

IRS INVESTIGATIONS OF UNPAID EMPLOYEE WITHHOLDING TAXES: A STEP-BY-STEP GUIDE

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It's an old story that the IRS combats everyday: When a business struggles and cash flow is tight, when there is not enough money to pay both rent and withholding taxes, the IRS takes a back seat, and the business uses IRS tax money to keep the lights on. The result is that the IRS is made an unwilling lender to fund operations. The hope is that the tide will turn, and the IRS can be repaid before they come calling. This is always a dangerous bet, and as we will see, it is especially dangerous in employment tax cases.

Liability for employment taxes does not just stay with the business; rather, the IRS spreads it to the business owners, officers, and even employees. Anyone who had decisionmaking power over the company's finances can be personally liable for a part of the unpaid taxes. This is called a trust fund recovery penalty (TFRP) investigation. Simply put, unpaid employment taxes are a cancer.

As the IRS casts a wide net to collect employment taxes, a three-tiered defense is usually required:

- To the initial collection of the employment taxes from the business (Tier 1).

- To the ensuing TFRP penalty investigation into the company's ownership and management (Tier 2).
- To the eventual collection of the trust fund taxes from those in the business who were responsible for the decisions not to pay the IRS (Tier 3).

The best employment tax defense will recognize in advance each step the IRS will pursue and prepare for it. With that background, here is the IRS's step-by-step game plan in a civil employment tax investigation.

Step 1. Assignment of an IRS Revenue Officer to the Case

The IRS considers employment tax liabilities to be a serious matter, and as a result, will assign an employment tax case to its highest level collection personnel—a revenue officer.

Chances are, the first move the revenue officer will make is to visit your client's home or business. Expect the revenue officer to drop off her business card along with Form 9297 (Summary of Taxpayer Contact) and a Letter 1058 (Final Notice of Intent to Levy and Notice of Your Right to a Hearing).

The revenue officer's initial knock on the door is to collect the employment taxes from the business. That will soon change.

Your client does not know it yet, but the revenue officer does not intend to simply investigate collection of the employment taxes from the business; the revenue officer will also be launching an investigation into the operations of the business. The investigation will be focused on control over company finances: Who had the decision-making authority that resulted in the employee withholding taxes not being paid to the government?

This is called a trust fund recovery penalty investigation, which supplements collection of the tax from the business. It permits the IRS to assess and collect part of the unpaid employment taxes from the individuals who were in control of the business. The IRS can collect trust fund taxes from both the business and from its owners, officers, and employees in any manner it deems fit. For example, the IRS could collect 50 percent from the business, 25 percent from the owner of the business, and the remaining 25 percent from the treasurer, not to exceed 100 percent of the trust fund amount.

The TFRP gets its name from the trust involved in handling employees' tax withholdings. When a business deducts tax withholdings from an employee's paycheck, there is a trust imposed on the decisionmakers to ensure the employee's taxes are paid to the IRS. When this does not happen—usually because the business is in financial distress—

Internal Revenue Code Sec. 6672 permits the IRS to charge the decisionmakers personally with the unpaid employment taxes and to then proceed to collect it from them.

The trust fund recovery is called a penalty, but the amount of the penalty is the taxes that were withheld from employees' paychecks—that is, income taxes and the employees' Social Security and Medicare contributions. The IRS can collect trust fund taxes from the business and from the individuals responsible for the nonpayment. The nontrust fund portion of the employment taxes—that is, the employer's payroll taxes not deducted from employees' gross pay—can only be collected from the business.

At first, however, the revenue officer's focus is on the collection of the taxes from the business (Tier 1).

Step 2. The Revenue Officer Investigates the Collection of an Employment Tax Liability from the Business

The summary of taxpayer contact dropped off by the revenue officer at her first visit will include a list (in order of the items she wants from the business) in order to determine how it can repay the taxes (expect the initial demands to include items like any unfiled returns); proof of current compliance with federal tax deposits; IRS Form 433B (Collection Information Statement for Businesses (which includes disclosure of a profit and loss statement and itemization of the company's assets)); and recent bank statements. There will be a deadline provided on the form, usually two to three weeks out.

To best protect your client at this stage, make sure he brings to your first consultation all the documentation he has received from the revenue officer, which should include the summary of taxpayer contact and the Final Notice of Intent to Levy. Supplement what your client brings you with an IRS account transcript. When reviewing the transcript, focus on if, and when, the Final Notice of Intent to Levy was issued.

The Final Notice of Intent to Levy is important as it permits the revenue officer to levy the business' bank accounts, receivables,

vehicles, and equipment thirty days after it was delivered. Within those thirty days, you have the right to file a collection due process (CDP) hearing, disputing the intent to levy and seize. Docket this filing to be done within thirty days after the date on the final notice. (The IRS also permits late-filed CDP cases, defined as those filed within one year of the date on the final notice, commonly known as equivalent hearings.)

Why file a request for a CDP hearing with the revenue officer? There are two primary reasons. First, and most importantly, the CDP prevents the revenue officer from taking levy action to collect the taxes while you work out a payment solution for the business. Second, the CDP also requires the revenue officer to send her case file on collecting the employment taxes from the business to the IRS Office of Appeals. This results in the revenue officer no longer having a collection case against the business; rather, the case has been transferred to an IRS appeals settlement officer. Late-filed equivalent hearings should provide your client the same primary benefits as timely hearings; what is given up is the right to Tax Court review of the appeals decision.

If the time to file a CDP has lapsed, or if a Final Notice of Intent to Levy is not issued, then you will be negotiating a collection alternative directly with the revenue officer rather than Appeals.

The most common collection alternatives for the business will be either an installment payment plan or uncollectible status (IRS forbearance). These solutions will be based on negotiations surrounding the Form 433B financial statement. Although the IRS can liquidate business assets if there is equity in them, it is hesitant to do so and should not interrupt business operations if the business is in compliance on its employment tax filings and deposits.

If the financial investigation into the business' ability to repay the taxes reveals it is unable to pay the debt quickly, then the revenue officer will start looking into its other sources for collecting employment taxes (i.e.,

the individuals who run the business) and will launch her trust fund investigation.

Step 3. Determination by the Revenue Officer That the Company Will Be Unable to Quickly Pay the Employment Tax Liabilities

The revenue officer is under guidelines to commence investigation of the TFRP within 120 days after her initial contact. (See Internal Revenue Manual 5.7.4.1 (Determination to Pursue and Recommend Assessment of the TFRP)). At that time, the revenue officer will make a determination whether the business can quickly pay the taxes in full; if they cannot be paid, the revenue officer will proceed to Tier 2 and expand her case to investigation of the TFRP to collect from the individuals.

Note that if the business owes under \$25,000 and can enter into a payment plan that will satisfy the debt in twenty-four months, the revenue officer can forgo the trust fund investigation. (See Internal Revenue Manual 5.14.5.2 (Streamlined Installment Agreements)).

If the business is able to make voluntary payments on the employment taxes, it is important that these payments get specifically designated as applied to the trust fund portion of the liability. This reduces the exposure of the individuals to the trust fund recovery penalty. Payments pursuant to an installment agreement, however, are not considered voluntary by the IRS.

Step 4. Investigation of the Trust Fund Recovery Penalty

The TFRP can only be investigated by a revenue officer. Automated Collection Service (ACS) cannot conduct the investigation; it is localized with high-level enforcement personnel. (See Internal Revenue Manual 8.25.1.5(2)(TFRP Assessment Process)).

If your client has not heard from a revenue officer, then there is no pending trust fund

recovery penalty investigation; and there is a three-year statute of limitations on the IRS investigation of the TFRP. So no news can be good news for targets of the trust fund recovery penalty.

Step 5. IRS Issuance of a Summons to the Company's Bank

The revenue officer wants copies of the business' bank signature cards and copies of its cancelled checks. Bank signature cards tell the revenue officer who had the ability to sign checks on behalf of the business. Cancelled checks let the IRS know who actually did sign the business checks.

There is a reason the IRS wants to know about check signing: Check signers are considered by the IRS to be individuals in control of company finances—in other words, decision-makers. Control over company finances is an element of proof for the IRS to tag individuals with the TFRP.

Sometimes, the bank signature cards and checks have a check signer who does not have control over the company finances, such as an accounting clerk. These duties likely were ministerial in nature, which is not enough for imposition of the trust fund recovery penalty. But the checks will make those individuals targets of a trust fund investigation, and a defense must be mounted to show the IRS that the checks are, in essence, a false positive indicator of liability, i.e., the check signing was delegated authority versus real control.

Step 6. IRS Letter 3586 Notifying the Presumed Decisionmakers That They Are under Investigation for the Trust Fund Recovery Penalty

Letter 3586 is short and to the point. It identifies the company with the payroll tax liability, states the payroll quarters that are owed, and that the individual is under civil investigation for the failure to pay trust fund taxes to the IRS. The letter is

often based on what the IRS learned from the bank records, i.e., who had signature authority, although more letters can be sent out to others as the IRS learns more as its investigation continues.

The letter will propose a date and time for an in-person interview with the revenue officer at IRS's office. The purpose of the interview is for the IRS to gather more facts as to who controlled company finances.

Step 7. Interview with the Investigating Revenue Officer

With an interview pending, it is important to determine if your client has a defense to the TFRP. If your client is clearly responsible for company finances (i.e., is an owner, officer, and check signer), then there may be no need to submit to the interview. Many revenue officers, if told that your client is in agreement to the trust fund, will cancel the interview and request that your client sign Form 2751 (Proposed Assessment of Trust Fund Recovery Penalty). This cuts short the investigation of an individual and allows the IRS to assess the TFRP and move that individual's case to the collection function.

If there is a trust fund penalty interview, here is a sample of the questions the revenue officer will likely ask:

- Who could review, sign, and authorize payroll?
- Who was capable of making financial decisions for the business?
- Who could direct or control the payment of bills?
- Who had knowledge that the payroll taxes were not being paid?
- Who was in charge of making federal tax deposits?

During the interview, the revenue officer will also question your client as to what he knows about others in the business; in other words, ask him to spill the beans. Expect your client to get questions like, "Besides

you, who else could authorize payroll or control bill payment?”

To conduct the interview, the revenue officer will use Form 4180 (Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes). If your client is submitting to the interview, review the 4180 with him in advance. Needless to say, it is extremely important to be prepared and educated on the IRS interview process in advance.

Step 8. Proposed Assessment of Trust Fund Recovery Penalty (IRS Letter 1153) and IRS Form 2751

If from the interview the revenue officer believes that your client had control and responsibility over the company's finances, she will send Letter 1153 (Proposed Assessment of Trust Fund Recovery Penalty), proposing personal liability for the taxes withheld from the employees. It is important to keep in mind that Letter 1153 is only a proposal of potential liability; it is not a final determination, and it is subject to administrative appeal within the IRS, as well as review by the U.S. District Court.

Keep in mind that when the revenue officer is investigating the TFRP, there likely will still be an unresolved collection case pending against the business. At this juncture, that case will either still be with the revenue officer or will have been transferred to Appeals from a CDP appeal.

Step 9. Filing of an Administrative Appeal Disputing the Proposed Assessment of the Trust Fund Recovery Penalty

If there is disagreement over the revenue officer's findings, IRS Letter 1153 provides a sixty-day right to file an administrative appeal. While the appeal is pending, remember that the liability remains proposed—nothing is on IRS's books and the result of the investigation is not yet considered final as to the individual.

Trust fund recovery penalty cases are usually fact intensive. You will need to

prepare for the appeals hearing, which often involves interviewing others in the business with first-hand knowledge of your client's lack of control over the business' financial decisions. Take the results of your interviews and draft supporting affidavits for signature by the business associates for submission to Appeals.

The IRS is not the end of the line in disputing the results of a TFRP investigation. If IRS administrative appeal is unsuccessful, further appeal to the U.S. District Court is available. A court filing can be made to the U.S. District Court to further dispute IRS's findings; this is commonly referred to as a “refund claim.” The U.S. Dept. of Justice will defend IRS's position in court.

Step 10. Prepare for IRS Collection of the Trust Fund Recovery Penalty from the Responsible Individuals

By now, hopefully the business has reached resolution with either the revenue officer or an IRS appeals officer on collection of the taxes directly from it, and the business either has an installment agreement in place or it has been placed in uncollectible status (IRS forbearance).

When the trust fund investigation concludes, and if there is personal liability, a new collection case will start against any individual who was responsible for handling the company's finances. This is Tier 3 collection of the trust fund taxes after assessment from the individuals.

Procedurally, in most trust fund cases the revenue officer has a case file for the collection of the taxes from the business and a resulting file for investigation of the trust fund penalty from the individuals. But most revenue officers, however, do not get a case file for collection of the trust fund penalty from an individual. After assessment of the TFRP, the case is usually routed back to the IRS collection queue for assignment to ACS or possibly back to a revenue officer.

If the trust fund taxes have not been paid by the time they are assessed against an individual, the same collection process the business went through starts for the individual. This means an IRS request for a personal financial statement (Form 433A) from the individual, as well as supporting personal records, such as personal bank statements, mortgage balances on personal residences, and balances in retirement accounts. And the individuals have the same rights to appeal a Final Notice of Intent to Levy in their personal trust fund collection case as the business did in its collection case.

Summary

An IRS employment tax investigation is likely to have multiple tiers of simultaneous enforcement, including collection of the liability from the business, investigation of the responsibility for the TFRP from the individuals, and then collection of any resulting trust fund assessments from the individuals.

To defend an employment tax case, it is necessary to have a clear understanding of each step the IRS will take and when it will take it. While most businesses can maintain their operations unaffected during an employment tax investigation, the failure to pay does implicate the individuals who operated the business, and the IRS will attempt to penalize them and drag their finances into the mix. **EA**

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