The Criminalization of Payroll Tax Liabilities: Why This Harsh Direction?

By Terrence A. Grady

Terrence A. Grady examines payroll tax liabilities.

Introduction

Oftentimes, and particularly during the recent financial crisis years, businesses fall into financial distress, and business owners decide to temporarily, but illegally, "borrow" funds from the IRS by failing to pay over to the IRS the payroll taxes they withheld from their employees' wages. The more common scenario is that the business never had enough funds to withhold the taxes in the first instance. In most instances, this "borrowing" is for use of the funds in the business to attempt to keep the business afloat during this financial distress. As a result, while most businesses continue to timely file their quarterly payroll tax returns, these returns accurately reflect little or no deposits/payments being made toward the liability incurred as reflected on those returns. Unfortunately, this "borrowing" tends to continue through several quarters and perhaps into several years, during which time the business is attempting to get out of financial distress.

Unfortunately, it seems that once a business begins to illegally "borrow" these payroll taxes from the IRS, it seldom survives. Frankly, if these delinquencies span into several quarters and even years, in almost all cases, this should signal the ultimate and inevitable failure of the business. It is a tragic ending when a business and its owners have struggled through hard times and financial distress and end up losing the business along with being personally saddled with much of the debts of the business through personal guarantees. Adding to the tragedy, the owners are personally liable for the payroll taxes that have accrued as a result of an assessment of the Trust Fund Recovery Penalty. And adding insult to injury, this tragedy reaches another dimension altogether when the IRS decides to criminally prosecute these owners for willfully failing to pay over these taxes.

With regard to criminal prosecution, it seems that the IRS is now commonly referring to criminal investigation/prosecution garden variety type payroll tax debts that were previously solely and appropriately handled through numerous civil sanctions, mechanisms and procedures that exist to handle, punish and resolve delinquent payroll tax liabilities, including imposing personal liability. Code Sec. 7202 criminalizes and imposes punishment and sanctions against business persons for the willful failure to pay over payroll liabilities. This statute criminalizes the failure of "responsible persons" of a business—persons who have the responsibility and duty to collect and pay over to the government the payroll taxes withheld from the company's employees' wages—for "willfully" failing to pay over payroll taxes to the IRS.

Code Sec. 7202 has been on the books for a very long time. However, up until approximately five years or so ago, this statute was very rarely used, resulting in the IRS rarely prosecuting a business owner for failing to collect and/or pay over payroll taxes. For obvious reasons in terms of fair and uniform tax administration and enforcement, the IRS simply did not criminalize these liabilities. There were nearly always substantial collection efforts against the business that failed, and those efforts often included

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very substantial contacts with the business and its owners and substantial efforts to collect the payroll debt civilly. It was viewed that all of these contacts compromised the justification and fairness of then pursuing the case criminally. Recently, it seems that those concerns regarding whether the IRS adhered to its collection policies, rules and regulations and what contacts were made with the business and business owners have largely been ignored in some payroll tax investigations/prosecutions. These include the policies regarding the procedures and time to evaluate, make and pursue a criminal investigation/referral at the time that there are firm indications of fraud, or abandon that route and handle it civilly. Because of the substantial "tax loss" involved and the low prosecution standard, it seems like the IRS simply wishes to steam roll these prosecutions with little regard to whether the taxpayer's rights and expectations are infringed upon or whether this is in compliance with long-standing prosecution policies.

In addition to those criminal tax prosecution policies, a fundamental premise for the nation's tax system to function properly is that the IRS recognizes that some businesses will illegally "borrow" these payroll tax dollars from the IRS. It is inevitable. Thus, the IRS has mechanisms, procedures, policies and sanctions in place to harshly penalize this inevitable borrowing and force businesses to immediately pay over the employment taxes collected from their employees and stay in compliance.[1] The failure to timely deposit penalty regime is just once facet of this system and is designed to impose rather punitive penalties for failure to timely deposit and pay over the collected liabilities. These penalties can and do accumulate quickly and relentlessly on noncompliant taxpayers. Despite all of these civil-type sanctions, mechanisms and procedures, businesses continue to "borrow" these funds from the IRS. While some businesses are successful in repaying the amounts borrowed, the great majority of these situations result in the business incurring very substantial liabilities that will likely never be repaid.

The IRS also has the power of summonses, liens, levies, property and business property seizures, garnishments, civil injunctions, *etc.* Suffice it to say, the IRS has more power and more weapons for the collection of debts than any private creditor.

In addition to monetary-type penalty sanctions, because the IRS has no recourse against employees who have had income and Social Security taxes withheld from their wages (despite the legal form of the business), Code Sec. 6672 authorizes the IRS to collect taxes from individuals who were responsible for the company's failure to pay them.[2] That civil personal liability pursuant to Code Sec. 6672 is referred to as the Trust Fund Recovery Penalty (TFRP).

While the IRS works through its civil arsenal with businesses, it is very clear to the businesses and business owners that these contacts and collection of debt are a civil, versus a criminal, matter. Because of this, businesses and business owners generally fully cooperate with the IRS and provide the IRS with all types of information and documentation regarding the debt, specific reasons for why the debt was incurred, and the plans for repayment. In almost all instances, particularly if the business desires to continue its business operations, it behooves the taxpayer to fully cooperate with the IRS in providing information and documentation and formulating some repayment arrangement. This cooperation almost always includes the taxpayer agreeing to a TFRP interview to impose personal liability against the business owner and many times, a concession of this personal liability.

Furthermore, with today's technology, the IRS's civil arsenal should be able to do even more and monitor payroll accounts on at least a quarterly basis and promptly detect if a business has fallen out of compliance with its payroll tax filings, deposits, or payments. The IRS should then be able to assign a revenue officer who can visit the taxpayer to inquire into the cause and nature of the delinquency, and also impose requirements to get into current compliance or shut the business down. Thus, the IRS has at its disposal a vast arsenal of mechanisms, detection and sanctions against taxpayers who fail to strictly comply with these deposit and payment requirements.

In addition to civil remedies to curb and rectify the delinquent paying over of payroll liabilities, as noted above, the IRS also has at its disposal a criminal sanction, Code Sec. 7202. However, all of the civil collection procedures and policies in place to detect, collect and prevent further illegal borrowings of these payroll tax liabilities begs the question of why the IRS resorts to criminal prosecution and punishment at all with these payroll tax liabilities, and also whether the IRS should be able to criminally prosecute and punish individuals after so much civil contact?

Criminal Payroll Tax Prosecutions

The criminal sanctioning of delinquent payroll tax liabilities has enormous potential adverse ramifications on business owners targeted with this type of criminal investigation. First and foremost, Code Sec. 7202 has a very low threshold for holding a taxpayer criminally liable for the failure to pay over payroll taxes to the IRS. In fact, the Code Sec. 7202 criminal standard is exactly the same as the civil standard used to hold taxpayers personally liable for the payroll taxes *via* the trust fund recovery penalty under Code Sec. 6672.[3] The standard for both is that the government must show that the person is a person associated with the business with the ability to control and direct its finances, including the ability to decide which creditors are paid (so called "responsible persons"),[4] and that the taxpayer "willfully" failed to pay over the payroll taxes to the IRS.[5] A showing of willfulness in both the civil and criminal contexts simply means that the taxpayer was aware of the requirement to pay over the taxes collected but chose to pay other creditors, including continuing to pay net wages, instead of paying the IRS. Accordingly, the standard for a criminal conviction is the same as the standard for civil liability, and the criminal standard is about as low a standard as exists in the entire federal criminal law regime.

For this type of case to have criminal investigation/prosecution appeal, the payroll tax liabilities, and hence the resulting "tax loss" under the U.S. Sentencing Guidelines, is generally high. Due to the nature of the liabilities at issue, the tax loss can quickly accumulate to very high levels, with "tax loss" often easily exceeding the $200,000, $400,000 and higher guideline thresholds even with small businesses. These high "tax loss" levels most certainly expose the taxpayer to a possible lengthy incarceration sentence. And if convicted, there will be a very significant restitution judgment imposed. That will be very difficult for a defendant to deal with, making ultimate financial survival of a criminal prosecution almost impossible and extending the consequences of prosecution well into future years past incarceration. Thus, the criminalization of these payment delinquencies, including the referral, criminal investigation, and prosecution for incurring these liabilities is a very bad development for the taxpayer.

The IRS's initial policy in pursuing this criminal sanction against business owners related to this liability was only in the most egregious situations or when it was clear that the business had sufficient funds to pay the liabilities, but the funds were siphoned off and away from the business operations for other purposes.[6] However, in recent years, the IRS has seemingly veered off of that policy and now seems to consider prosecution based simply on the amount of the liability and/or the length of the delinquencies. In many cases, the amount of the liability seems to be the only factor considered in making a criminal referral with little or no review made of the extent of contacts with the Collection Division had with the taxpayer. Corresponding with this reality, a major frustration with Code Sec. 7202 prosecutions is that some of these prosecutions can be viewed as being initiated when the IRS finally concludes that it is not collecting the outstanding tax debt fast enough or it will never be able to fully collect the entire tax liability. In some instances, this decision is made many quarters or years after the IRS Collection Division became aware of the liabilities and became actively involved with the business in attempting to collect the liabilities. In some instances, the IRS Collection Division ignored IRS collection policies and allowed additional substantial quarterly liabilities to be incurred in light of substantial payroll tax debt initially owing in the first place.

So, if the IRS knowingly allowed these additional liabilities to accrue with an already noncompliant taxpayer, at what point should the IRS choose a direction for the handling of liabilities? And, if once a decision is made to proceed down the civil path, should the IRS then be precluded from subsequently making a criminal referral when it is clear that the taxpayer will not be able to pay the liabilities? This, of course, is not fair and equal tax administration and enforcement or sound criminal prosecution policies. Simply put, the frustration and/or inability to collect the debt is not an appropriate basis to prosecute the business owner. Nor is it fair and equitable for the IRS to be on the scene watching and allowing liabilities to accrue, far after a firm indication of fraud exists under the Code Sec. 7202 standard, only to change course midstream and turn the civil matter into a criminal matter.

Given the severe consequences, in trying to assist a taxpayer avoid or mitigate the severe consequences of a criminal investigation/prosecution, counsel must fully examine the origin of the liability, as well as the amount and type of contacts the IRS Collection Division had with the taxpayer's company and the "responsible persons" as these liabilities were being accrued. The IRS has developed policies regarding making timely decisions on whether to handle a tax investigation civilly or criminally and how to proceed once a decision has been made. None of these policies allow the IRS to continue with civil efforts once a criminal tax referral has been made or to continue handling a matter civilly when it is clearly aware that there are firm indications of fraud that exist, unless the case will remain forever civil. Accordingly, it is crucial to be cognizant of what procedures the IRS is supposed to follow and determine what actions the IRS took. This is helpful to attempt to dissuade the IRS from moving forward with prosecution, and examining the policies in place again begs the question of why the IRS resorts to criminal prosecution and punishment at all in these cases.

Therefore, in a situation where a business timely filed its payroll tax returns but did not remit payment and has run up a substantial payroll tax liability over a period of years and the IRS is aware of these delinquencies and even on the scene and attempting to collect the liabilities, and somewhere along the line the IRS decided to make a criminal referral and prosecution over this liability, certain questions and procedures must be explored. Counsel should thoroughly examine when the criminal referral determination was made and determine whether the IRS, particularly the Collection Division, adhered to its policies and procedures in attempting to collect the liability in the first instance and when should the IRS have determined that firm indications of fraud were present. With Code Sec. 7202 prosecutions, a firm indication of fraud determination can be readily made. At that point, if the IRS Collection Division is actively monitoring and collecting the liabilities and working with the business and the owners, if a criminal referral is to be made, it should be made then or not pursued at all. It is fundamentally unfair to continue down the civil path, regardless of the existence of express misrepresentations being made or not made to the taxpayer regarding the precise nature of the investigation during that time, and at some subsequent date decide to make a criminal referral if the collection actions are not fruitful. Among the questions that must be asked are the following:

- When did the IRS first become aware of the payroll tax liabilities (suffice it to say that if timely filed Forms 941 quarterly returns are filed reflecting no deposits/payments but a liability, the IRS is aware of the liability at that point)?
- How long did the business continue filing quarterly payroll returns despite not making any tax deposits/payments?
- What actions did the IRS Collection Division take during the time the liability was accruing?
- Was a revenue officer assigned the collection of the liability?
- Did the IRS Collection Division/Revenue Officer identify, investigate, and then impose the Trust Fund Recovery Penalty on "responsible persons" associated with the business?
- Did the taxpayer cooperate with the Collection Division and to what degree and what were the taxpayer's reasonable expectations related to that cooperation?
- When did the IRS Collection Division make the criminal referral?
- When did the Collection Division and Civil Division develop a firm indication of fraud versus a first indication of fraud? Should a firm indication of fraud determination have been made earlier?

Again, these questions are important because Counsel must determine what steps the IRS took in attempting to collect the liability and ultimately when the determination was made that a firm indication of fraud exists. Because the prosecution standard is so low, understanding IRS procedures and determining if the IRS followed its procedures is crucial to having any chance to present any arguments that the criminal prosecution is unwarranted, unconstitutional and unjust. Further, understanding these procedures also illuminates that a criminal investigation/prosecution under Code Sec. 7202 is completely and utterly unwarranted and unjust in many cases. The procedures the IRS must follow, and what the practitioner should do when in the midst of a Code Sec. 7202 case, are explored below.

IRS Procedure

When collecting a payroll tax debt and when potentially making the case a criminal matter, the IRS is bound by the Constitution and has specific internal policies to follow. The Constitutional concerns are highlighted in *N.J. Tweel*[7] and its progeny,[8] and also to a certain extent in the INTERNAL REVENUE MANUAL (IRM). The IRM also sets the collection procedures and protocols the IRS is supposed to follow. After reviewing all of these materials the question of whether Code Sec. 7202 is viable in most cases comes into distinct focus.

Tweel Issues

Tweel sets forth the general guideline that the IRS cannot conduct a criminal tax investigation under the auspices of a civil tax audit/investigation. The principles that have developed from this general mandate over the years that the IRS is supposed to adhere to related to how a matter must be handled if a civil IRS employee comes across some indicia of fraud. If the employee uncovers indicia of fraud, the policy provides that the IRS employee can continue the civil audit, so long as the indicium of fraud is a *first* indication of fraud.[9] Essentially, when faced with a first indication of fraud, the civil employee may further investigate and develop the case to see if there was in fact fraudulent activity.

However, once the civil employee determines there is a *firm* indication of fraud, per the policy, the examiner is required to make a criminal referral at that time, if one is to be made at all, or forego a criminal referral and continue to handle the matter civilly. If a criminal referral is made, the civil activity is terminated, and the IRS then handles the matter from a criminal perspective only. However, if there is a firm indication of fraud and the employee decides to continue the civil process, then the fraud must be handled solely from a civil standpoint, and a criminal referral can no longer be made.[10]

Further, it is important to reiterate that the key determination must be made once there is a firm indication of fraud. That is when the civil versus criminal decision must be made. Once a firm indication of fraud is present, the matter must either be referred criminally, or proceed civilly with a criminal referral no longer being appropriate. Accordingly, if the first indication of fraud is also a firm indication of fraud, the decision must be made at that time.

Additionally, there is now a Fraud Technical Advisor position within the IRS who is supposedly a civil division agent versus being directly associated with the Criminal Investigation Division. In these payroll tax cases, this is seemingly designed to allow the Collection Division to consult with the FTA about possible fraud implications without crossing the policy line of being directed in its collection efforts/investigation by a CID agent. This position is arguably a sheep in wolf's clothing, being merely an attempt to disguise an IRS criminal agent as an IRS civil agent. In these Code Sec. 7202 cases, an examination of the collection contacts will now generally reflect that this FTA is being consulted early on regarding the existence of fraud and being contacted many, many months, and sometimes years before a final determination is made that a firm indication of fraud exists and the case is referred for criminal prosecution. This procedure tends to cloud the issue and decision making of whether a firm indication of fraud exists or not. Interestingly, and justifiably so, the firm indication of fraud remains paramount, even with the introduction of the Fraud Technical Advisor.[11] Due to the Code Sec. 7202 standard, the appearance of a firm indication of fraud absolutely signals the time for the key determination of civil versus criminal in a payroll tax case, even with the creation of Fraud Technical Advisors. Since the standards to impose civil liability and criminal liability are the same and are very, very low, this determination of whether there is a firm indication of fraud should be quite simple: did the responsible person know of his obligation to pay over the payroll taxes to the IRS, and did that individual willfully fail to pay the taxes over. This is usually demonstrated by a showing that the person preferred and directed payment to other creditors, which includes continuing to pay net wages, instead of paying over the taxes to the IRS. Simply put, if there are quarters of liabilities with little or no payments, this standard exists.

So, what more is there to determine regarding a firm indication of fraud under this standard? The Revenue Officer is not to be the criminal investigator. All the Revenue Officer and Collection Division should be doing is determining if there is a firm indication of fraud or not and then determining if it wishes to handle the matter civilly or criminally. If a criminal referral is not made at that point but made quarters or even years later when collection efforts fail and additional liabilities have been incurred, a criminal investigation/prosecution at that point should be foreclosed.

These first and firm indication of fraud principles were put in place for fundamental fairness in the treatment of taxpayers and the administration of the tax system, and to protect the constitutional rights of taxpayers. A taxpayer should not be led to believe that a matter is being handled purely from a civil liability standpoint and fully cooperate with the IRS, only to have the IRS turn around and use the totality of that cooperation against the taxpayer by then pulling out a big club and criminally prosecuting the taxpayer for that conduct. Accordingly, the IRS has drawn a line in the sand at the firm indication of fraud point, deciding that it is at that time that the IRS must decide which direction it takes a case. Once a firm indication of fraud is present, a criminal referral is possible, so civil investigation and collection of information beyond that point that is later used against the taxpayer criminally amounts to conducting a criminal investigation under the auspices of a civil audit. That is a violation of taxpayers' Fourth Amendment rights.[12]

Accordingly, the presence of first and firm indicators of fraud is crucial in a Code Sec. 7202 case. As soon as a firm indication of fraud is present, the IRS must make a decision whether to keep the case civil, or refer it as a criminal matter. That point in time is crucial, because if there is a firm indication of fraud and no criminal referral is made (*i.e.,* the civil investigation continues), that can amount to a misrepresentation to the taxpayer that the investigation is not going to turn criminal. This is because astute practitioners know and understand the IRS policies and expect that the IRS follows its own policies. And if the investigation continues civilly past the firm indication of fraud, only to turn criminal later, there are good arguments to put forth that there was a criminal investigation done under the auspices of a civil audit. As noted above, per *Tweel* and its progeny, such an investigation is a violation of taxpayer's Fourth Amendment rights. Therefore, practitioners should be keenly aware of firm indications of fraud, if and when they arise, and what actions the IRS takes after the firm indicators arise.

Accordingly, in many Code Sec. 7202 cases, it will be discovered that civil actions were continually taken well past a firm indication of fraud, with the IRS continuing its civil investigation and enforcement, complete with extensive contacts, beyond the time their own policies dictate that it should have ceased and stopped. *Tweel* and IRS policy dictate that when those civil contacts continue past the firm indication of fraud, a criminal case is no longer a justified option. If this mandate is not followed, *i.e.,* to come in with a criminal case after-the-fact, it is an infringement on the taxpayers' rights. And that infringement appears to now be happening with regularity, as Code Sec. 7202 cases seem to spring out of civil collections cases with unprecedented regularity, including springing out of civil collections cases that have immediate and undeniable firm indications of fraud, such as cases of pyramiding the liabilities and cases of taxpayers who have started and stopped numerous businesses with payroll liabilities. When faced with such a case, the constitutional rights of the taxpayer must be vigorously defended by arguing *Tweel* and the total disregard of IRS policy.

IRS Collection Division Policies

In addition to *Tweel* and the related IRM sections discussing first and firm indicators of fraud, the IRM is replete with sections pertaining to proper IRS collection methods.[13] For this reason, and as noted above, counsel needs to thoroughly review the collection history and contacts to review how the IRS handled the payroll liabilities to determine if the IRS might have violated any of its own internal guidelines for how the Collection Agent should have handled this matter. This is crucial, because as noted with respect to *Tweel*, when the IRS does not follow its own policies, the IRS could be making misrepresentations as to the true nature of the investigation that is ongoing. That could possibly amount to a violation of the taxpayer's constitutional rights. Further, the IRS not following its own internal policies can lessen the prosecution appeal of cases. And in addition, a thorough review of IRS collections policy leads to the conclusion that the place for Code Sec. 7202 is a small, narrow band of cases—this is likely the reason why up until recently Code Sec. 7202 was a rarely used device, as the current emphasis on Code Sec. 7202 is entirely unprecedented.

What is too often seen is a Revenue Officer coming on to the scene and attempting to collect large liabilities through levies, all the while allowing the taxpayer business to accrue more liabilities. This is simply not efficient or effective tax administration, and this is contrary to IRS collection procedures and positions.[14] If the IRS follows its procedures, particularly when a Collection Agent is on the scene handling the account and seeing the liabilities arise in the face of levies and pyramiding, the IRS should issue an injunction, seize assets, and put the business out of business. If these IRS collection policies and procedures are not followed, but it is ultimately decided that a criminal referral and investigation/prosecution be initiated, the taxpayer pays a high price of those errors. That is unjust and detrimental to the select taxpayers who do not receive the standardized and approved procedure.

The point here is that when IRS policies are not followed by IRS employees, liabilities can essentially arise with the IRS's approval, as the Revenue Officer is often on the scene watching the liabilities arise without taking any measure more drastic than a levy. For the IRS to later come in with allegations of criminal liability quarters or even years later amounts to unjust treatment of select taxpayers and the violation of their rights. In many instances, the collection division handling shows that had the IRS followed its standard procedures, the business owner would likely not be facing such large liabilities (or an attendant criminal tax prosecution due to the size of the liabilities). Such situations where policies are not followed amount to taxpayers being punished for activity which would have been stopped had the IRS followed its dictated and mandated procedures. Instead, the IRS now often watches the liabilities rise without taking collection measures beyond levying and then prosecutes the taxpayer for those liabilities. That is against IRS policy, and the IRM and creates a misrepresentation as to what type of investigation is and will be occurring. And further, it is fundamentally unfair and unjust for the IRS to disregard its own policies and watch huge liabilities arise, then later come in and say despite the fact that they should have taken harsher civil action earlier but did not do so, criminal prosecution is now the answer.

IRS collections policies are important because at some point, the government has to help its citizens help themselves. We see this every day with laws requiring seatbelts and helmets and laws banning smoking in certain places. IRS Collections procedures act in the same way. When pyramiding or continued noncompliance is an issue, the procedures are in place to stop the non-compliance and get the taxpayer compliant. Taxpayers need those paternalistic regulations, and if they are not appropriately followed, they will only allow the business owner to go further down the path of noncompliance. Effectively, the taxpayer intends to pay the liabilities in full regardless, but ends up in a worse situation because regulations were not followed correctly as to that specific taxpayer, regulations which would have cut off the liability oftentimes ages ago and severely lessened the amount owed. This seemingly harsh determination to put the business out of business unless the business stays in current compliance must be made to help the taxpayer help himself. This is particularly important as too often it now seems that Code Sec. 7202 referrals are based on dollar amounts and failed collection efforts. There seems something inherently unjust about allowing liabilities to accrue in the face of IRS policies and regulations which should act to cut the liabilities off and then criminally prosecuting a person for those liabilities which should have been cut off.

For all of the reasons noted, the rise in use of Code Sec. 7202 in some of these fact patterns with substantial Collection Division involvement after collection methods have failed or been generally unsuccessful is disturbing. Policies are in place to either turn the case criminal from the beginning (since firm indications of fraud are generally present from day one in these cases) or rectify the situation civilly. The use of Code Sec. 7202 after civil collection has failed is almost always against IRS policy, raises serious questions about infringing taxpayers' constitutional rights, and should be more closely examined by the IRS. Simply finally getting perturbed with taxpayers after collection efforts have failed or due to extremely high liabilities does not justify criminal prosecution. Therefore, cases that justify use of Code Sec. 7202 should be far fewer than what current IRS prosecution activity suggests.

FOIA Request and Records

In order to perform the investigation required to discover exactly what steps the IRS has taken in a Code Sec. 7202 case, the very first step should be to obtain all records/documents from the IRS related to its collection efforts/contacts with the business and business owners. These records are the only way practitioners are able to verify and check the procedures followed (and not followed) by the IRS, all in an effort to determine if there is any constitutional or procedural hurdle the IRS cannot overcome in bringing a potential §7202 action, and also to see if there is any information to present to the IRS and Department of Justice to dissuade them from seeking prosecution.

Gathering the necessary records is done via a Freedom of Information Act (FOIA) request.[15] In most instances, in recognition that there is a criminal investigation, the IRS disclosure office takes liberty in redacting or withholding documents/information on the basis of various FOIA exemptions. The most notable of these is FOIA exemption (b)(7) (the "law enforcement" exemption).[16] Because a thorough review of these records is essential, and because administratively appealing the IRS's FOIA determination is sometimes futile, counsel must generally initiate litigation against the IRS to attempt to obtain all of the necessary records. In fact, litigation is generally the only fruitful way to challenge the claimed FOIA exemptions and receive all of the IRS collection records. Important in this regard is the recognition that the records being requested were developed prior to any criminal referral or investigation. Therefore, for the most part, there should not be any applicable exemptions supporting the failure to completely produce and turn over all of the pertinent collection records. Regardless, the IRS Disclosure Office, in recognition of an active criminal case, will likely assert the law enforcement and other exemptions. Thus, in an effort to obtain all of these records, a FOIA civil suit must generally be filed. At that point, you then obtain a more objective review that generally ends with counsel receiving the necessary IRS collections records, perhaps less a minimal amount of items that likely do qualify for the law enforcement exemption and are not worth fighting over in a litigation setting. Once these documents are obtained, the necessary review of IRS collection actions can be undertaken.

Conclusion

Once a payroll tax payment delinquency is detected, the IRS should send out a Collection Agent to determine the problem, monitor the delinquencies and determine if this business can continue or not. It is a clear policy that continuing to incur additional payroll tax liabilities in the face of already existing substantial payroll tax liabilities is unacceptable to the IRS. If a business cannot get and stay current when having already incurred very substantial payroll tax liabilities, the IRS should make and enforce the hard but appropriate decision to close the business or otherwise force the company to become current with its obligations. Following that policy is simply fair and effective tax administration. Instead, though—as seen in increasing instances—the IRS is content with allowing Revenue Officers to work cases for quarters and even years, in the face of pyramiding and other firm indications of fraud, and then decide to criminally prosecute taxpayers under Code Sec. 7202. The IRS now appears to have no problem with having an employee on the scene watching enormous liabilities arise, gathering admissions and confidential documents, and also gathering the taxpayer's defenses to civil allegations of being a "responsible person" and "willful," and then prosecuting the taxpayer under the same exact standard criminally, where the same defenses will be put forth by the taxpayer. There is something fundamentally unjust about the IRS allowing taxpayer's to dig their own grave, including inducing the taxpayer to divulge all of their defenses and run up an even larger tax liability, and then pushing the taxpayer into the grave. Code Sec. 7202 was not used like this in the past, and the current use should only be used with careful discretion.

Business owners "borrow" payroll taxes when the business of their dreams begins to suffer financial distress. The IRS should be able to quickly detect these illegal practices before the ensuing liabilities morph into an unmanageable debt that will never be paid. The business will likely close and the owners will be personally liable. This type of financial distress is severe and can take years to recover from, if at all.

So, in recognition that the IRS Collection Division can detect and control this payroll debt, does the IRS need to move forward and prosecute and incarcerate these business owners? With all of these civil procedures and policies in place to handle these payroll tax liabilities, why is criminal prosecution and incarceration being pursued over these debts? Why this harsh direction?

Endnotes

1 Code Secs. 3102 and 3402 require employers to withhold federal Social Security and income tax from their employees' wages. The taxes withheld from each employees' wages constitute a special fund held in trust for the benefit of the United States under 26 U.S.C. §7501. *I. Slodov,* SCt, 78-1 USTC ¶9447, 436 US 238, 98 SCt 1778; *A. Fiataruolo,* CA-2, 93-2 USTC ¶50,627, 8 F3d 930, 938.

2 *Slodov, supra* note 1; *R.W. Monday,* CA-7, 73-2 USTC ¶9589, 421 F2d 1210; *R.L. Gephart,* CA-6, 87-1 USTC ¶9319, 818 F2d 469; *G. Rem,* CA-2, 94-2 USTC ¶50,537, 38 F3d 634.

3 Code Sec. 6672 provides:

> Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.

Code Sec. 7202 provides:

> Any person required under this title to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall be guilty of a felony.

As is clearly demonstrated, the similarities are striking. An individual may be personally liable for unpaid taxes pursuant to §6672 if two requirements are met. The individual must be a "responsible person" for collection and payment of the employer's trust fund withholding taxes, and also must have "willfully" failed to pay over to the government the amount due. *Gephart, supra* note 2; *A. Hochstein,* CA-2, 90-1 USTC ¶50,205, 900 F2d 543, 546. Similarly, for a Code Sec. 7202 conviction, an individual must be a "responsible person" with respect to the collection and accounting for of the payroll tax liabilities, and must have "willfully" failed to collect or truthfully account for and pay over the payroll taxes to the government. *W.C. Crabbe,* CA-10, 2010-1 USTC ¶50,197, 364 FedAppx 412, 419–20. Therefore, the standards under both Code Secs. 6672 and 7202 are the same.

4 A "responsible person" is any person required to collect, truthfully account for, and pay over the relevant tax. With respect to this element, "courts generally take a broad view of who qualifies as a responsible person." *Rem, supra* note 2, 38 F3d, at 642; *J.O. Denbo,* CA-10, 93-1 USTC ¶50,177, 988 F2d 1029, 1032; *R.D. Barnett,* CA-5, 93-1 USTC ¶50,269, 988 F2d 1449, 1454. In determining whether an individual is a responsible person, the court looks generally to his degree of influence or control over the company's finances. *See Hochstein, supra* note 3, 900 F2d, at 547; *Crabbe, supra* note 3, 364 FedAppx, at 419–20. Individuals who have a significant degree of control are considered responsible. This definition is meant

ENDNOTES

to encompass "all of those connected closely enough with the business to prevent the [tax] default from occurring." *Fiataruolo, supra* note 1, 8 F3d, at 939. Such determination of responsibility is based upon the individual's "status, duty and authority" to ensure compliance with the employer's tax withholding obligations. *L. Raba,* CA-5, 93-1 USTC ¶50,039, 977 F2d 941, 943. The core question "is whether the individual has *significant control* over the enterprise's finances." *Hochstein, supra* note 3, 900 F2d, at 547. Even if an individual's day-to-day function in a given enterprise is unconnected to financial decision-making or tax matters, he is still responsible as long as he has the authority to pay or to order the payment of delinquent taxes. *Fiataruolo, supra* note 1, 8 F3d, at 930; *Crabbe, supra* note 3, 364 FedAppx, at 419–20. *citing D.P. Taylor,* CA-10, 95-2 USTC ¶50,578, 69 F3d 411, 416. The courts recognize that casting a wide net of responsibility under Code Sec. 6672 serves the important purpose of encouraging all of those with authority to stay abreast of a Company's tax withholding and payment obligations. *See Barnett, supra,* 988 F2d, at 1456–57.

5 "Willfulness" amounts to a "voluntary, conscious and intentional decision to prefer other creditors over the Government." *Denbo, supra* note 4, 988 F2d, at 1033. Willfulness does not require proof of any motive (*i.e.,* evil or bad motive) other than an intentional violation of a known legal duty, nor does it require any specific intent to defraud the government. *P. Pomponio,* SCt, 76-2 USTC ¶9695, 429 US 10, 97 SCt 22, Syllabus, 12; *J.S. Burden,* CA-10, 73-2 USTC ¶9547, 486 F2d 302, 304; *J.N. Bowen,* CA-5, 88-1 USTC ¶9164, 836 F2d 965, 967–68. A person willfully fails to pay withholding taxes when other creditors are paid with knowledge that withholding taxes are due. Willfulness is established by a responsible person's use of funds or knowledge of the use of funds for payments to other creditors after the responsible is aware of the failure to pay the withholding tax. *Hochstein, supra* note 3, 900 F2d, at 548, *R.J. Kalb,* CA-2, 74-2 USTC ¶9760, 505 F2d 506; *D.L. Bowlen,* CA-7, 92-1 USTC ¶50,098, 956 F2d 723.

6 Examples of these would be the operation of an employee leasing company where the taxpayer business receives gross wage payments plus a profit percentage from its clients but simply ignores turning these funds over to the IRS and the owners abscond with all of the tax dollars. Another instance might be for business owners who start one company after another and never pay over the payroll tax dollars.

7 *N.J. Tweel,* CA-5, 77-1 USTC ¶9330, 550 F2d 297.

8 *See D.M. Grunewald,* CA-8, 93-1 USTC ¶50,122, 987 F2d 531; *F.L. Peters,* CA-7, 98-2 USTC ¶50,650, 153 F3d 445; *J. Rutherford,* CA-6, 2009-1 USTC ¶50,202, 555 F3d 190.

9 IRM Section 25.1.2.2 (Oct. 30, 2009); IRM Section 25.1.3.1 (Oct. 30, 2009); IRM Section 25.1.2.7 (Jan. 11, 2013).

10 IRM Section 25.1.3.2 (Dec. 27, 2011); IRM Section 25.1.2.2 (Oct. 30, 2009); *Grunewald, supra* note 8; *Peters, supra* note 8.

11 IRM Section 25.1.3.1 (Oct. 30, 2009); IRM Section 25.1.2.7 (Jan. 11, 2013).

12 *See Tweel, supra* note 7; *Grunewald, supra* note 8; *Peters, supra* note 8; *Rutherford, supra* note 8.

13 *See* IRM Section 5.7 (varied enactment dates).

14 These selected IRM Sections show some of the proper collections procedures which are often not followed in payroll tax cases:

IRM Section 5.7.8 (May 7, 2012) refers to in-business repeater or pyramiding taxpayers. The IRM notes that the IRS needs to properly identify repeater and pyramiding taxpayers and take appropriate action to bring them into compliance. The Manual further notes that when determining the appropriate course of action to resolve pyramiding accounts, weight must be given to the fact that efforts and attempts to educate the taxpayer on maintaining compliance have not resulted in continuous compliance. Accordingly, it is clear that appropriate action must be taken to bring the taxpayer into compliance, and that after efforts have been made to educate the taxpayer, appropriate actions must be taken to achieve continuous compliance.

The IRM in Section 5.7.8.4 (May 7, 2012)—Working Repeater Trust Fund Taxpayers to Address Pyramiding, notes that the Revenue Officer should get the taxpayer current with federal tax deposits from the date of first contact. The Revenue Officer should monitor compliance with federal tax deposits and verify that the deposits are being made and are accurate. That same section provides that pyramiding must be stopped immediately and that the Revenue Officer should advise the taxpayer that enforcement action will be taken if proof of compliance is not provided while the delinquency is being resolved. Further, when a taxpayer does continue to pyramid, all appropriate remedies should be used to ensure compliance and stop pyramiding. The IRM further provides that when routine actions have not been effective to stop pyramiding, alternative solutions including seizure, injunction, and pursuit of the TFRP must be used.

IRM Section 5.7.8.4 notes that installment agreements are not to be used with taxpayers who continue to accrue tax liabilities and are not in compliance. Similarly, IRM Section 5.7.8.4.3 (May 7, 2012)—Offer in Compromise, notes that Offers in Compromise are only considered when federal tax deposits are timely. These sections effectively rule out an installment agreement and an offer in compromise as a potential collection tool when compliance is lacking. Accordingly, other arrangements besides installment agreements or offers in compromise would have to be looked at to ensure compliance.

IRM Section 5.7.8.4.1 (May 7, 2012)—Seizure and Sale of Repeater Taxpayers Assets, notes that if additional trust fund liabilities accrue after contact with the taxpayer, a seizure should be made if the seizure is the most appropriate action after conducting a risk analysis.

Section 5.7.8.4.1 of the IRM also notes that taxpayers who continue to pyramid are considered "won't pay" taxpayers. Under IRM Section 5.10.1.6 (July 3, 2009), "won't pay" taxpayers should be considered for seizure of assets.

IRM Section 5.17.4.17 (Aug. 1, 2010)—Civil Injunctions Under I.R.C. §7402(a) to Restrain Pyramiding, notes that injunctions may be appropriate against employers and other responsible parties who have a history of pyramiding and continue to do so. Section 5.17.4.17.2 notes that the government has pursued preliminary injunctions against taxpayers who remain in business, in order to prevent them from failing to pay future trust fund taxes or transferring or assigning property or funds until the trust fund liabilities are satisfied. In addition, the IRS has further sought authorization to seize assets or property if the injunctions are violated. This amounts to the closing of the business.

15 *See* Freedom of Information Act, 5 U.S.C. §552; 26 C.F.R. §601.702.

16 5 U.S.C. §552(b)(7).