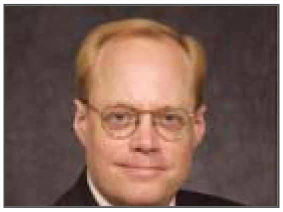
Forbes



Robert W. Wood

THE TAX LAWYER

TAXES 4/09/2015

Newest Tax Fraud Threat? Your Payroll Tax

This time of year, there are new stories every week about tax evasion convictions and indictments, sending a scare just as it comes time to file your taxes. This year the stories were eclipsed by an uptick in identity theft tax fraud. But a new report from the Treasury Inspector General warns of another big problem: payroll tax fraud.

The IRS can be tough on collecting income taxes, but is even tougher where payroll taxes are concerned. After all, the money is withheld from employee wages and supposed to be over to the IRS. If the IRS doesn't get it, the losses can mount quickly. And no matter how good a reason the employer has for using the money for something else, the IRS is strict.

Payroll services are one common answer, so the employer doesn't have discretion to use the money to pay vendors or for anything else. But what if the payroll service takes the money? That horrific possibility features prominently in the Inspector General's new report, which flatly states that there are risks of fraud.

The risk is real, especially considering that 40 percent of small firms use a third-party payer. The specifics of the payroll service duties and responsibilities vary, but if the payroll services doesn't send in the money to the IRS, the employer is still on the hook.

The report faults the IRS for not cross-checking and verifying payroll services and companies for which they are acting. And catching errors quickly is another big problem. Because of the snowballing nature of payroll tax liabilities, it is important for the IRS to detect and respond immediately when payroll tax defaults occur.

Does any of this mean payroll services are a bad idea? No, but it does suggest caution. The IRS is very clear that if you sign up with a payroll services and outsource all the payroll tax filings and payment functions, the employer is still liable. The payroll service may be liable under your contract, but the IRS still can look to the employer.

And that means the officers and directors of the employer have personal liability too. When a tax shortfall occurs, the IRS can make personal assessments against all responsible persons with ownership in or signature authority over the company. The IRS can assess a Trust Fund Recovery Assessment against every responsible person under Section 6672(a). You can be liable even if have no knowledge the IRS is not being paid.

The penalty can be assessed against multiple responsible person, allowing IRS to pursue them all to see who coughs up the money first. Responsible means officers, directors, and anyone who makes decisions about who to pay or has check signing authority.

Multiple owners and signatories generally squabble and do their best to sic the IRS on someone else. Factual nuances matter in this kind of mud-wrestling. So do legal maneuvering and just plain savvy. One responsible person may get stuck while another who is even more guilty may get off scot-free.

Meanwhile, the government can still try to collect from the company that withheld on the wages. The IRS also wants to make sure this kind of bad tax situation doesn't occur again. The government can move to shut down the business so the situation doesn't get worse. In extreme cases the government may seek criminal penalties.

More commonly, the government may seek to enjoin this behavior. If the government thinks the situation is getting worse, it can seek an injunction. The idea is to stop the bleeding so the government gets its tax money. Where a business gets deeper and deeper into tax debts, the practice is sometimes referred to as pyramiding.

For alerts to future tax articles, follow me on Forbes.com. Email me at Wood@WoodLLP.com. This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.