Tax Talk

by Mark C. Milton

Lawyers May Face Civil and Criminal Sanctions for Failing to Comply with Payroll Tax Obligations

Bob and Betty worked together for several years as junior partners at a large law firm. They recently decided to leave the big firm to open their own boutique firm, B&B Law, PC (B&B), a professional corporation. Not accustomed to handling payroll and paying operating expenses at their previous firm, B&B hired an in-house bookkeeper, Sam, to manage the firm's books, process payroll for the firm's six employees (three lawyers, a bookkeeper, a secretary, and a paralegal), and pay the firm's bills. Bob and Betty soon learned that federal law required B&B, like most businesses, to withhold income and Federal Insurance Contribution Act (FICA) (such as Social Security and Medicare) taxes from its employees' paychecks, account for the money, and turn the money over to the Internal Revenue Service (IRS) each quarter, along with a quarterly payroll tax return (IRS Form 941).

B&B's next quarterly payroll tax return and payment are due in a few weeks, but B&B has not paid its last three invoices from its key online legal research provider, Wexus. While B&B has enough money in its checking account to pay Wexus or this quarter's payroll taxes, the firm cannot pay both. Wexus will suspend the firm's online account access if the past due invoices are not paid, and B&B's lawyers need Wexus to research critical issues in their ongoing medical malpractice case that they are sure will bring in a large contingency fee, thus solving the firm's financial crisis. B&B decides to pay Wexus and beg off the IRS until their big contingency fee arrives. Sadly for B&B, after paying Wexus, Bob and Betty learn that their client lied about his injuries, and they have no case against the doctor they sued. B&B misses its next several payroll tax payments, and ultimately the firm dissolves. The firm's failure to meet its payroll tax obligations could have dire consequences for Bob, Betty, and Sam.

This scenario is all too common. Cash-strapped small businesses, including small law firms, frequently face the dilemma of whether to: (1) make quarterly payroll tax payments to the IRS or (2) pay the firm's employees, key suppliers, and/or other creditors to keep the business afloat. In more sinister situations, rather than using the funds to pay other creditors, business owners simply use the withholdings to fund lavish lifestyles, effectively stealing the money from the Treasury with no intention of ever paying the IRS. In an effort to collect more revenue and deter noncompliance with payroll tax obligations, the U.S. Department of Justice and the IRS have stepped up their efforts to pursue not only civil penalties, but *criminal* sanctions against individuals who fail to meet their payroll tax obligations. This includes lawyers. Accordingly, lawyers managing their own law practices must understand and recognize the civil and criminal consequences that could result from skirting their payroll tax obligations.

Overview of Federal Payroll Tax Requirements

The Internal Revenue Code (26 U.S.C.) requires employers to withhold federal income and FICA taxes from their employees' wages. On at least a quarterly basis, employers must then report the amount of taxes withheld from employees' paychecks on a payroll tax return and turn over the withholdings to the IRS along with the employer's matching share. Prior to remitting the withholdings to the IRS, the employer holds the employees' portion of the payroll taxes in a trust for the benefit of the government. Federal law prohibits the employer from using the funds for any other obligations, such as paying bills. "It is no excuse that, as a matter of sound business judgment, the money was paid to suppliers and for wages in order to keep the corporation operating as a going concern—the government cannot be made an unwilling partner in a floundering business."[1]

Trust Fund Recovery Penalty (Civil)

Once an employer withholds payroll taxes from an employee's pay, the employee receives credit for having paid the taxes even if the employer fails to remit the taxes to the IRS. Public policy favors this outcome, because in most cases, employees do not control whether the employer turns the withheld money over to the IRS. To recover the loss to the Treasury that results from a business failing to turn over the trust fund portion, the IRS can assess a civil penalty against the individuals in the business responsible for the nonpay-

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ment.[2] The penalty, for which the individuals are personally liable, is equal to the amount of the taxes withheld but not remitted. This is commonly referred to as the trust fund recovery or 100 percent penalty. Even for small businesses, this amount can be substantial over several quarters.

Business owners, as well as any person with financial decision-making authority in a company, may be liable for the trust fund recovery penalty if they knew that the business was not meeting its payroll tax obligations. In the example above, Bob, Betty, and Sam could all face liability for the amount of withholdings not paid to the IRS if they knew the tax withholdings were being used to pay Wexus. As the firm's principals, Bob and Betty would certainly be responsible for the firm's failure to meet its payroll tax obligations. As for Sam, the bookkeeper, some courts have found that mere signature authority on a corporate bank account is sufficient to impose personal liability on an employee of a business, even if they have no ownership or decision-making authority. Unfortunately, many people with financial decision-making authority (i.e., part-time bookkeepers and office managers) do not realize that they could face personal liability for a business's failure to withhold, account for, and remit payroll taxes. Such a penalty assessed against an employee like Sam, with no ownership in the business, can be devastating.

Injunctive Relief and Possible Criminal Contempt

The scope of civil remedies for noncompliance with payroll tax obligations may also include injunctive relief, which could impose additional burdens on a small law practice. For example, a federal court in Michigan recently issued an injunction requiring a law firm to file all employment tax returns on a timely basis, to deposit all payroll taxes in an appropriate federal depository bank, and to pay its payroll taxes on a timely basis. The court then enjoined the firm from assigning property or making any other payments until it paid the employment taxes. Finally, the court required the firm to provide monthly affidavits to the IRS verifying that the requisite tax deposits had been made. In its civil complaint, the Department of Justice alleged that the firm had been engaged in a practice known as pyramiding, whereby a business withholds taxes from its employees but intentionally fails to remit them to the IRS as mandated by law. In this case, the injunction imposed possible criminal contempt sanctions against the firm's lawyers if they failed to comply with their payroll tax obligations.

Other Criminal Sanctions

Greater cause for concern for lawyers who run their own practices is the possibility of criminal prosecution for failing to meet their payroll tax obligations. Throughout 2013 and 2014, the Department of Justice, working with IRS Criminal Investigation, has obtained dozens of criminal convictions in employment tax cases, several against attorneys. For example, in February 2014, an attorney and businessman from upstate New York was sentenced to 15 months in prison for failing to pay employment taxes for various businesses he ran from 2002 through 2008. In March 2014, a New Jersey attorney was sentenced to six months in prison, six months of home confinement, and three years of supervised release and ordered to pay more than $27,000 for evading income tax and failing to pay employment taxes. Finally, in April 2014, the owner of a small law practice in Oklahoma pled guilty to three counts of willfully failing

to pay employment taxes. The lawyer also agreed to pay more than $300,000 in restitution. All of these defendants deducted and collected federal income taxes and FICA taxes from their employees' paychecks but failed to pay them to the IRS.

Avoiding Payroll Tax Problems

To avoid payroll tax problems, including both civil and criminal sanctions, lawyers managing their own law practices should: (1) understand their payroll tax obligations and the consequences that may result from noncompliance; (2) determine whether they can avoid the headaches of payroll tax compliance altogether by paying those who perform services for their firm as independent contractors (this can be a tricky determination and one that should be made with input from a tax professional); (3) ensure that they have internal procedures in place to manage their payroll tax obligations or outsource payroll tax processing to a third party (many banks and/or payroll processors offer this service); (4) seek operating capital from other sources before ***ever*** using payroll tax withholdings to fund their law practice; and most importantly, (5) seek advice from competent tax counsel if they have any questions about their payroll tax obligations. ⊙

Endnotes

[1]*Collins v. United States*, 848 F.2d 740, 741-42 (6th Cir. 1988).

[2]26 U.S.C. 6672.