

# CRIMINAL INVESTIGATIONS INCREASE AS DOJ STEPS UP EMPLOYMENT TAX ENFORCEMENT

*Business Litigation Alert*  
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**Practices & Industries**

Tax Investigations & Defense

The Department of Justice Tax Division announced recently that one of its top enforcement priorities is employment tax fraud and abuse. While local U.S. attorneys and the Tax Division have in the past occasionally prosecuted employment tax evasion cases, the bulk of the government's resources are spent on more traditional enforcement efforts involving corporate and personal income tax evasion. These cases generally result from IRS audit efforts where taxpayer fraud is identified. The matter is then referred to the Criminal Investigation Division of the IRS for further investigation and ultimately for presentment to the U.S. attorney for prosecution.

Growing budget deficits, the economic downturn, and global financial pressures have caused the Department of Justice and the IRS to look for ways to close the "tax gap" resulting from the failure of the government to collect taxes that should have been collected under current law but were not. In 2001, approximately 17 percent of the estimated \$345 billion-per-year tax gap was attributed to employment tax under-reporting and fraud. Recent estimates place the tax gap at \$500 billion which, assuming the 17 percent figure is correct, means there is \$75 billion in under-paid employment taxes every year. Clearly, the government has identified an area ripe for prosecution and recovery.

Pressure from the U.S. Senate came last July, when a number of Senate subcommittees vigorously urged the IRS to redouble its efforts against tax cheats and, in particular, to consider criminal prosecution of repeat employment tax offenders or where employment tax evasion and fraud is clearly intentional, widespread, and involves substantial amounts of money. Accordingly, the announcement by the Criminal Tax Division came as no surprise, and the government has already started to more vigorously investigate and prosecute employment tax offenders.

Employment tax withholding is a key component of our voluntary compliance tax system. Each employer is required to pay the employee's share of social security and Medicare, as well as to withhold from an employee's pay the income tax owed by the employee. These funds are supposed to be collected and paid to the government on a regular basis. Oftentimes, especially in an economic crunch, employers are tempted to "tap" these funds rather than pay them over directly. It is expected that the

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government will now view this type of mishandling of funds as a criminal violation in certain cases, and will likely pursue parallel civil and criminal remedies including the filing of tax liens and a prosecution of not only the entity, but also all responsible officers and employees.

It is expected that the government will also look very closely at a systematic treatment of workers as “independent contractors” as opposed to employees. No withholding is required when a worker is legitimately an “independent contractor.” The government has identified “misclassification” as a prime source of fraud and plans to investigate independent contractor cases vigorously and thoroughly. Similar schemes involving payments to employees in cash, partial cash payments, or other “off the books” schemes will likely also be carefully investigated and vigorously prosecuted.

The government has a variety of charges available to it, all classified as felonies, and all contemplating possible jail sentences. Employment tax fraud can be prosecuted as a simple tax evasion, as a filing of a false return, or the willful failure to collect or pay over employment taxes. The government has also been known to interpose a conspiracy charge in tax cases, which enables it to join multiple defendants in a single case under a common scheme or pattern. This gives the government a significant investigatory and evidentiary advantage and also allows it to solicit the cooperation of co-conspirators in exchange for leniency.

In fiscal year 2006, the government initiated only 47 criminal investigations regarding employment taxes. That number jumped to more than 160 investigations in fiscal years 2007 and 2008. The lesson is clear: what used to be handled civilly by the IRS is now being aggressively prosecuted. The 80 percent incarceration rate for tax evaders with an average period of incarceration of 19 months in fiscal year 2006 grew to 29 months in fiscal year 2009. This points to an increased intolerance toward tax evaders by the judiciary.

It is highly recommended that business entities carefully review their employment tax policies and procedures, especially independent contractor agreements. In addition, employment tax audits by the IRS need to be approached much differently than before. Simply, a relaxed and informal employment tax audit now carries the real potential of turning into a criminal investigation when before, a civil resolution was the norm. Careful advanced audit planning, consultation with competent tax counsel, and a solid understanding of employment tax obligations and internal policies is an absolute requirement when faced with an audit. And responsible employees need to be informed and counseled prior to participating in any audit discussions.

Employment tax enforcement has typically been viewed to be a civil matter and not much cause for concern. Violations were handled in a civil forum, and without the risk of any criminal sanctions or penalties. Personal and corporate income tax evasion was the government’s focus. This presumption is now misplaced, and corporate and business entities must now view their employment tax obligations to be ripe for review by the Government and the subject of possible criminal sanctions, unlike in the past.