



CONFIDENTIAL

Special Report

What happens if an employer continues to incur new payroll tax liabilities or not pay the old ones?

My name is Stephan H. Brewer, CPA, CTRS, JSM Tax, NTPI Fellow. I have over 19 years in the tax resolution business, I've dedicated myself to helping taxpayers like you who find themselves at odds with the IRS.

Below you will find the nature progression through the collection cycle for a payroll tax case. The most important point solves your problem or seek help as near to the top as possible. The bottom of the document is Criminal Investigations and you want to stay as far away from that as possible.

The employer will receive several notices from the taxing authorities regarding the outstanding balances due. Eventually, if the employer does not respond to the notices received or does not pay the outstanding tax, the IRS can proceed with enforced collection action such as levies against the company bank account, accounts receivables, and other income sources. Generally, before the IRS issues a levy, they must provide the taxpayer with the Final Notice of Intent to Levy for each tax period, which provides the taxpayer with appeal rights prior to any proposed levy action. A taxpayer can request an appeal.

However, a taxpayer has had a prior appeal within the last two years, and continues to incur new employment tax liabilities, the IRS can bypass their notice requirements (IRC 6330) and issue a levy on the new tax period via the “Disqualified Employment Tax Levy” (DETL). The taxpayer will not be provided with the Final Notice of Intent to Levy. As a result, the taxpayer is not provided with the opportunity to appeal. So, employers beware. The IRS must, however, issue the CP-504B Notice of Intent to Levy prior to any levy action. Otherwise, any levy will be considered an “illegal levy”.

What can an employer do if the IRS issues a “Disqualified Employment Tax Levy” (DETL) and they have payroll due?

First, the employer can try to work with Collections to request partial or full release of levy to cover the amount due to cover payroll. Generally, the employer will have to provide proof of payroll and a copy of the most recent bank statement. Most times, the IRS will release the amount to cover payroll ONLY. However, if the employer continues to incur new tax liabilities, and is not in compliance with their tax filings and their federal tax deposits, the IRS will be less likely to do a partial or full release of the levy.

Second, if Collections does not want to do a full or partial release of levy, the taxpayer can file an appeal via the Collection Appeal Program (CAP), Form 9423. Usually, the hearing will be held within two weeks of filing the CAP. Be careful, if the IRS issued a bank levy, the taxpayer has 21-days to release the levy before the bank sends the funds to the IRS. If the 21-days expire and the IRS receives the funds from the levy, it is very difficult to get the funds back unless the IRS issued an erroneous levy.

Also note that the CAP hearing only addresses the issue of whether Collections followed proper procedure. If Collections did not follow proper procedure, the levy will be released. However, if Collections followed procedure, the levy will not be released, and the case will go back to Collections (from Appeals).

Please keep in mind that there are other consequences associated with delinquent payroll tax liabilities. The IRS will file federal tax liens for every tax period with a balance due. The IRS will also conduct a **Trust Fund Recovery Penalty Investigation** to personally assess a portion of the payroll taxes to the responsible person(s). The IRS will personally assess one or more individual(s) (officer, Controller, CEO, CFO, etc.) the amount of the federal income tax withholdings, one-half of social security and one-half of Medicare taxes that was deducted from the employees’ paychecks. Eventually, if the employer does not change and get current, the IRS can proceed to shut down the business.

Who can be considered a Responsible Person for personal assessment?

If you are considered a responsible person who acted willfully you may become personally liable to the IRS for the trust fund recovery penalty. A similar analysis will eventually be conducted by the state taxing authorities. Typically, responsible persons are owners or corporate officers, but they can sometimes be employees of the company such as the bookkeeper or office manager. If the individual has authority to provide input on whether another creditor of the company or not payroll taxes will get paid, there is an increased likelihood that the IRS will consider them a responsible person.

Any person that has the authority to make a final determination on whether or not employment taxes are paid will always be considered a responsible person. Additionally, individuals that oversee day-to-day operations including owners, corporate officers, and managing partners will be closely scrutinized. Also, at risk are employees of the company that are involved in ensuring that employment taxes are paid, even if they do not make the final determination of whether or not payment is made. This is especially true if the employee is authorized and as the ability to avoid default by paying the employment taxes. On the other hand, employees and investors that do not have the authority to write checks, have duties unrelated to the payment of taxes, and/or are not involved in daily operations are less likely to be considered responsible persons.

Although the IRS has some published guidelines in making this determination, there are no assurances that an individual will not be considered a responsible person, and individuals that have the ability to satisfy the debt should be especially wary. If one has theoretical authority to provide input on whether or not employment taxes are paid due to their position within the company, the IRS will likely consider them a responsible person, even if they did not actually make the final decision. Shockingly, there have been instances where the IRS has deemed someone a responsible person even though they argued with the owner about paying employment taxes and ultimately quit their job over the dispute.

Failure to Pay Employment Taxes After Notice is Received.

After an employer initially fails to collect, account for, or pay employment taxes, the IRS may give issue Form 2841, Notice to Make Special Deposits of Taxes to such an employer and require deposits of future payroll tax withholdings in a special trust account for the government. Deposits into this account must be made within two days of being withheld from employees, and payments to the government must be made each month. An employer who does not strictly adhere to this may be prosecuted.

Courts have held that in order to impose criminal liability, due process requires an individual to be on notice that he or she is violating the tax code. Therefore, the notice must be hand-delivered to individual employers. However, for entities such as a corporation or partnership, if the notice is delivered to any officer or partner, all other similarly situated individuals as well as the entity are considered to be on notice.

In this situation, because notice has been given, strict criminal liability is imposed on any person who fails to withhold employment taxes from employees, deposit the funds into the special trust account, and pay the funds over to the government when they are due. Strict criminal liability means no intent or willfulness is required for prosecution of this crime. Failing to pay over employment taxes after notice has been given may lead to imprisonment of up to one year and fines of up to \$5,000. The Federal Criminal Code has an alternative maximum fine provision that may impose larger fines. Moreover, each failure to comply is a separate offense.

Certain defenses may be used to avoid criminal prosecution. For instance, if an individual did not comply due to circumstances out of his or her control, no crime has been committed. However, circumstances out of one's control do not include a lack of funds immediately after payment of wages. Additionally, lack of sales or other business difficulties typically are not considered circumstances out of one's control. Other allowable defenses include theft, embezzlement, destruction of the business, or bank failure before a tax deposit is due.

How Does the IRS Develop an Employment Tax Fraud Case?

According to information provided by IRS employment tax auditors and examiners, the most common forms of employment tax fraud are:

- Willful failure to account for, collect, or pay over taxes (IRC 7202)
- Willful failure to file a return (IRC 7203)
- Willful failure to pay taxes owed (IRC 7203)
- Willful submission of a false statement under (IRC 7206(1))
- Failure to collect and deposit in a special trust fund account (IRC 7215 and IRC 7512(b))
- Attempts to obstruct or impede tax administration (IRC 7212(a))

However, prior to the filing of criminal tax charges significant workup and investigations occur. This generally involves a process that first screens for initial indicators of fraud which are sometimes referred to as badges of fraud. The mere presence of first indicators of fraud is not sufficient to bring a case against a taxpayer and these indicators must be developed into what the IRS terms "firm indications of fraud." Once firm indications of fraud have been developed, the auditor or examiner will determine whether the matter should be referred to IRS Criminal Investigations for further development.

What Are First Indicators of Tax Fraud?

First indications of tax fraud can be described as a mere suspicion by the auditor or examiner that the taxpayer has committed fraud. IRS policy and resource manuals direct agents that they are not only legally able to ask taxpayers questions about discrepancies, but they are expected to do so. In fact, an array of investigative techniques is set forth in Internal Revenue Manual § 25.1 – Investigative Techniques. Agents are advised that even at this initial stage, investigative techniques should seek to develop all aspects of fraud including errors of law, errors of fact, errors in accounting, and irregularities like backdated documents.

Badges of fraud set forth in IRM §25.1.2.3 may aid this investigation and include indicators of fraud for income, expenses and deductions, books and records, allocation of income, the conduct of the taxpayer, and methods of concealment. For instance, common badges of fraud regarding allocations of earnings or income frequently include disbursements to fictitious payees or the inclusion of income or deductions on the tax return of a related taxpayer, when tax rate differences are a factor. Similarly, there are thirteen badges of fraud relating to income including:

- Failure to include certain sources of income
- Inability to account for a substantial increase in net worth
- Concealment of bank or other financial accounts
Use of a check cashing service to convert client checks or other income into cash or other practices that deviate from accepted business norms
- Inadequate explanations for use of large amounts of cash especially in industries where the use of currency is not common or customary.

When first indicators of fraud are detected, the agent will discuss the facts and circumstances with a manager. If the agent and managers agree that fraud is likely, plan of action should be developed to establish and document the affirmative acts or firm indications of fraud.

Developing Firm indicators of Fraud

Once initial indicators of fraud are detected and the matter is escalated, the agents will work to develop firm indicators of fraud. As opposed to initial indicators, firm indicators of fraud can only be developed through a case-specific assessment of the facts and circumstances present. Essentially, the agent will work to further establish and develop the type of fraud detected at the initial stage. They may assess taxpayer filings or even seek additional information to further develop the initial indicators of fraud into firm indicators.

For taxpayers, a suspension of the investigation may seem to indicate that the matter has been resolved. However, in reality, it may be a sign that the agent has gathered sufficient evidence to develop the initial indicators into firm indicators of fraud. In fact, the Internal Revenue Manual directs agents that upon discovery or development of firm indicators of fraud, the examination should be immediately suspended. Furthermore, the agent is instructed to provide no reason for the suspension of the examination.

How Does the Refer Employment Tax Fraud Matters to Criminal Investigations?

- If the facts of the case warrant a criminal referral, the examiner will prepare a referral on Form 2797, Referral Report of Potential Criminal Fraud Cases. See IRM 4.23.9.6.5. The referral should include a detailed analysis of all evidence used to establish that firm indicators of fraud exist. According to IRS documents the report should include:
All affirmative acts conducted by the taxpayer or his or her agent
- How the taxpayer has justified or explained his or her actions or accounting practices
Additional supporting documents like the last filed tax return, financial statements, or checks from entities of public record are provided to CI at the 10-day conference.

The referral will then be forwarded to the referring examiner's manager for additional approval. Thereafter, the referral is directed to IRS Criminal Investigation (CI) for approval by the Criminal Investigation Special Agent in Charge and the Supervisory Special Agent (SSA). Once this approval is granted, the matter will be assigned to a Special Agent.

Facing an Audit or Examination?

One can probably already see the danger that is inherent in even a seemingly routine audit. That is, the agent assigned to your matter may interpret innocent actions as indicators of fraud and proceed with a more stringent investigation into your finances. If you may have engaged in "odd" transactions, like visiting a check cashing service or paying employees in cash, they agent may interpret these actions as signs of fraud. In light of actions like these, the agent may even interpret mistakes on tax filings as a sign that the taxpayer is engaged in more than meets the eye or is being disclosed. All the while, you may make statements or admissions to the agent thinking that they would help.

Then, when the examination is abruptly halted, they may even believe that they have successfully navigated the audit. In reality, IRS-CI is likely assessing and may be building a criminal case against the taxpayer. At the same time, the taxpayer is sitting idly while time that could be used to prepare to meet the criminal tax charges is passing.

What Should I do if I'm Contacted for an Employment Tax or Other Audit?

If you have been contacted for a tax audit and are concerned about certain underlying issues, it is prudent to contact a tax attorney immediately. If criminal tax charges are a concern it is essential that you speak to a lawyer because only the attorney-client privilege or work product doctrine are sufficient to protect any disclosures, you may make. Returning to your original accountant or to tax preparer can result in the preparer attempting to protect his or her license by blaming the taxpayer. If he or she is subpoenaed to testify against you, the privilege will not protect disclosure and you should fully expect the testimony to be unfavorable.

Therefore, at the outset of any audit or examination, it is often wise to seek out a tax attorney. At this stage, an attorney can help guide the audit process and reduce the likelihood of common mistakes that could raise the first indication of fraud suspicions. However, if an examiner seems particularly interested in certain transactions and seems to be probing for any inkling of impropriety, it is probably time to contact a tax controversy and litigation attorney.