New York Law Journal

Web address: http://www.law.com/ny

VOLUME 230—NO. 12 THURSDAY, JULY 17, 2003

TAX LITIGATION ISSUES

BY JOHN J. TIGUE JR. AND JEREMY H. TEMKIN

IRS Steps Up Investigations of Payroll Tax Abuses

IT IS NO secret that most tax crimes go undetected and unpunished because the Internal Revenue Services' criminal enforcement resources are simply too limited to detect anything but a modest fraction of the tax offenses committed each year.

For the past five years, there have been fewer than 3,000 special agents investigating tax and other financial crimes. Last year, the IRS initiated just under 2,500 criminal tax investigations — an increase from the low mark of 1,785 tax investigations commenced in 2000, but still substantially below the 4,000 cases initiated a decade ago.

The IRS seeks to maximize its limited resources by targeting specific behaviors and industries for enforcement. One area currently targeted is employment tax evasion, and the IRS has established an Employment Tax Enforcement Program as one of its specific enforcement priorities. As a result, the IRS has tripled the number of employment tax evasion investigations it has initiated since 2000, averaging fewer than 40 such investigations per year for 1998 through 2000 and initiating 64 investigations in 2001 and 92 in 2002. For fiscal year 2003, it is on pace to open 120 criminal employment tax investigations[1] — still a relatively small number, but a sign that the IRS is allocating greater resources to back up its stated commitment to pursuing employment tax evasion.

John J. Tigue Jr. *is a principal in Morvillo, Abramowitz, Grand, Iason & Silberberg and a fellow of the American College of Trial Lawyers.* **Jeremy H. Temkin** *also is a principal in Morvillo, Abramowitz.* **Judith L. Mogul,** *an attorney, assisted in the preparation of this article.*

John J. Tigue Jr. *Jeremy H. Temkin*

Liability

Employers and employees are both legally responsible for payment of employment taxes to the government. Most employers are required to withhold federal income taxes, as well as the employees' portion of Social Security and Medicare taxes from their employees' paychecks. Employers must report and deposit these taxes (known as trust fund taxes) in approved depositories. Those who are self-employed or whose employers do not collect or pay over the required taxes remain liable for those taxes and must remit them themselves. When these taxes are not paid, in some instances, employees may not qualify for Social Security, Medicare or unemployment benefits.

Types of Employment Tax Schemes Targeted. While struggling companies will occasionally fail to pay over withheld taxes and instead invest such funds in their business, such cases are rarely prosecuted criminally, but are generally addressed through the imposition of interest and penalties. The IRS' enforcement efforts have, however, uncovered a wide range of deliberate employment tax-evasion schemes. These schemes have graduated beyond the simple and straightforward cash payrolls into more elaborate and complex schemes. For some, evasion of employment taxes is the sole object, while for others non-payment of employment taxes is merely incidental to a more extensive fraud. In some schemes, the affected employees are knowing and willing participants, while in others they are unwitting victims.

Under-the-Table Payments

One of the most common payroll tax evasion ploys is for a company simply to pay all or part of its payroll in cash. Frequently the schemes involve either siphoning cash receipts to pay employees (thereby reducing both income and deductions) or disguising one form of deductible expense (salaries) as another form of expense. While these variations have no impact on the amount of income tax paid by the company, it saves the company money by reducing employment taxes and enables the employer to pay employees with "untaxed" money. Additionally, the result of such schemes is also often illegal underpayment of related

benefits, such as pension contributions. For a small business, particularly one that takes in large cash receipts, paying a portion of employee wages in cash is quite simple, not uncommon, and somewhat difficult to detect. But larger companies or those without significant amounts of available cash, have devised more complicated maneuvers that leave a paper trail.

One of the schemes reported by the IRS concerned a Brooklyn-based packaging company whose owner generated cash to pay his employees by writing checks to shell companies, and then preparing false invoices from the shell companies purporting to show that the payments were deductible business expenses. The owner pleaded guilty to conspiracy to defraud the United States and the IRS and to evading employment taxes on more than $540,000.

In *United States v. Gambone*,[2] the owners of a construction company used three distinct tactics to shield cash wages from the IRS. Some employees were simply paid completely off the books, from non-payroll accounts. Other employees who worked over time, were paid only for "straight time" from the payroll account, and provided with separate checks from nonpayroll accounts for overtime pay. The defendants also disguised raises to employees as expense reimbursements, which allowed these payments to be made free of taxes, and presumably permitted their fraudulent deduction as business expenses.

Of course, to avoid payroll taxes, any fraudulent reduction in the payroll is accompanied by corresponding false reporting on both the employer's payroll tax returns and W-2s issued to the employees. In *Gambone*, some of the defendants were charged with aiding and assisting their employees in filing false income tax returns under 26 USC §7206(2), as well as conspiracy to defraud the United States in violation of 18 USC §371. The U.S. Court of Appeals for the Third Circuit rejected their argument that 26 USC §7204, which makes it a misdemeanor to provide a false W-2 to an employee and carries a shorter statute of limitation, provided the sole basis for their prosecution. In upholding their felony convictions for assisting their employees in filing false income tax returns, the court held that where the only evidence consists of furnishing a false W-2, §7204 does provide the exclusive remedy, but that, in combination with some other evidence suggesting the intent to cause a false return to be filed, provision of a false W-2 may be considered as evidence supporting a felony conviction under §7206(2). The court concluded that the defendant's creation of false time cards, intricate and deceptive bookkeeping and issuance of checks to employees from nonpayroll accounts constituted "affirmative steps" to encourage their employees to file false returns sufficient to support their convictions.

Communications with an the accountant will only be privileged if advice is of a legal, rather than an accounting nature.

Pyramiding

According to the IRS, businesses involved in "pyramiding" often repeatedly engage in the practice of intentionally failing to remit to the IRS payroll taxes withheld from its employees, filing for bankruptcy in order to discharge their payroll tax liability and then starting up under a new name only to resume the practice of retaining withheld payroll taxes. Presumably one way in which the IRS distinguishes between cases it will handle civilly and those for which it will seek criminal sanctions is the recurrent nature of the scheme as well as the abuse of the bankruptcy laws. Another salient feature is the use to which the payroll tax money is put. In many civil cases, the money is used to continue operating a cash-strapped business where the business owners or operators believe they will ultimately be able to fulfill their employment tax obligations. By contrast, criminal pyramiding prosecutions frequently involve the diversion of payroll taxes for private use.

For example, in a recent pyramiding prosecution described on the IRS Criminal Investigation Web site, the owner of a lawn care service pleaded guilty to failure to pay over to the IRS more than $1 million in withheld payroll taxes, a portion of which he used for his personal benefit and to pay his child support obligations. In another recent case, a former office manager, responsible for all accounting duties at her company, was sentenced to 15 months in prison for failing to pay more than $125,000 in payroll taxes, a portion of which she embezzled for personal use.

Employee Leasing

Employee leasing is the practice whereby a business contracts with an outside company, sometimes known as a professional employment organization (PEO), to handle all aspects of its personnel functions. Typically, the workers are treated for all administrative and tax purposes as the employees of the PEO, which leases them back to the client company. The client company pays the PEO the amount of the gross payroll, plus whatever fee the PEO charges, and the PEO is responsible for paying the employees their salaries, depositing payroll taxes and filing the required payroll tax returns.

Although employee leasing is a legitimate practice, it is subject to abuse, sometimes on a massive scale, when the

PEO fails to remit payroll taxes to the IRS. In an article he co-authored on the IRS Employment Tax Enforcement Program,[3] former IRS Criminal Investigation Chief Mark Matthews describes the prosecution of the president of an employee leasing company that, during a period of less than two years, failed to pay over to the IRS more than $13 million dollars in payroll taxes for more than 6,000 employees leased to over 100 businesses. The defendant, who used the withheld payroll tax money to support a "lavish lifestyle," was sentenced to 41 months in prison.

Recently, five individuals pleaded guilty in the U.S. District Court for the Eastern District of New York to charges that they evaded up to $13 million in employment taxes through the operation of five successive PEOs, also in less than two years. The defendants operated each PEO for a brief period, opened a new PEO to which they would transfer their client companies' business, and then abandoned the former PEO with outstanding payroll tax obligations, but no revenues or assets. In addition to their evasion of employment taxes, the defendants were also charged with having diverted both the payroll taxes and funds borrowed from a financing company based on their accounts receivables, for personal use and to finance other business ventures.[4] In addition to prosecuting the operators of employee leasing companies who abscond with payroll taxes, the IRS has recently begun to seek and obtain civil injunctive relief against such companies, placing them into receivership, freezing their assets and prohibiting their owners from operating similar services.[5]

Non-Filers

Another one of the IRS' current enforcement priorities is the prosecution of non-filers, which the IRS has identified as a growing problem that undermines public confidence in the service's ability to administer the tax laws fairly and effectively. Many non-filers are tax protesters who routinely employ a number of constitutional and statutory arguments to support their claims that taxation is either illegal or voluntary. A number of businesses have adopted the same arguments as individual non-filers.[6] The IRS is aware of 1,500 such businesses, but thus far has done little to enforce the tax laws against them.[7]

Last month, the government obtained an indictment of the owner of a Texas manufacturing company for failing to withhold, collect or account for $175,000 in payroll taxes for his employees during a three-year period and for filing false refund claims for $235,000 in payroll taxes paid during the three previous years. According to The New York Times, the defendant had openly bragged about not paying taxes and was an advocate of the "861 position," which maintains that only income from foreign-owned companies is taxable. If convicted, the defendant faces significant incarceration and fines.

Enforcement Is a Challenge

The IRS is facing an uphill battle. As with most forms of tax evasion, employment tax evasion is often difficult to detect. The IRS' enforcement efforts may, on occasion, be aided by employees who learn that their employers have not paid over taxes withheld from their payroll. In other instances, the evasion of employment taxes may be discovered through audit or during the course of an investigation of other criminal activity. However, although its statistics reveal that the IRS has indeed committed greater investigative resources to the enforcement of employment tax laws, there appears to be a decline in the correlation between the number of prosecutions recommended and the number of indictments and informations charging employment tax violations. During the previous five years, the Justice Department brought charges in 85 percent to 98 percent of the cases recommended for prosecution. However, during the first seven months of this fiscal year, of the 40 prosecutions recommended, only 28 were actually brought, a prosecution rate of only 70 percent.[8] Whether this reflects a disconnect between the IRS and Justice Department in terms of enforcement priorities or serves as a commentary on the quality of the investigations conducted by the IRS remains to be seen.

(1) treas.gov/IRS/ci/tax_fraud/docemploymenttax.htm.

(2) 314 F3d 163 (3d Cir. 2003).

(3) J. Kehoe & M. Matthews, "Employment Taxes – Who is Responsible?" CCH Journal of Tax Practice & Procedure, June-July 2001.

(4) Press Release, "Five Individuals and Two Corporations Indicted in $13 Million Federal Payroll Tax Fraud Scheme," usdoj.gov/tax/usaopress/2002/2002apr19.htm.

(5) See Department of Justice Press Release, "Court Orders Payroll Service Company into Receivership; Prohibits Defendants from Operating Any New Payroll Service Company," April 11, 2003, www.usdoj.gov/tax/paysourcepr.htm.

(6) www.treas.gov/IRS/ci/tax_fraud/docnonfilers.htm.

(7) David Cay Johnson, "Boast of Refusal to Pay Taxes Leads to 27-Count Indictment," The New York Times, June 22, 2003.

(8) www.treas.gov/I.R.S./ci/tax_fraud/docemployment-tax.htm. The IRS does caution that actions on specific investigations may cross fiscal years, so that the data shown for one category of action may not always represent the same universe of cases shown in other actions for the same fiscal year. Notwithstanding this caveat, the Justice Department is commencing employment tax prosecutions at a substantially lower rate than it has in previous years — on track to commence the same number of prosecutions for 2003 as it averaged for 1998, 1999 and 2000, despite the fact that on average the IRS commenced fewer than a third the number of investigations during the same period.

This article is reprinted with permission from the July 17, 2003 edition of the NEW YORK LAW JOURNAL. © 2003 ALM Properties, Inc. All rights reserved. Further duplication without permission is prohibited. For information, contact American Lawyer Media, Reprint Department at 800-888-8300 x6111. #070-07-03-0016