

Failure to Withhold and Remit Employment Taxes Results in Civil and Criminal Sanctions

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The IRS is really cracking down on those employers who fail to pay and remit employment and withholding taxes of employees. Not only are employers' tax returns being audited but now liens are being placed against the property owned by delinquent taxpayer employers. To add insult to injury, the IRS now really means business by adding new civil and criminal actions with prosecution efforts being directed towards individuals and businesses that willfully attempt to avoid filing and paying employment taxes. During the past three years, the IRS has revealed that 117 individuals have been sentenced to confinement in federal prisons, halfway houses, and homes for detention for criminal violators. About 77.0% of the persons sentenced for abating employment taxes served an average of 17 months confinement. After the confinement, they were ordered to make restitution to the government for the taxes evaded plus interest and penalties.

Some of the most common types of employment tax non-compliance which caused civil and criminal efforts on the part of the IRS include:

1. ***Pyramiding of employment taxes*** by businesses withholding taxes from employees but intentionally failing to remit the collected money to the IRS. When employers are short on cash, the employer would opt to use the withheld taxes as operating capital. Big mistake! The tax liabilities accumulate quarter by quarter until an employer has no chance of catching up. The only option is bankruptcy, but the federal tax liens are not discharged in bankruptcy.
2. ***Utilizing unreliable third party payers.*** These businesses collect the employment taxes from employers and are then responsible for sending the collected money to the government. They include payroll tax service providers and professional employer organizations. The payroll tax providers are fairly well known but professional employer organizations are those that offer employee leasing, which means they can handle administrative personnel and payroll accounting functions for employees who have been "leased" to other companies that use their services. When these professional employer organizations fail to remit the collected employment taxes to the IRS, the IRS will go against the employer as well as the third party payer.
3. ***Fruitless agreements.*** Individuals and promoters engaged in employment tax scams often base their actions on a variety of false or misleading arguments. In-court interpretations of the tax law that have been uniformly rejected by the courts are employed. Some employers might improperly use the Form 941C Supporting Statement to Correct Information on Form 941. The employer, through a separate promoter, will file this form in an effort to fraudulently obtain a refund of previously paid employment taxes.

4. **Offshore employee leasing** is a scheme that was given the title of “A Listed Transaction by the IRS in 2003”. This scheme involves the abuse of an otherwise legal business practice of employee leasing. The typical scam transaction results from an individual taxpayer who allegedly resigns from his/her current employer or professional corporation and signs an employment contract with an offshore employee leasing company. The offshore company indirectly leases the employee’s services back to the original employer using a domestic leasing company as an intermediary.
5. **Misclassifying worker status** to avoid remitting employment taxes to the federal government, employers may incorrectly try to treat employees as independent contractors. On numerous occasions, we have written about the grave errors that result from misclassification of a common-law employee as an independent contractor. The Service has taken the position rather severely, but justly, that misclassification is a feature by which the Service will pursue action. To understand the doctrine, please remember that a worker is an employee if the person for whom services are performed has the right to **control** and direct a person who performs the services not only as a result of the work but also as to the details and means to accomplish it. The Service has applied a 20-factor test to determine whether employer/employee relationships exist. Unfortunately, a taxpayer may not know how the Service will weigh these features. The Service may reach a different classification than the taxpayer because of weighting one factor over another. Sometimes a private letter ruling can be secured to provide an employer with assurance that the employer and the Internal Revenue Service’s opinions are in synch. The only unfortunate aspect of a private letter ruling is that the activity is not only expensive but time-consuming.

A very cautionary statement is that employers who misclassify employees as independent contractors will be liable for the employment taxes on wages paid to the misclassified worker and be subject to penalties unless they are eligible for relief under Section 530 of the Revenue Act of 1978.

6. **Paying employees in cash.** The Service found that employment tax abuse often stems from paying employees in whole (or part) by cash. Paying by cash is not against the law. On the other hand, it is against the law to do so solely to evade income and employment taxes. Income and employment taxes are owed no matter how the employees are compensated.
7. **Filing false payroll tax returns** or failing to file payroll tax returns. This narrative is self-explanatory. Always file your tax returns.
8. **Corporation officer compensation** being treated as corporate distributions. In Subchapter S corporations, the temptation to evade employment taxes by improperly treating officer compensation as corporate distributions instead of wages or salaries is intense. Officers are employees of the corporation for employment tax purposes. Compensation they receive for service is subject to employment taxes. An employee, under the Master/Servant relationship, cannot have separate activities outside the employer/employee status. A classic mistake is that corporations will pay corporate officers as if they were board members who were clearly independent. Officers who receive board fees are still employees. Officers who receive payment for consultancy

activities to the employer are still doing so under their employment basis regardless of whatever circuitous efforts are attempted to distort the relationship.

What happens if you are caught?

Employers who fail to report and pay employment taxes are liable for penalties for failure to deposit and failure to pay as well as underpayment of interest. A special caution exists for any person responsible for collecting, accounting for, or paying over-withheld taxes. If such person willfully fails to do so, that person will be liable for recovery not only of the taxes but also a penalty that could be as much as 100% of the unremitted trust fund taxes as well as interest and other related punishment. The word "person" is not limited to one class, but rather can include an officer or an employee of the corporation, limited liability company member, or employee of a partnership, or any other individual of authority and control whose duty it is to collect the tax.

In addition to the 100% penalty for willfully failing to collect taxes from withholdings and employee ownership tax, an employer could also be subject to a conviction of guilty by felony. This conviction would be punishable by a fine above and beyond the 100% penalty of not more than \$10,000 and/or imprisonment for not more than five years. This omission is serious and requires the attention of all parties.

On the issue of control, we are including a summary sheet of the 20-factor test that the IRS uses for determining if an independent contractor is truly an employee ([click here to open the summary sheet](#)). This issue becomes a critical factor with most professionals since they may classify someone in good faith as an independent contractor when in fact the Service may look at them clearly as an employee.

For the past 26 years, we have written narrative about the dangers of misclassification of employees. The Service has added more teeth and enforcement activity to its arsenal for compliance.

If you have any questions on any of these issues, please call to schedule a time so we can talk. The special attention should be made in classification of employee. For this reason, we have included the 20-factor sheet for your review. Please remember that the weighting of these is not pro rata but could be judgmentally different based on the Service's interpretation.

Do not merely rely on the representations of the independent contractor. Verify the representations and realize that the employer is ultimately the person with the greatest risk.

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