement efforts.

### Trust Fund Recovery Penalties

When an employer fails to collect, account for, and pay over the employee's share of employment tax, the IRS may pursue the amounts required to be withheld from any or all of those individuals determined to be responsible persons. IRC § 6672 provides:

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.

In other words, the IRS can impose personal liability for unpaid trust fund taxes on any or all “responsible persons” that “willfully” fail to meet their obligations.<sup>20</sup> The trust fund recovery penalty (TFRP) is also referred to as the 100% penalty, in that the amount of the penalty equals the full amount of the trust fund liability.

An individual is considered a responsible person if he or she has “both the responsibility and authority to avoid the default.”<sup>21</sup> A person is responsible for collecting, accounting for, and paying over if he or she has “the authority required to exercise significant control over the employer’s financial affairs, regardless of whether such control was exercised.”<sup>22</sup>

Merely signing checks or preparing tax returns at the direction of supervisors does not rise to the requisite level of control. “However, a responsible person need not have the final word in the company regarding the payment of creditors. Officers and higher level employees of a company who are non-owners may still be required to sacrifice their jobs (i.e., quit) to avoid being responsible for the TFRP, rather than obey the orders of an owner to pay other creditors but not to pay current federal trust fund taxes as they become due.”<sup>23</sup> Finally, it is well established that more than one person in a company may be a responsible person.<sup>24</sup>

Willfulness in the context of IRC § 6672 has been defined as “a deliberate choice voluntarily, consciously, and intentionally made to pay other creditors instead of paying the Government ... [and it] may also include a reckless disregard of an obvious and known risk that taxes might not be remitted.”<sup>25</sup> While mere negligence will not suffice, “a responsible person cannot avoid reckless behavior through insulation and may not ‘immunize himself from the consequences of his actions by wearing blinders which will shut out all knowledge of the liability for and the nonpayment of its withholding taxes.’”<sup>26</sup> Moreover, “willfulness is shown where a responsible person fails to take action, ... or where other creditors are paid after the deficiency is known.”<sup>27</sup>

### Civil Enforcement

Despite the assessment of substantial civil penalties and interest, the filing of Notices of Federal Tax Liens, and enforced collection efforts,

including offsets, levies,<sup>28</sup> and seizures of assets, some employers continue to ignore their employment tax obligations and allow liabilities to pyramid quarter after quarter. When this occurs, there is a risk that the IRS will seek a civil injunction pursuant to IRC § 7402.<sup>29</sup>

Section 7402(a) “encompasses a broad range of powers necessary to compel compliance with the tax laws.”<sup>30</sup> These powers include the district court’s ability to issue “orders of injunction ... as may be necessary or appropriate for the enforcement of the internal revenue laws.”<sup>31</sup> In determining the propriety of injunctive relief under IRC § 7402(a), courts require the government to demonstrate: (1) a substantial likelihood of success on the merits; (2) irreparable injury will be suffered absent the injunction; (3) the threatened injury outweighs the potential damage of the proposed injunction; and (4) the injunction would not be adverse to the public interest.<sup>32</sup>

“Injunctive relief is appropriate if the defendant is reasonably likely to violate the federal tax laws again.”<sup>33</sup> In making this determination, courts will “consider such factors as: (1) the gravity of harm caused by the offense; (2) the extent of the defendant’s participation, and his degree of scienter; (3) the isolated or recurrent nature of the infraction and the likelihood that the defendant’s customary business activities might again involve him in such transaction; (4) the defendant’s recognition of his own culpability; and (5) the sincerity of his assurances against future violations.”<sup>34</sup>

An injunction can include various requirements, including ongoing compliance with employment tax laws, providing notice of all future employment tax deposits to the IRS, prohibitions against opening new business or obtaining new employer identification numbers, and restrictions on paying certain liabilities or transferring assets until all pending tax liabilities are paid in full.<sup>35</sup>

If an employer violates an injunction, DOJ will seek an order of civil or criminal contempt, which can result in monetary damages, closing the business, and even incarceration of the responsible individuals.<sup>36</sup>

### Fraud Referrals and Data Analytics

In an effort to increase employment tax compliance, the IRS increased the training of revenue officers and other compliance employees to recognize potential indicators of fraud related to payroll tax violations. If such indicators are identified, employees are instructed to consult with group managers and fraud enforcement advisors to determine if the matter should be referred to IRS Criminal Investigation.<sup>37</sup>

The IRS is also becoming more adept at data analytics. For example, IRS Criminal Investigation established the Nationally Coordinated Investigations Unit (NCIU) in 2017, and in late 2019, the unit was awarded a Commissioner’s award related to employment tax and their innovation and use of data analytics to identify noncompliance. The team also briefed the secretary of the treasury on the employment tax initiative.<sup>38</sup> It stands to reason that identifying civil and criminal noncompliance in employment tax is ripe for data analytics because the IRS has all the data it needs to connect the dots and select the best cases for civil action and criminal investigation.

### My Client Is Out of Compliance—What Are the Options?

An employer who is out of compliance has various options, depending on the status of IRS enforcement efforts. First and foremost, the employer must get into current compliance. Continued failure to comply with employment tax obligations will aggravate the situation

and impair the ability to reach a resolution with the IRS or DOJ.

If the employer failed to file or filed willfully false employment tax returns, the statute of limitations on assessment never begins to run. To come into compliance, the employer can file delinquent or amended returns pursuant to the IRS long-time policy statement that recommends a six-year look-back period.<sup>39</sup> However, taking advantage of the IRS's policy does not guarantee that earlier years will not be audited, and the returns that are filed will result in the automatic assessment of applicable delinquency penalties—failure to deposit, file, and pay—that can be in excess of 50 percent of the tax due, plus interest. This approach also does not prevent an audit of the returns filed, which could result in additional civil penalties or a criminal referral.

For those taxpayers who are at risk for criminal investigation and prosecution, the best option may be a formal voluntary disclosure. In November 2018, the IRS updated its longstanding voluntary disclosure practice and reiterated that, to avoid a criminal referral, a taxpayer must make a timely, accurate, and complete disclosure.

## Conclusion

Our tax system is one of voluntary compliance, which works when everyone pays their fair share. However, employers often face trials and tribulations that hamper compliance. Such situations have become more prevalent in these tough economic times and employers are often faced with difficult choices. In light of the substantial civil costs and criminal exposure associated with failure to collect, account for, and pay over employment tax, employers should seek assistance as soon as they find themselves out of compliance and choose wisely in selecting which creditors are given priority. ☉

## Endnotes

<sup>1</sup>I.R.S. Progress Update, Fiscal Year 2020, *Putting Taxpayers First*, I.R.S. Pub. 5382.

<sup>2</sup>*Id.* at 22.

<sup>3</sup>Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011-2013, Executive Summary, I.R.S. Pub. 1415 (rev. Sept. 2019).

<sup>4</sup>*Id.* at 2.

<sup>5</sup>I.R.C. § 3402(a).

<sup>6</sup>Treas. Reg. § 31.3403-1.

<sup>7</sup>I.R.C. § 3102.

<sup>8</sup>See I.R.C. § 7501(a); *Thibodeau v. United States*, 828 F.2d 1499, 1506 (11th Cir. 1987).

<sup>9</sup>I.R.C. §§ 3111(a), (b).

<sup>10</sup>I.R.C. §§ 3301, 3306(b). “The [Railroad Retirement Tax Act] RRTA serves as the functional equivalent of FICA for railroad employers, employees, and employee representatives (a group unique to the railroad industry).” IRM 5.1.24.2 (Aug. 15, 2012); I.R.C. §§ 3202, 3221.

<sup>11</sup>See IRM 21.7.2.3.4(1) (Oct. 1, 2019).

<sup>12</sup>Employer's Tax Guide (Circular E), I.R.S. Pub. 15 (2020)

<sup>13</sup>See IRM 20.1.4.2.2.2 (Feb. 9, 2018). Payments made directly to the IRS can result in a failure to deposit penalty. *Id.*

<sup>14</sup>IRM 21.7.2.4.7 (Feb. 27, 2013). A Form 944, *Employer's Annual Federal Tax Return*, is for small employers, who file annually instead of quarterly. IRM 21.7.2.4.9 (Oct. 1, 2019).

<sup>15</sup>See IRM 21.7.3 (Aug. 18, 2020). An employer who pays compensation subject to RRTA must file Form CT-1, *Employer's Annual Railroad Retirement Tax Return*. See IRM 21.7.2.2 (3) (Oct. 1, 2019).

<sup>16</sup>IRM 21.7.2.3.3.3 (Feb. 27, 2013).

<sup>17</sup>I.R.C. § 6722(a), (e).

<sup>18</sup>Federal Tax Compliance Research: Tax Gap Estimates for Tax Years 2011-2013, Executive Summary, IRS Pub. 1415 (rev. Sept. 2019).

<sup>19</sup>See I.R.C. § 6656; see also IRM 20.1.4 (Feb. 9, 2018), 21.7.2.3.4(3) (Oct. 1, 2019).

<sup>20</sup>See IRM 5.7.3.3 (Nov. 12, 2010).

<sup>21</sup>*Salzillo v. United States*, 66 Fed. Cl. 23, 32 (2005); see also IRM 5.7.3.3.1 (Aug. 6, 2015).

<sup>22</sup>*United States v. Jones*, 33 F.3d 1137, 1139 (9th Cir. 1994).

<sup>23</sup>See IRM 5.7.3.3.1.2 (Nov. 12, 2010) (citing *Brounstein v. United States*, 979 F.2d 952, 956 (3rd Cir. 1992)).

<sup>24</sup>*Jenkins v. United States*, 101 Fed. Cl. 122, 132 (2011); *Brinskele v. United States*, 88 Fed. Cl. 334, 346 (2009) (citing *Stuart v. United States*, 337 F.3d 31, 36 (1st Cir. 2003)).

<sup>25</sup>*Godfrey v. United States*, 748 F.2d 1568, 1577 (Fed. Cir. 1984) (internal citations and quotation marks omitted).

<sup>26</sup>*United States v. Waterhouse*, 122 Fed. Cl. 276, 285 (2015) (quoting *Bolding v. United States*, 565 F.2d 663, 674 (Ct. Cl. 1977)).

<sup>27</sup>*Waterhouse*, 122 Fed. Cl. at 285 (internal citations omitted); see also *United States v. Kim*, 111 F.3d 1351, 1357 (7th Cir. 1997) (a responsible person has a duty to use all unencumbered funds to pay deficient taxes, once known).

<sup>28</sup>See I.R.C. §§ 6331 (levy and distraint), 6330(h)(1) (disqualified employment tax levy); see also IRM 8.22.6.3.3 (Aug. 26, 2020).

<sup>29</sup>See *McComb v. Jacksonville Paper Co.*, 336 U.S. 187, 192 (1949) (“Decrees ... are often necessary to prevent further violations where a proclivity for unlawful conduct has been shown.”) (internal citations omitted).

<sup>30</sup>*United States v. Askins & Miller Orthopaedics, P.A.*, 924 F.3d 1348, 1358 (11th Cir. 2019).

<sup>31</sup>I.R.C. § 7402(a); *United States v. Ernst Whinney*, 735 F.2d 1296, 1300 (11th Cir. 1984).

<sup>32</sup>*Keeton v. Anderson-Wiley*, 664 F.3d 865, 868 (11th Cir. 2011).

<sup>33</sup>*United States v. Dampier Electric, Inc.*, No. 1:19-cv-01419, 2020 WL 1317343, 125 A.F.T.R.2d 2020-1298, at \*4 (E.D. Calif. Aug. 31, 2020) (citations omitted).

<sup>34</sup>*Id.* (citations omitted).

<sup>35</sup>See *United States v. Dampier Electric, Inc.*, No. 1:19-cv-01419, 2020 WL 5105796 (E.D. Calif. Aug. 31, 2020); *United States v. Askins & Miller Orthopaedics, P.A., et al.*, No. 8:17-cr-92-T-27AAS, 2020 WL 619550, (M.D. Fla. Feb. 10, 2020); *United States v. Bestcare Nursing and Residential Services, Inc., et al.*, No. 1:16-cv-00899, 2016 WL 6998774 (D. Md. Aug. 4, 2016).

<sup>36</sup>*United States v. Baker Funeral Home, Ltd., et al.*, 196 F. Supp. 3d 530 (E.D. Pa. 2016).

<sup>37</sup>IRM 5.1.24.5.9 (Mar. 2, 2018).

<sup>38</sup>INTERNAL REVENUE SERVICE: CRIMINAL INVESTIGATION, ANNUAL REPORT 2020, <https://www.irs.gov/pub/irs-pdf/p3583.pdf>.

<sup>39</sup>IRM 4.12.1.3 (Oct. 5, 2010) (formerly Policy Statement 5-133).