Federal and State Employment Tax Issues ©

Seminar prepared for the Virginia Society of Enrolled Agents

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The three most common problems

1. Not filing;
2. Not making timely deposits; and
3. Misclassifying employees as "independent contractors."

Any ONE issue is sufficient to cause major problems.

Any combination of MORE THAN ONE problem is enough to destroy a business and potentially the next decade of an owner or officer's life.

1. Unfiled returns

IRC §7203 makes it a **misdemeanor** to willfully fail to pay any tax or to make a return.

- failure to pay a tax;
- **failure to file a return**;
- failure to keep records; and
- failure to supply information.

Each time obligation to file arises and taxpayer willfully fails to comply, a separate offense is committed. Each tax period is charged separately.

1. Unfiled Returns

IRC §6020(b). Authority of Secretary to execute return.

If any person fails to make any return required by any internal revenue law or regulation made thereunder at the time prescribed therefor, or makes, willfully or otherwise, a false or fraudulent return, the Secretary shall make such return from his own knowledge and from such information as he can obtain through testimony or otherwise.

Va. Tax Code § 58.1-111. Taxpayer refusing to file return; estimated tax.

Whenever any taxpayer liable under the law to file a state tax return with the Department shall fail or refuse on demand to file a correct and proper return, the Department may make an estimate of the amount of taxes due the Commonwealth by such taxpayer, from any information in its possession, and assess the taxes, penalties and interest due the Commonwealth by such taxpayer.

1. Unfiled Returns

Translation: If the taxpayer doesn't file the 941/944s or VA-5/16s, the IRS, Virginia, and VEC can, and will, come up with their own numbers.

** Virginia is MUCH faster than the IRS on this front. Often the state responds within weeks of a business missing a return filing date.

1. Unfiled Returns

IRS “Substitute for Return” Assessments (“SFRs”) made under IRC §6020(b):

- Employment taxes are not subject to the deficiency procedures.
- Information is often obtained from unemployment agencies.
- Can be abated if taxpayer files Forms 941 (or 941X) as a “request for audit reconsideration.”

1. Unfiled Returns

Virginia or VEC "estimated" or "nonfiler" assessments:

- Virginia will usually abate nonfiler assessments to amounts shown on later-filed Forms VA-5 or VA-16.
- VEC takes a harder stance on abating prior "estimates," almost always sticking to their position that once an estimated assessment is complete, it is final. But with enough kvetching, they will usually abate their estimate in favor of the taxpayer's late-filed report. Full payment of the resulting tax liability is usually required.

2. Failure to Make Deposits

"We didn't have the money."

"Our employees would have quit."

"We expected a big check early the next week."

"We were going to make the deposit a couple days late."

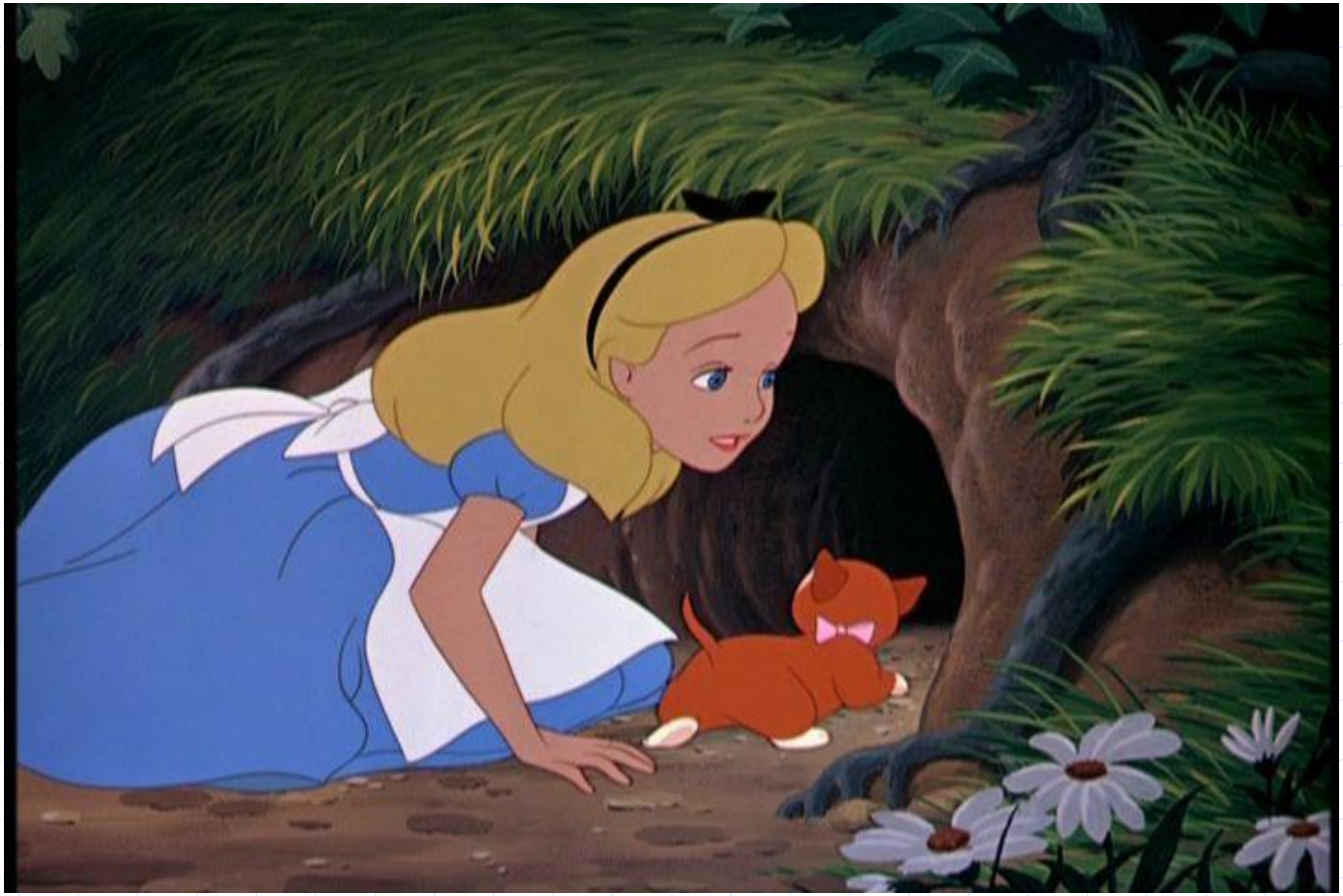
2. Failure to Make Deposits

All of the reasons commonly given distill down to one economic reality: A business that does not have sufficient cash reserves or current income to finance operations and that chooses to cover the shortfall by making the IRS or Virginia an involuntary lender.

It is no different than sticking up a 7-Eleven in order to make payroll.

Businesses with recurrent cash flow problems or that simply don't make enough money never have the ability to "catch up" and continue to dig the hole deeper and deeper.

3. Worker Classification



A combination of mistakes

Unfiled returns alone, meaning all of the deposits were made but the returns were not filed, can be easily remedied. But combining a failure to file with a failure to deposit is a recipe for disaster…

** Filing and payment are not separate concepts for most clients! Many people make two mistakes instead of one by not filing because they don't have enough money to pay the tax reported on the return.

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WWW.JUSTICE.GOV/USAO/VAE/

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Virginia Business Owner Pleads Guilty to Failing to Pay Employment Taxes

RICHMOND, Va. – Richard A. Long, age 58, of Midlothian, Virginia, pleaded guilty to failing to truthfully account for and pay over employment taxes. He faces up to five years in prison and a $250,000 fine when he is sentenced by United States District Judge John A. Gibney on January 7, 2015.

Dana J. Boente, United States Attorney for the Eastern District of Virginia; Ron Cimino, Deputy Assistant Attorney General for Criminal Matters, Tax Division; and Thomas J. Kelly, Special Agent in Charge, IRS Criminal Investigation, Washington D.C. Field Office, announced the plea.

According to a Statement of Facts filed with the plea agreement, Long acknowledged that he owned, operated, and was the president of Mercedes-Volvo Service Center, a Virginia-based automotive repair business specializing in high-end vehicles. He was the person responsible for collecting, truthfully accounting for, and paying federal income, Social Security, and Medicare taxes for his employees. Long admits that from 2007 through the first quarter of 2013 he paid employees of Mercedes-Volvo Service Center net wages subject to federal taxes totaling $1,334,418.54. Instead of making the required $328,952.21 in estimated tax payments to the IRS with the federal taxes that he had withheld from employees' paychecks, he kept the funds and failed to pay the IRS the taxes due. Even though Long never paid these federal taxes to the IRS, he annually issued himself and his employees IRS Forms W-2 that reflected the federal tax withholdings.

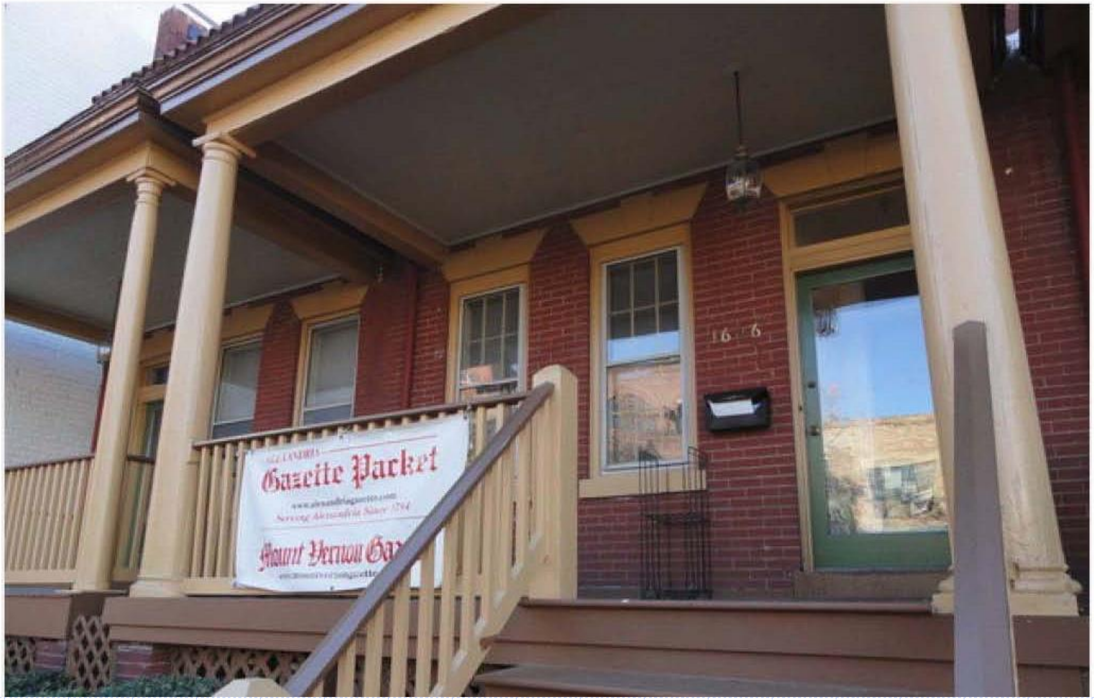
This case is being investigated by special agents of IRS – Criminal Investigation and is being prosecuted by Special Assistant United States Attorneys Rebecca Perlmutter and Todd Kostyshak, both of whom are trial attorneys with the DOJ Tax Division, and with the assistance of the U.S. Attorney's Office.

A copy of this press release may be found on the website of the U.S. Attorney's Office for the Eastern District of Virginia. Related court documents and information may be found on the website of the District Court for the Eastern District of Virginia or on PACER by searching for Case No. 3:14-cr-117. More information about the Tax Division and its enforcement efforts can be found at www.justice.gov/tax.

Connection Newspapers CEO Charged with Tax Evasion

Executive failed to pay more than $984,000.

By Jason Spencer (Patch Staff)
Updated July 20, 2011 at 10:30 am | 2



The president and chief executive officer of a company that publishes community newspapers in Maryland and Northern Virginia — including the Burke Connection, Springfield Connection and Fairfax Station- Clifton Connection — pleaded guilty Tuesday to two misdemeanor counts of failing to pay federal payroll taxes.

Peter Labovitz, who has led Connection Newspapers for 20 years, did not pay more than $984,000 in federal income and FICA taxes between 2002 and 2008, according to a Justice Department news release. During that time, Labovitz oversaw the company's day-to-day operations, directed employees

A combination of mistakes

IRC §7202 makes it a **felony** to willfully fail to collect, truthfully account for, and pay over withholding taxes.

(VA Tax Code §58.1-1815 makes the same a Class 1 misdemeanor.)

IRC §7201 makes it a **felony** to willfully evade any tax. It covers two crimes:

- Attempting to evade assessment; or
- Attempting to evade payment.

Failing to file can be charged as part of a felony scheme to evade both assessment and payment, if in addition to the failure to file the IRS can prove appropriate "affirmative acts."

A combination of mistakes

The investigation and prosecution of tax crimes involving employment taxes has been high on the priority list for the Tax Division of the Department of Justice and the IRS Criminal Investigation Division for the past decade. Why?

A combination of mistakes

Employment tax cases involving unpaid deposits present a "double whammy" to the public fisc:

1) No withholding was paid in, and
2) refund claims by employees are generally honored.

Responsibility for paying the tax on their income remains vested in the employee, even if the employer was required to properly withhold and pay over but fails to do so. IRC 3402(d). The IRS has historically been lax about this, giving credit for all claimed withholding on Forms 1040 and pursuing a non-paying employer for the tax, but they are <u>not statutorily required to do so</u>.

A combination of mistakes

A collapse in the level of voluntary compliance by employers with the withholding requirements could collapse the entire system.

Since the Current Tax Payment Act of 1943 was enacted, most of the income tax owed by individual taxpayers has been collected and paid over via payroll deduction.

According to the IRS Criminal Investigation Division: "The prosecution of these cases is key to supporting the Service's overall compliance goals, enhancing voluntary compliance with the tax laws, and promoting fairness and equity in our tax system."

A combination of mistakes

Factors warranting prosecution:

- History of nonfiling.
- Repeated contacts by the Service.
- Knowledge of the filing requirements.
- Age and occupation of the taxpayer.
- Large tax due after credits and payments.
- Large number of cash transactions.

A combination of mistakes

Willfulness means a "voluntary, intentional violation of a known legal duty." IRS doesn't need to prove an evil motive or a bad purpose.

Criminal intent is present if the nonfiling was "voluntary and purposeful and with the specific intent to fail to do that which he knew was required." But mere "careless and reckless disregard" does not constitute willfulness.

Cheek v. U.S., 498 U.S. 192 (1991);
U.S. v Pomponio, 429 U.S. 10, 12 (1976).

A combination of mistakes

Sentencing in criminal tax cases (evasion, failure to file, etc.) is based on the Federal Sentencing Guidelines, as amended from time to time.

- Tax loss table + enhancements or reductions determine offense level.
- Offense level + criminal history determine sentencing range.
- Sentencing ranges divided into zones that determine composition of the sentence.

A combination of mistakes

Sentencing Zones:

Zone A: Sentence can be for straight probation.

Zone B: Sentence at a minimum must be for probation with conditions of intermittent confinement, community or home detention.

Zone C: At least half the sentence must be imprisonment; the balance supervised release.

Zone D: Only imprisonment is permitted; no probation, even with conditions of confinement.

The IRS and DOJ have a clear preference for tax cases involving felonies and tax loss amounts that will result in significant periods of incarceration.

A combination of mistakes

Voluntary disclosure policy --

IRS won't prosecute if delinquent returns are filed in a truthful, timely and complete submission.

- TP must cooperate with the IRS in determining the correct tax liability;
- TP must pay or arrange to pay the tax, interest, and penalties.

A combination of mistakes

Disclosure is not timely if:

- IRS has initiated an investigation (civil or criminal), or has notified TP it will do so;
- IRS has received information (an informant, ex-wife, etc.) about the TP's noncompliance;
- TP is aware of some event which is likely to lead to such an investigation.

A combination of mistakes

Period of retroactive compliance.

- No statute of limitations on assessment of tax where returns are unfiled
- Three year statute of limitations on refund or crediting of overpayments.
- Six year retroactive compliance policy.

What else can happen (other than jail)?

IRS Penalties:

Late filing penalty (§6651(a)(1)):

- 5% per month to a maximum of 25%.
- Computed on net amount due after any timely payments or credits.
- Late filing due to fraud (§6651(f)): Rate is tripled to 15% per month to a maximum of 75%.

Late payment penalty (§6651(a)(2)):

- ½% per month to a maximum of 25%.
- Computed on net amount due after any timely payments or credits.

What else can happen?

IRS Penalties (continued):

Late deposit penalty (§6656):

1. 2% if FTD is not more than 5 days late,
2. 5% if FTD is for more than 5 days late but not more than 15 days late,
3. 10% if the FTD is for more than 15 days late.
4. If the IRS sends out a notice about the missed deposit(s), the rate goes up to 15%.

See TimeValue Software for "Tax941" calculator.

What else can happen?

<u>Virginia penalties</u>:

Late-filing: 6% per month, maxes out at 30%.

Late-payment: 6% per month, maxes out at 30%.

Interest: Compounded daily at the federal underpayment rate (IRC §6621), plus 2%.

What else can happen?

<u>IRS and Virginia Enforcement Action</u>: Liens.

- Public record. Can damage business reputation, credit rating, security clearances, activate contractual provisions relating to tax compliance
- IRS = Notice of Federal Tax Lien (NFTL); Virginia = Memorandum of Lien
- Attach to all business assets, including A/R. If there is a factor involved, you have a problem.

What else can happen?

<u>IRS and Virginia Enforcement Action</u>: Levies.

- Virginia calls levies "liens."
- Department of Taxation can issue levies on the 31^{st} day after an assessment is made.
- The IRS (generally) must follow the IRC §6330 restrictions and provide notice and opportunity for a CDP hearing before issuing levies.
- Treasury Offset Program ≠ "Levy."
- Pay special attention when your client is a government contractor, either a prime contractor or a subcontractor – get a copy of the contract!

What else can happen?

<u>Owner / Responsible Person Liability: IRS</u>

The Trust Fund Recovery Penalty ("TFRP"): IRC §6672 imposes a penalty on all "responsible persons" for "willful" failure to collect and remit payroll taxes. Amount is 100% of the withheld taxes.

Principal issues:

- Duty to collect, account for and pay over.
- Willfulness.

Trust Fund Recovery Penalty

Penalty limited to “trust fund” portion of taxes, as defined by IRC §7501:

- Withheld federal income taxes.
- Withheld portion of FICA tax.
- Withheld portion of Medicare tax.

Does not include employer’s share of FICA, Medicare, or accrued interest or penalties.

Trust Fund Recovery Penalty

Many folks are potentially "responsible persons:"

- Officer or employee of corporation.
- Partner or employee of partnership.
- Corporate director or shareholder.
- Another corporation.
- Surety or lender.
- Accountant.

Trust Fund Recovery Penalty

Indicia of "responsibility:"

- Power to direct collection of payroll taxes.
- Accountability for and authority to pay taxes.
- Authority to determine which creditors should or should not be paid.
- But employees who merely act at the direction of an officer or shareholder, but with no independent authority, are not liable.

Trust Fund Recovery Penalty

Responsibility – questions the IRS will ask (see IRM 5.7.4.2 and Form 4180 Report of Interview):

Who are the officers, directors and shareholders?

Who hires and fires employees?

Who determines which creditors should be paid?

Who signs and files the Forms 941?

Who controls payroll/nonpayroll disbursements?

Who prepares and sign checks?

Who controls the corporation's voting stock?

How are officers' duties defined in the bylaws?

Trust Fund Recovery Penalty

Special statute of limitations on assessment:

TFRP assessment must be made within three years of the later of --

- The actual filing date of the 941 return for the quarter in which the liability arose, or
- April 15th of the year following the end of the withholding tax quarter in question.

Trust Fund Recovery Penalty

The TFRP is a “mere collection device:”

IRS will collect the underlying tax only once.

Even after payment of the TFRP, if further payments are made by the corporation the penalty will be abated as to all responsible persons, and the excess will be refunded (but only if a timely refund claim is filed).

What else can happen?

Owner / Responsible Person Liability: Virginia

VA Tax Code § 58.1-1813.

A. Any corporate, partnership or limited liability officer who willfully fails to pay, collect or truthfully account for and pay over any tax administered by the Department of Taxation, 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 of the amount of the *tax evaded, or not paid, collected or accounted for and paid over*,* to be assessed and collected in the same manner as such taxes are assessed and collected.

B. The term "corporate, partnership or limited liability officer" as used in this section means an officer or employee of a corporation, or a member, manager or employee of a partnership or limited liability company, who as such officer, employee, member or manager is under a duty to perform on behalf of the corporation, partnership or limited liability company the act in respect of which the violation occurs and who (1) had knowledge of the failure or attempt as set forth herein and (2) had authority to prevent such failure or attempt.

** Virginia interprets the term "tax evaded, or not paid, collected or accounted for an paid over" to mean "tax, penalty, and interest."*

What else can happen?

<u>Owner / Responsible Person Liability: Virginia</u>

When Virginia makes separate assessments (new "bills") against the owners or officers, they are called "converted assessments."

Information on corporate shareholders and officers, LLC members, and general partners is readily available to the state in the Clerk's Information System.

Cleaning up the mess

First Steps

Step 1: Current compliance.

"Uh, Trudy, how's the coffee coming?"

Cleaning up the mess

(<u>Step 1: Current compliance continued</u>)

The IRS will not discuss payment options of any kind for delinquent employment tax liabilities until the taxpayer is in current compliance:

1. Filing compliance (outside payroll service)
2. Payment compliance (TaxPay or similar service)

For employment tax cases, businesses need SIX MONTHS of clean compliance history.

** Virginia usually insists on delinquent returns being filed prior to setting up a payment plan, but you can often get one set up for just the existing "bills" without the rep looking too closely.

Cleaning up the mess

Step 2: Knock it down to size

IRS Penalty Abatement:

"Generally, relief from penalties falls into four separate categories:

- Reasonable cause
- Statutory exceptions
- Administrative waivers
- Correction of IRS error."

IRM 20.1.1.3(1).

IRS Penalty Abatement

Penalties may be avoided if delinquency was due to "reasonable cause and not willful neglect."

IRM states "any reason which establishes that the taxpayer exercised ordinary business care and prudence, but was unable to comply with a prescribed duty within the prescribed time, will be considered."

See IRM 20.1 et seq; Treas. Reg. §301.6651–1(c); Policy Statement P–2–7.

IRS Penalty Abatement

Meet the Reasonable Cause Assistant ("RCA)."

The "RCA is a decision support interactive software program developed to reach a reasonable cause determination." It "will be used when considering penalty relief due to reasonable cause. RCA is to be used after normal case research has been performed" for the failure-to-file, failure-to-pay, and failure-to-deposit penalties.

"Use of RCA will ensure consistent and equitable administration of penalty relief consideration."

When an employee has determined that a taxpayer has requested penalty relief based on reasonable cause, whether the request was made by telephone or in writing, RCA will be accessed to determine if penalty relief will be granted.

IRM 20.1.1.3.6.

IRS Penalty Abatement

First Time Abate (FTA)

The RCA provides an option for penalty relief for the 6651(a)(1), IRC 6651(a)(2) and 6656 penalties if the following are true:

1. TP has not previously been required to file a return or has no prior penalties for the preceding 3 years, and
2. TP filed, or filed a valid extension for, all currently required returns and paid, or arranged to pay, any tax due.

IRM 20.1.1.3.6.1 (08-05-2014).

Note that IRS will consider the taxpayer current if they have an open installment agreement and are current with their installment payments. See IRM Procedural Update No. SBSE-20-0414-0623.

IRS Penalty Abatement

How do you ask for it?

- Form 843;
- Written request to revenue officer;
- If case is in Examination, written request to the revenue agent.

IRS Penalty Abatement

Request Recalculation of the IRC §6656 Penalty Under Rev. Proc. 2001-58

Section 3304(a) of RRA added subsection (e) to section 6656 of the Code, which permits a depositor receiving a penalty notice (with respect to any deposit of tax made for a specific tax return period) to designate, during the 90-day period beginning on the date of the penalty notice, the deposit period or periods within the specified tax period to which a deposit of tax shall apply.

TP can request recalculation under 6656(e) by following Rev. Proc. 2001-58.

How do you calculate it? Sign up for and use TimeValue's Payroll Penalty online tool to see if a request under Rev. Proc. 2001-58 will save your client any money.
** BUT NOTE the time deadline for filing such a request – you must prepare and file it within 90 days of the first CP-series notice the IRS sends assessing the 6656 penalty!

Virginia Penalty Abatement

Must file Offer in Compromise form and check the box for "Request for Waiver of Penalty Due to Reasonable Cause," then attach a statement explaining why the business didn't file or pay on time.

Virginia Penalty Abatement

Virginia has wide discretion in decisions to waive penalties and very little published guidance on factors that sway such discretion one way or another.

Responses from the Department are often terse, containing almost no explanation for the decision, making such decisions seem even more arbitrary . . . which they often are!

Cleaning up the mess

Step 3: Voluntary Payments

Whether you start with the IRS or state depends on:

- Who is exerting the most pressure / collection posture
- The amount of the liabilities
- Personal exposure of owners, officers, employees
- The business' ability to pay.
- Whether the business is viable and should be saved or whether it would be best to shut it down.

Usually Virginia discovers the problem first and is more quickly able to take levy action. It is often prudent to set up payment arrangements with Virginia before turning your attention to the IRS.

Voluntary Payments

Sending Payments to the IRS

1. Get transcripts and copies of the Forms 941.
2. Calculate the TFRP.
3. Calculate the ASEDs on the TFRPs.
4. Send PAPER CHECKS to IRS designated to the quarter with the longest remaining time on the TFRP ASOL. Write on the memo line of the check the EIN, form, period, and "TRUST FUND ONLY." Repeat the designation instructions in a cover letter and send the check with the letter. The IRS *will* mispost this payment. Check back to make sure they put it on the correct module and used TC 670 DPC 02. If not, get it fixed or ATFR will calculate the wrong amount for the TFRP.

Calculating the TFRP

Easy if all FTDs made: TFRP = $0.

Easy if no FTDs made: TFRP = total TF per Form 941.

How do you calculate the TFRP if only some of the FTDs were made?

- IRS posts all payments, including FTDs, to the non-TF portion first.
- Paying by EFTPS and filling in the information for income tax, Social Security, and Medicare does NOT = "designation instructions." *See Babcock v. United States* (C.D. Cal. 2009).

Calculating the TFRP

So I made FTDs, which included a TF component and I can’t get credit for them?

IRM 5.7.4.3, flush paragraph, provides that a *timely* FTD can be treated as designated to the TF portion if the deposit was in the required amount and TP provides payroll records showing the breakdown between TF and non-TF components.

- Ask the Revenue Officer to compute the TFRP in this manner, or
- File a Protest Letter in response to the Letter 1153(DO).

But you can use this method to calculate the unpaid TF portion for the purpose of sending voluntary payments designated to the TF portion if you plan to appeal a TFRP proposal and win.

Cleaning up the mess

Step 4. Make arrangements for the rest.

1. **Try to make voluntary payments against the TF portion as long as possible. Remember that OIC payments can be designated while the OIC is under review.**
2. **Try to set up a BMF installment agreement that provides for fast payment of the total balances in exchange for the IRS not pursuing the TFRP.**
3. **OICs are difficult to win and there is a policy against accepting OICs from in-business TPs with unpaid TF liabilities.**
4. **Consider bankruptcy, or asset sale in combination with a request for certificate of discharge.**