

Timely File Payroll Taxes Because The IRS Is Watching

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The federal government doesn't like to wait for its money. That's why it requires employers to withhold estimated income taxes — and other employment taxes — from employee paychecks and hand that money over according to a mandatory schedule. Unfortunately, a report from the U.S. Department of the Treasury released in 2017 found that employers simply weren't paying over employment taxes in a timely manner. The report found that at the end of 2015, 1.4 million employers owed the federal government around \$45.6 billion in employment taxes, interest and penalties. The Treasury Inspector General for Tax Administration recommended in the report that the Internal Revenue Service develop a new and focused strategy to increase its ability to collect back payroll taxes promptly. As a result, employers can expect the IRS to begin taking a much more aggressive approach to employment tax enforcement.



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The Basics: Payroll Taxes and Form 941

Form 941 is used for reporting payroll taxes — the money that an employer must withhold from an employee's wages for remittance to the IRS. This includes Social Security, Medicare and income taxes.

Only three types of employers are excepted from the Form 941 filing requirement:

- Seasonal employers, as defined in the Internal Revenue Code, who paid no wages in a given quarter
- Household employers whose workers receive less than \$1,900 in cash or cash equivalent, like room and board, in a given year
- Farm employers

If you represent an enterprise that does not fall into one of these three categories — and they almost never do — your client has an obligation to pay file Form 941 and pay quarterly payroll taxes.

Trust Fund Recovery Penalty

A company's failure to pay employment taxes on time may make it liable for the rather

terrifying trust fund recovery penalty, or TFRP. This penalty can be levied against anyone (1) who is responsible for collecting or paying employment taxes and (2) who “willfully fails” to collect them and/or make those payments. The rationale for the TFRP is that the “responsible person” holds these taxes in trust for the government until such time as they make a federal tax deposit in that amount.

Note that if the business in question fails or otherwise disappears, the IRS is can go after any individuals who meet those two requirements, making them personally responsible for paying the penalty. This could include not only business owners and officers but partners, employees, third-party payers and anyone else with authority and control over the employer’s funds.

The trust fund recovery penalty is equal to the total amount of unpaid income taxes withheld plus the employees’ share of the FICA taxes — i.e. Social Security and Medicare taxes — plus interest. It does not include penalty, interest or the Medicare/Social Security employer-matching portion of the payroll tax. Once the TFRP is personally assessed, it will begin to accrue interest of its own. IRS Notice 784 provides more information about personal liability and trust fund penalties.[1]

The Perfect Storm: Circumstances That Are Likely to Trigger the Trust Fund Recovery

During times when cash is short, business owners may attempt cost-cutting procedures to free up capital. To ease an immediate cash flow problem, cash-strapped businesses or other entities may stick their hand into the proverbial cookie jar and tap into money withheld from employees’ wages for Social Security, Medicare and income taxes. They will use this money to pay creditors instead of paying the IRS. They mean to “borrow” this money temporarily, but often fail to pay it back. In doing so, the business relegates the IRS to the back of the line of creditors or ignores it altogether, banishing it to a deep dark abyss.

The IRS first attempts to collect the entire outstanding payroll tax liability from the corporation — i.e., the trust fund tax, as well as the non-trust fund tax penalties and interest. If the corporation cannot pay the tax liability in full or if it drags its heels for too long, the IRS may assert the TFRP against the owners, officers, directors, shareholders or other responsible parties.

First Stage of Enforcement: The 903 Letter

When the IRS realizes that an employer hasn’t been depositing employment taxes as required, the first step the agency is likely to take will be to send what’s called a Letter 903. This letter, the “You Haven’t Deposited Federal Employment Taxes” letter, acts as legal notice of the employer’s delinquency and also summarizes the actions the IRS may take if the required payments are not made at once.

Employers who continue to throw caution to the wind by failing to pay employment taxes will get 903 letters every quarter. Should they later end up in court, they can expect those 903 letters to play a starring role in the evidence used against them. These letters will prove to the jury that the employer had ample notice of failure to pay and the possible consequences.

Watch Out for the Form 4180 Trap

In some cases, an IRS agent may contact an employer to schedule a trust fund recovery penalty interview, also called a 4180 interview. The interviewer will ask the employer the questions listed on IRS Form 4180 and write the employer’s answers on the form, then have the business owner — or other person in authority— sign it. Unfortunately for the employer, the form asks questions that confirm they’re responsible for authorizing employment tax payments and note the details of any delinquent or nonexistent payments. In other words, completing this form amounts to a freely signed confession of wrongdoing. If the IRS agent believes that the employer is “responsible” and “willful,” the agent forwards the file to a

supervisor, who nearly always approves the issuance of a Letter 1153 — or trust fund recovery penalty letter. The agent will issue the 1153 letter which will include a proposal to assess the responsible person with the TFRP.

Needless to say, employers should avoid participating in a 4180 interview if possible. If an IRS agent contacts your client attempting to schedule such an interview, the best advice you can give your client is to politely decline and to speak to you before agreeing to anything. After carefully assessing the situation, you can advise your client on which course of action is best.

In addition to negotiating with the IRS, your client has the absolute right to protest and challenge the agent's proposal within 60 days. So long as your client's protest is marked on or before the 60-day deadline, the IRS must consider the protest and withhold assessment of the TFRP until your client has had an opportunity for a hearing. The protest is forwarded to IRS appeals where a settlement officer may hold a hearing to determine whether the agent made a mistake in proposing to assess your client.

Even if your client loses the protest and is assessed, all hope is not lost. Your client can still negotiate for an affordable installment agreement, file for an "offer in compromise" or, if the company is in the process of paying back the tax liability or meets other eligibility requirements, request that their account be placed in "currently not collectible" status. For example, a direct debit installment agreement may be an option — IRS guidelines allow a revenue officer to cancel an employment tax investigation if the liability is under \$25,000 and the employer can pay it back by direct debit within 24 months.

Challenge the Assessment in U.S. Tax Court

Your client can also challenge the assessment in U.S. tax court so long as their petition is timely filed. If your client owes more than \$25,000 or can't possibly pay the liability within 24 months, you should consider whether they may be able to prove uncollectibility. To complete this process, your client will need to fill out Form 433A, an onerous task that requires the client to open up their financial kimono and disclose more information than they might otherwise feel comfortable sharing with Uncle Sam.

Meeting all the requirements to prove uncollectibility can be quite a challenge — revenue officers are not known for being pushovers. If, however, you can demonstrate to the revenue officer that your client can't possibly pay the delinquent sums now or in the future, the revenue officer may cancel the investigation.

The last and least desirable way to get out of a 4180 interview is for your client simply to agree to pay the TFRP. The whole point of the 4180 interview is to prove that an individual is responsible for paying that penalty. If your client simply agrees to pay it — and fill out another form, Form 2751 — there's no reason for the IRS agent to hold the interview. Of course, since that also binds your client to pay the entire penalty, it's not exactly an ideal solution.

At the same time, acquiescing to assessment of the TFRP does not mean that your client is barred from seeking contribution from other employees who may also be liable. Section 6103(e)(9) of the Internal Revenue Code authorizes an individual to request from the IRS the names of other persons the IRS has found liable — regardless of whether the IRS has attempted to collect the penalty from them — and any amount collected. However, a person is considered liable under Sec. 6103(e)(9) only when an assessment has been made against them. If no assessment has been made against the individual, then no disclosure is required.

Your Client's W-2s May Be Used Against Them

Employers who fail to pay employment taxes often issue Form W-2s that claim tax withholding in the appropriate amounts. Unfortunately, issuing such W-2s is just another way of telling the IRS, "Here's how much I collected in employment taxes, even though I didn't actually send you a penny." Neither the IRS nor the U.S. Department of Justice will be amused by this. If

your client is unfortunate enough to be delinquent in paying their employment taxes, you should caution them about issuing W-2s that make such a claim. Your client should also refrain from claiming withholding on their individual tax return — Form 1040.

Injunctive Relief

The IRS can use injunctive relief against employers who fail to pay employment taxes, particularly against serial offenders. For example, some business owners will start a business, run it into the ground and then close it down without paying their employment taxes — then move on to a new business and do the same thing. This process is called pyramiding, and the IRS can get an injunction against such business owners to bring the pyramid crashing down.

Can Any Defenses Be Raised to the TFRP?

The harsh reality is that it is relatively easy for the IRS to prove a case. In addition to past-due tax, the IRS must show willfulness. Willfulness has a much broader meaning than many people realize. For example, if a responsible person intended to pay the trust taxes but was unable to do so due to lack of funds, this is insufficient to support a claim that they were not “willful” under the law.

By far the most damning evidence of willful failure to pay is when the responsible person made payments to other creditors during the quarter. While courts recognize that reasonable cause is a legitimate defense to the assertion of the TFRP, those cases in which the courts have found it are few and far between. To show how high the bar is, even when the owner of a company ordered a responsible person not to pay the taxes, courts have held that the responsible person should have risked being fired rather than pay other creditors.[2] The IRS is no less unforgiving. Indeed, it takes the intractable position that even a genuine, yet mistaken, belief that the business was required to pay other creditors in preference to trust fund taxes does not make the failure to pay nonwillful.[3]

Nonetheless, there are some cases where reasonable cause was found to be an acceptable excuse. Sometimes the targeted individual was not responsible for withholding taxes pursuant to corporate documents or a partnership agreement. Other times the evidence of willfulness applied to the business entity but not to the target individual. Furthermore, the IRS is not perfect. It does make clerical errors, especially in the heat of the moment.

How Does the IRS Apply Trust Fund Recovery Penalty Payments?

The IRS applies payments in its best interest. This means that the IRS first applies a payment made from business assets to the non-trust fund portion of a company’s tax liabilities. Only after any such liability is satisfied does the IRS apply payments to the trust fund portion of the taxes.

By following certain procedures, taxpayers generally can designate that the IRS apply the voluntary payments toward the trust fund taxes only. If the individual pays the assessed TFRP but does not agree with the assessment, they can file a “claim for refund and request for abatement.”

Employment Tax Criminal Penalties

The trust fund recovery penalty, as bad as it is, isn’t the worst fate that could befall someone who fails to pay employment taxes. The IRS can and does prosecute offenders under several criminal statutes, including tax evasion, willful failure to collect, account for or pay over tax, false return, obstruction and conspiracy to defraud. These charges are all felonies and can result in major fines and up to five years of jail time.

Conclusion

Given the dangers involved in failing to pay employment taxes and the IRS's ramped up enforcement efforts, skimping on those deposits is a seriously risky way to save money. If your client has already run up some delinquencies on their employment taxes, they should either make good on that money immediately or reach out to an experienced tax attorney for help. They will need a solid legal plan in place to deal with the inevitable consequences of failing to pay the IRS its due.

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[1] www.irs.gov/pub/irs-pdf/n784.pdf

[2] Brownstein, 979 F.2d 952 (3d Cir. 1992)

[3] IRM 5.17.7.1.3(7)

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