Update On IRS Enforcement In Employment Tax Cases

PRESENTED BY: CHAYA KUNDRA, ESQ.
www.KundraTaxLaw.com
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Overview

• With the issuance of more injunction notices, threats of shut down & incarceration, Letters 903 and criminal sanctions, we discuss how the IRS is responding to "repeat offenders" of employment tax liabilities.
Overview Of Employment Taxes

• FICA (§§3101-3128), FUTA (§§3301-3311), Income Tax Withholding (§§3401-3406), RRTA (§§3201-3232)

  – Employment taxes are due on “wages” paid to a worker who is an “employee”
Overview Of Employment Taxes

• Employment Tax Returns
  – Form 940 (Employers Annual Federal Unemployment Tax Return)
  – Form 941 (Employer's Quarterly Federal Tax Return)
  – Form 943 (Employer’s Annual Federal Tax Return for Agricultural Employees)
  – Form 944 (Employer’s Annual Federal Tax Return)
  – Form 945 (Annual Return of Withheld Federal Income Tax)
  – Form CT-1 (Employer’s Annual Railroad Retirement Tax Return)
7 Most Common Types Of Non-Compliance

1. Pyramiding
   - Business withholds and intentionally fails to remit taxes to the IRS
     • Often due to insufficient profit or capital for operating costs
   - Quarterly employment tax liabilities accumulate (“pyramid”) until the employer has little hope of catching up
   - Frequently, businesses shut down or file for bankruptcy, then start a new business under a different name, starting the cycle over
7 Most Common Types Of Non-Compliance

2. Unreliable third-party payers
   - Typically payroll service providers (PSP) and professional employer organizations (PEO) file employment tax returns and make employment tax payments
   - When PSPs and PEOs close, they may leave millions in unpaid employment taxes
   - Business owners are required to verify payments made on their behalf and must not allow their IRS address of record be changed to that of the third party payer
7 Most Common Types Of Non-Compliance

3. Offshore employee leasing
   - The offshore company indirectly leases the individual’s services back to the original employer using a domestic leasing company as an intermediary.
   - While employee’s job does not change, say pay is deferred compensation.
   - Promoters of these arrangements improperly claim that neither employment taxes nor income taxes are owed on the “deferred” compensation
   - The IRS designated this as a “Recognized Abusive and Listed Transaction” in 2013 and takes civil and criminal actions against promoters and participants
7 Most Common Types Of Non-Compliance

4. Misclassifying worker status
   - Not eligible for relief under Section 530 of the Revenue Act of 1978

5. Paying employees in cash
   - The IRS will build its case using all available information even if there are no payroll records or checks
7 Most Common Types Of Non-Compliance

6. Filing false – or no – payroll tax returns

7. Treating compensation as corporate distribution
   – S Corporation improperly treats officer compensation as a corporate distribution for statutory employee
How The IRS Combats Non-Compliance

- Audits and filing tax liens against property the taxpayer owns
- IRS may begin levy action against business
- TFRP may be assessed against responsible parties
- Injunctions may be sought
- IRS Criminal Investigation investigates and refers for prosecution individuals and businesses where willfulness is present
Statutory Provisions

• Three main code sections may apply
  – Sec. 6672(a): 100% civil penalty assessed to those responsible for failing to
    withhold or pay employment taxes
  – Sec. 7202: The “willful” failure to withhold and pay employment taxes is a felony
    • May be fined up to $10,000
    • May be imprisoned up to five years
    • Or both
  – Sec. 7201: Criminalizes tax evasion, including unsuccessful attempts to evade tax
    • May be fined up to $100,000 ($500,000 for corporations)
    • May be imprisoned up to 5 years
    • Or both, together with costs of prosecution
Statutory Provisions

• These sections – which define the willful failure to collect or pay employment tax and the willful attempt to evade or defeat tax in a similar way – give the IRS relatively broad discretion to choose either civil or criminal action
  – The Internal Revenue Manual provides limited guidance on which to choose
    • Willfulness is defined as acting “deliberately, knowingly, and with the specific intent to violate the law”\(^1\)
    • The IRM Fraud Handbook notes that tax fraud “requires both a tax due and owing; and fraudulent intent”\(^2\)

\(^1\)IRM §4.23.9.6.2, ¶2
\(^2\)IRM §25.1.1.2, ¶2
Criminal Or Civil Charges?

• The IRS has typically brought criminal charges only in the most blatant cases of abuse, involving
  – Tax professionals
  – Multiple acts of wrongdoing
  – Inconsistent documentation

• The IRS often chooses civil proceedings where business owners were struggling with cash flow and chose to pay creditors instead

• No need to prove an “evil” motive
Criminal Investigations Increasing

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Source: IRS Criminal Investigation Annual Report 2018
Criminal Charges: Proving Fraudulent Intent

- IRS agents are instructed to look for affirmative actions
  - Such as failing to withhold taxes, filing late returns, concealing assets, and misappropriating or diverting corporate assets\(^1\)

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\(^1\)IRM §9.1.3.2.2.2, ¶7
\(^2\)IRM §25.1.1.3, ¶1.b
\(^3\)IRM §25.1.1.3, ¶2
Criminal Or Civil Charges: Defining “Willfully”

• Acting “willfully”
  – Criminal: Defines acting willfully as an intentional, voluntary violation of a law the person knew about,\(^1\) not negligence, mistakes, or misunderstanding of the law\(^2\)
    • Per the DOJ Criminal Tax Manual: “defendant voluntarily and intentionally violated a known legal duty.”\(^3\)
      – Examples include paying creditors instead of employment taxes
  – Civil: Defines acting willfully as a voluntary, intentional, and conscious decision. No need to prove intent to defraud.\(^4\)

\(^1\)Gilbert, 266 F.3d 1180 (9th Cir. 2001)  \(^2\)DOJ 2012 Criminal Tax Manual 9.04[2]  \(^3\)Kobus, 103 Fed. Cl. 575 (Fed. Cl. 2012), citing Godfrey, supra note 42
\(^4\)Quinn, 566 Fed. Appx. 659 (10th Cir. 2014)  \(^5\)Godfrey, 748 F.2d 1568, 1576—77 (Fed. Cir. 1984)
Criminal Or Civil Charges: Other Factors

• Where the burden of proof lies
  – Criminal: Government must prove beyond a reasonable doubt
  – Civil assessment/responsible party: Individual must provide that she is not responsible and did not act willfully

Tax Professional: U.S. v. Lynch

• Mr. Lynch was an experienced tax attorney who moved employees and assets between a number of entities to avoid employment taxes – over 10+ years

• Convicted of 16 counts of willfully failing to pay employment taxes, in violation of Sec. 7202

Tax Professional: U.S. v. Lord

• Ms. Lord was an accountant for 20+ years before serving as the company’s acting president and CFO
  – Previously held two positions where she was involved in paying employment taxes
• Convicted on six counts of willfully failing to make payroll tax payments for her employer under Sec. 7202
  – Sentenced to 21 months’ imprisonment followed by three years of supervised release
  – Order to pay $776,849.47 in restitution

1Lord, 404 Fed. Appx. 773 (4th Cir. 2010)
Multiple Acts Of Wrongdoing: U.S. v. DeMuro

- Mr. and Mrs. DeMuro were convicted of conspiracy to defraud the government and of failing to pay trust fund taxes
  - LLC withheld but did not pay more than $500,000
  - Mrs. DeMuro used her ailing father’s assets for personal purposes, not to pay the tax owed

1DeMuro, 677 F. 3d 550 (3d Cir. 2012)
Multiple Acts Of Wrongdoing: U.S. v. Farr\textsuperscript{1}

- Ms. Farr, manager of an alternative medical clinic, was convicted under Sec. 7201 for willfully failing to pay a trust fund recovery penalty assessed against her
  - Failing to pay quarterly employment taxes owed
  - Pyramiding of clinic operating entities
  - Paying employees in cash

\textsuperscript{1}Farr, 701 F.3d 1274 (10th Cir. 2012)
Multiple Acts Of Wrongdoing: U.S. v. Brennick

- Mr. Brennick was convicted of 18 counts of failing to pay withholding taxes, 9 counts of structuring currency transactions to avoid reporting requirements, and one count of corruptly impeding the IRS, in violation of Sec. 7212
  - Withdrew money for gambling
  - Used multiple EINs
  - Illegally structured cash withdrawals
  - Lied to the IRS

Multiple Acts Of Wrongdoing: U.S. v. Thayer

- Mr. Thayer pled guilty to one count of filing a false income tax return in violation Sec. 7206(1), and one count of conspiring to defraud the United States
  - Failed to pay employment taxes at a boat-building company and at a seafood store he owned
  - Sentenced to 79 months of imprisonment
  - Ordered to pay $125,000 in fines, $48,460.59 for costs of prosecution, and $4,791,267.18 in restitution

1Thayer, 201 F.3d 214 (3d Cir. 1999), cert. denied (2000)
Multiple Acts Of Wrongdoing: Super\(^1\)

- Mr. Super, owner of a security company, entered into an agreement with the IRS to pay federal employee trust funds taxes due on behalf of his employees but failed to make any payments
  - The IRS issued levies against the company, but he still failed to make payments
  - To avoid the levies, he opened a second company transferred all of his assets and clients there
  - When the IRS pursued the second company, Super transferred all assets and clients to a third company

- Convicted of tax evasion
  - Sentenced to 2 years in prison
  - 3 years of supervised release
  - Ordered to pay $165,076 in restitution

\(^1\)IRS Criminal Investigation Annual Report 2018
Multiple Acts Of Wrongdoing: Kane\textsuperscript{1}

- Ms. Kane, owner of a temporary employment agency, set up a long-running, off-the-books payroll scheme to evade employment taxes and workers’ compensation insurance premiums
  - Evaded paying more than $1.3 million in federal taxes
- Pled guilty to 18 counts of willful failure to collect and pay taxes and five counts of mail fraud
  - Sentenced to two years in prison
  - Three years of supervised release
  - Ordered to pay restitution

\textsuperscript{1}\textit{IRS Criminal Investigation Annual Report 2018}
Multiple Acts Of Wrongdoing: Rizzolo

• Mr. Rizzolo, owner of a Las Vegas strip club, first pled guilty to conspiring to defraud the United States
  – Paid employees in cash
  – Failed to provide accurate records of payments
• Then, concealed assets and income to prevent the IRS from collecting
  – Deposited $900,000 from the sale of another strip club to an offshore account
  – Withdrew $50,000 from a bank account, wrote a check to a third party, then collected the cash from the third party to avoid an IRS levy and seizure of the funds
  – Falsely stated that he had no income or assets and no ability to pay the taxes owed
• Convicted of attempting to evade and defeat paying employment taxes
  – Sentenced to 24 months in prison and six months of supervised release
  – Ordered to pay restitution of $2,637,290

\(^1\text{IRS Criminal Investigation Annual Report 2018}\)
Multiple Acts Of Wrongdoing: Small

• Mr. Small, owner of a school bus transportation service, was convicted of failing to pay payroll taxes
  – Sentenced to three years in prison
  – Ordered to pay restitution of $1,694,725

• First, he was found guilty of
  – Operating the business under three different names
  – Failing to pay employment taxes for each of the three businesses

• Then, he continued to accrue employment tax liabilities
  – Did not deposit FICA taxes or income taxes withheld from his employees’ wages
  – Withdrew $286,052 from the business bank account in cash and cashier’s checks
  – Bought and maintained a Lamborghini Diablo
  – Filed for bankruptcy with the intent to hinder and obstruct the IRS’s collection efforts

IRS Criminal Investigation Annual Report 2018
Multiple Acts Of Wrongdoing: Lewis¹

- Mr. Lewis, CEO of a software company, was convicted of conspiring to defraud the government by failing to pay employment taxes
  - Conspired with the head of finance to circumvent payroll and accounting processes by paying some employees with manual paychecks
  - Hid that withholdings were not being paid to the IRS
  - Caused the company to file false quarterly employment tax returns
- Sentenced to 21 months in prison and ordered to pay restitution of $1,812,706 million
  - Co-conspirator was sentenced to 15 months in prison

¹IRS Criminal Investigation Annual Report 2018
Inconsistent Documentation: U.S. v. McLain¹

- Mr. McLain, owner of a health care staffing company, failed to file employment tax returns and did not withhold or pay employment taxes
  - Argued that nurses were independent contractors, although he had had to file certification that nurses were treated as employees
  - Sentenced to 48 months’ imprisonment
  - Fined $75,000

¹McLain, 646 F. 3d 599 (8th Cir. 2011), cert. denied (2012)
Inconsistent Documentation: U.S. v. Crabbe

- Mr. Crabbe was convicted of failing to pay withholding taxes and filing false returns
  - Returns filed omitted some employees
  - Mr. Crabbe saw and signed tax forms that showed different information

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1Crabbe, 424 Fed. Appx. 782 (10th Cir. 2011) or Crabbe, No. 06-cr-00294-MSK (D. Colo. 5/17/10)
Financial Distress Or Sympathetic Circumstances

• **Boyajian**: paid creditors instead of employment taxes and was found to have acted willfully¹

• **In re Lee**: While not involved in day-to-day management, held responsible due to control over business matters, meeting periodically with the company’s manager, maintained authority over finances and only person authorized to sign checks²

• **Bernabe**: abused verbally by the company’s president and ordered not to prioritize payroll taxes—still found responsible as having acted willfully in failing to pay taxes³

• **Wells**: Husband stated he was handling tax matters, lied about it, intercepted IRS correspondence addressed to her, and still she was found to be a responsible officer⁴

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¹Boyajian, No. 04-4835 (KSH)(D.N.J. 10/16/06)  
²In re Lee, No. 96-1-0698-PM (Bankr. D. Md. 5/29/97)  
³Bernabe, No. CV 10-02508 DDP (JEMx), (C.D. Cal. 2011)  
⁴Wells, No. 08-2110(NLH)(JS) (D.N.J. 10/21/09)
Collecting Unpaid Employment Taxes
In Federal Court

A. Collection suit against employer (business)
   – Suit will seek full amount of unpaid employment taxes

B. Collection suit against “responsible person(s)” assessed Trust Fund
   Recovery Penalty (TFRP) under section 6672
   – TFRP assessed only on “trust fund” portion of taxes
   – Joint and Several Liability
   – Person must be responsible to collect, truthfully account for, or pay over the
     trust fund taxes, and have “willfully” failed to do so
Collecting Unpaid Employment Taxes
In Federal Court: Injunction Suit

D. Injunction suit: May be filed against employer and principal officer(s) or owners
   - A civil injunction is a civil order that either requires a defendant to perform some act and/or prohibits the defendant from engaging in a specific act
     • Intended to regulate conduct
   - The Tax Division refers to civil injunctions in the employment tax context as “pyramiding injunctions”
     • The goal is to prevent the employer from continuing to pyramid employment taxes
   - The statutory authority for bringing pyramiding injunction cases is in 26 USC 7402(a)
     • How a federal district court is authorized to issue an injunction, based on what “may be necessary and appropriate for the enforcement of the internal revenue laws”
     • This is a flexible standard
Collecting Unpaid Employment Taxes In Federal Court: Injunction Suit

• The Tax Division’s practice is to bring suit against the business and against its owners individually

• A civil injunction is a very flexible tool, because the terms of the order can be tailored to the individual facts of each case
  – The injunction will require the business to timely file and pay its employment taxes
Collecting Unpaid Employment Taxes In Federal Court: Reach Of Injunction Suit

• In addition to requiring timely filing and payment of employment taxes, a civil injunction can
  – Require check in with RO re: Forms 940 and 941 and proof of payment
  – Conditionally prohibit the business from transferring or assigning property
  – Require owner to notify IRS prior to applying for a new EIN or opening a new business
  – Require US counsel pre-approve any payroll service providers used by the business
  – In the most extreme cases, authorize the appointment of a receiver — to ensure that the business timely files and pays its employment taxes
Collecting Unpaid Employment Taxes
In Federal Court: Injunction Suit Timing & Sanctions

• No statutory guidelines or time limitations for a civil injunction
• If the business is not in compliance with injunction, DOJ will likely file a contempt motion. Such sanctions can include:
  – Appointing receiver for payroll at the business’s expense
  – Entering a money judgment against owner for liabilities accruing after order
  – Incarceration for the owner until the returns are filed and delinquent taxes paid
  – Shutting down the business permanently
Recent Updates: Collection Employment Taxes

• In the last 3 years, the IRS has become more timely in assessing trust fund recovery penalties

• More than 99% of assessments are completed within 45 days so the IRS can secure an injunction, make the case for fraud, and/or seize assets

• IRS sees every trust fund recovery penalty as a potential criminal case
  – Number of agents working cases and amount of time dedicated to employment tax cases have increased
  – Most referrals are well over $1 million

• Even if Criminal Investigations declines referral or a referral is never made, Collection can still
  – Seize assets
  – Look to successor companies, nominees
  – Issue injunctions
  – Shorter incarceration
Recent Updates: Appeals Managerial Approval Of Penalties

• Verification of managerial approval for penalty assessment. This applies to assessments of trust fund recovery penalties

• See §6751(b)
  – Initial determination is approved in writing by immediate supervisor or higher
  – Includes assessments of trust fund recovery penalties
  – Exceptions do exist, see Sec. 6751(b)(2)
  – Penalties include any additions to tax or additional such amounts
Q&A

Chaya Kundra, Esq.
Founding Partner
Kundra & Associates, P.C.
(301) 424-7585
CKundra@KundraTaxLaw.com