INTERNAL REVENUE SERVICE

IRS News Release

Media Relations Office | Washington, D.C. | Media Contact: 202.622.4000
www.IRS.gov/newsroom | Public Contact: 800.829.1040

IRS Warns Businesses, Individuals to Watch for Questionable Employment Tax Practices

IR-2004-47, April 5, 2004

WASHINGTON — The Internal Revenue Service issued a consumer alert today for eight schemes where federal employment taxes are not properly withheld or paid by employers from their employees' paychecks. The IRS alert to business owners and other taxpayers follows a string of recent convictions and court rulings involving employment tax schemes.

"Failure to pay employment taxes is stealing from the employees of the business," said IRS Commissioner Mark W. Everson. "The IRS pursues business owners who don't follow the law, and those who embrace these schemes face civil or criminal sanctions."

There are many reasons employers don't withhold or pay employment taxes. For some, it may be an attempt to use the government as a bank to 'borrow the money for a short while' with good intentions to pay it back later. For others, it may be a situation where an employer collects the taxes and elects to keep it during a period of financial difficulty rather than pay it to the IRS. For a small number, it involves philosophical differences with the tax law of the United States that courts consistently reject. Regardless of the reason, federal law requires employment tax withholding and payment by employers.

Employment taxes consist of federal income tax withholding along with Social Security and Medicare taxes and unemployment taxes. Also, many states have withholding requirements for various employment related taxes, such as contributions to a worker's compensation fund. Improper reporting or payment of employment taxes affects the ease with which employees can claim future benefits from these programs.

The IRS takes a variety of steps to combat employment tax non-compliance. The agency has a number of civil actions it can take like audits and filing tax liens against property the taxpayer owns. In addition to civil actions, IRS Criminal Investigation investigates and refers for prosecution individuals and businesses that have willfully attempted to avoid filing and paying employment taxes. These efforts have led to significant criminal convictions resulting in incarceration and fines.

— MORE —

During the past three years, 117 individuals have been sentenced to confinement in a federal prison, a halfway house or home detention for criminal violations related to employment taxes. Approximately 77 percent of the persons sentenced for evading employment taxes served an average of 17 months confinement and were ordered to make restitution to the government for the taxes evaded, plus interest and penalties.

Recent examples of employment tax prosecutions can be found at IRS.gov by typing “employment fraud” in the search box and clicking on “Significant Employment Tax Case Summaries.”

The IRS urges all businesses to resist the temptation to become involved in or victimized by unlawful activities. The eight most common types of employment tax non-compliance include:

1. **Pyramiding.** "Pyramiding" of employment taxes is a fraudulent practice where a business withholds taxes from its employees but intentionally fails to remit them to the IRS. An often cause is a lack of profit or capital for operating costs, so the business owner uses the trust funds to pay other liabilities. The quarterly employment tax liabilities accumulate (or “pyramid”) until the employer has little hope of catching up. Businesses involved in pyramiding frequently shut down or file for bankruptcy and then start a new business under a different name starting the cycle over.

2. **Unreliable Third Party Payers.** There are two primary categories of third party payers – Payroll Service Providers and Professional Employer Organizations. Payroll Service Providers typically perform services for employers such as filing employment tax returns and making employment tax payments. Professional Employer Organizations offer employee leasing meaning that they handle administrative, personnel, and payroll accounting functions for employees who have been leased to other companies that use their services. Many of these companies provide outstanding services to employers. Unfortunately, in some instances, companies of both types of services have failed to pay over to the IRS the collected employment taxes. When these employment service companies dissolve, millions in employment taxes can be left unpaid. Employers are urged to exercise due diligence in selecting and monitoring a third party payer. For example, when choosing a third party payer, employers should look for one that is reputable and uses the Electronic Federal Tax Payment System (EFTPS). This allows the business owner to verify payments made on their behalf. Also, an employer should never allow their address of record with the IRS be changed to that of the third party payer.

3. **Frivolous Arguments.** Unscrupulous individuals and promoters have used a variety of false or misleading arguments for not paying employment taxes. These schemes are based on an incorrect interpretation of “Section 861” and other parts of the tax law and have been refuted in court. One variation of this scheme involves the improper use of Form 941c, *Supporting Statement to Correct Information on Form 941,* to attempt to get a refund of previously paid employment taxes. Recent court cases have resulted in criminal convictions of promoters. Employer participants

— MORE —

could also be held responsible for back payments of employment taxes, plus penalties and interest.

4. **Offshore Employee Leasing.** This scheme, which was designated as a Listed Transaction by the Service in 2003, misuses the otherwise legal business practice of employee leasing. Under the typical promotion, an individual taxpayer supposedly resigns from his or her current employer or professional corporation and signs an employment contract with an offshore employee leasing company. The offshore company indirectly leases the individual's services back to the original employer using a domestic leasing company as an intermediary. The individual performs the same services before and after entering into the leasing arrangement. While the total amount paid for the individual's services stays the same or increases, most of the funds are sent offshore as "deferred" compensation. The "deferred" compensation is then paid to the individual as a "loan" or ends up in an account under the individual's control. Promoters of these arrangements improperly claim that neither employment taxes nor income taxes are owed on the "deferred" compensation. Because it is a Listed Transaction those who use the scheme are required to disclose their participation on current tax returns, and will be liable for the unpaid tax and subject to penalties and interest. Civil and criminal actions are being taken against promoters and participants in offshore leasing schemes – one promoter was convicted of defrauding the U.S. and sentenced to 70 months imprisonment, two other promoters have been ordered by the courts to stop marketing the scheme and a San Diego doctor plead guilty to tax evasion and is awaiting sentencing.

5. **Misclassifying worker status.** Sometimes employers incorrectly treat employees as independent contractors to avoid paying employment taxes. Generally if the payer has the right to control what work will be done and how it will be done, the worker is an employee. Employers who misclassify employees as independent contractors (and are not eligible for relief under Section 530 of the Revenue Act of 1978) will be liable for the employment taxes on wages paid to the misclassified worker and subject to penalties.

6. **Paying Employees in Cash.** Paying employees in whole or partially in cash is a common method of evading income and employment taxes. There is nothing wrong with compensating an employee in cash, but employment taxes are owed regardless of how the employees are paid. And the IRS will build its case using all available information even if there are no payroll records or checks.

7. **Filing False Payroll Tax Returns or Failing to File Payroll Tax Returns.** Preparing false payroll tax returns intentionally understating the amount of wages on which taxes are owed or failing to file employment tax returns are methods commonly used to evade employment taxes.

8. **S Corporation Officers Compensation Treated as Corporate Distributions.** In an effort to avoid employment taxes, some S Corporations are improperly treating officer compensation as a corporate distribution instead of wages or salary. By law, officers are employees of the corporation for employment tax purposes and compensation they receive for their services is subject to employment taxes.

The IRS encourages employees to report any concerns that an employer is failing to properly withhold and pay federal income and employment taxes. Taxpayers can contact the IRS at 1-800-829-1040 or report suspected tax fraud by calling 1-800-829-0433.

Employers must report employment taxes withheld from their employees on Form 941, *Employer's Quarterly Federal Tax Return*. Employers are also responsible for filing Form 940, *Employer's Annual Federal Unemployment Tax Return*. Payment of employment taxes must be made to an authorized bank or financial institution according to federal tax deposit requirements. Employers may also pay these taxes electronically. Information on how to file or pay employment taxes electronically is found at www.irs.gov/efile and www.eftps.gov.

—30—