Payroll service providers give many small companies a good way to pay and report payroll taxes. For many small companies this relatively specialized task does not justify a dedicated employee. The task of having someone do it part time and do it right presents a challenge to many small businesses. Consequently, it is a logical business function to outsource. Payroll service providers administer payroll and employment taxes taking care of all of the reporting, collecting, and depositing of employment taxes with state and federal authorities. The payroll service provider, by specializing in this function, provides the necessary expertise to properly file the forms, manage the time frames and keep up with changing laws and regulations. The business model leading to the creation of payroll service providers offers a good example of how certain business functions can best be performed by an outside vendor specializing in that function rather than the company with the “regular” business. When done well it saves the business owner significant headaches in an area requiring compliance with very technical rules under time sensitive deadlines.

Examples of the type of services handled by a payroll service provider include preparing the paychecks for all of the employees of the business; preparing and filing Forms 940 and 941 for the employer using the business’s EIN; preparing Form W-3 and Forms W-2 for the employees of the business using the business’s EIN. Typically, the payroll service provider will have access to the business bank account from which it can withdraw the money necessary to make payroll and tax payments (and to pay itself.) This type of access requires a high level of trust in the payroll service provider by the business and should require at least a minimal amount of oversight by the business; however, the type of oversight needed is exactly the type of expertise that the company lacks when it sets out to hire a payroll service provider.

Most payroll service providers do exactly what they are hired to do; however, over the past couple of decades a number of stories have come out demonstrating that a business owner cannot simply turn this function over to a payroll service provider and pay no attention. The people who run payroll service providers have the same ability to breach the trust of the businesses with whom they contract as a rouge employee in the business’s accounting department who seeks to embezzle from the business. The difference is the scale upon which the payroll service provider operates since it has access to the funds of hundreds or thousands of businesses. A fraudulent payroll service provider creates a huge problem for many businesses when it starts

SEEKING RELIEF WHEN A PAYROLL PROVIDER VICTIMIZES YOUR CLIENT

PROFESSOR KEITH FOGG directs the Federal Tax Clinic at the Legal Services Center at Harvard Law School where he is a clinical professor of law. He joined the Villanova Law School faculty in 2007 after working for over 30 years with the Office of Chief Counsel, IRS. He began a visit from Villanova to Harvard in 2015 to found the tax clinic at Harvard and joined the Harvard faculty in 2017. Professor Fogg received his B.A. from the College of William and Mary, his J.D. from the University of Richmond T.C. Williams School of Law and his M.L.T. in tax from the College of William and Mary Marshall Wythe School of Law. He developed a course for the Georgetown LLM program, Federal Taxation of Bankruptcy and Workouts, which he taught there for 15 years as an adjunct. He has also taught as an adjunct professor at William and Mary and University of Richmond law schools and as a visiting professor at University of Arizona.

He is a national authority on tax procedure especially in the area of collection and bankruptcy law as it relates to tax. He co-authors a blog with Professor Les Book, procedurallytaxing.com, which focuses on current tax procedure issues. Professor Fogg serves as the editor of the ABA Tax Section publication “Effectively Representing Your Client before the IRS.” He authors the collection chapters in “IRS Practice and Procedure” created by Michael Saltzman and currently edited by Les Book. He was chosen as the IRS Chief Counsel Robert H. Jackson National Attorney of the Year in 2007 and the ABA Tax Section Janet R. Spragens Pro Bono Award winner in 2015. He is a past chair of the ABA Tax Section Pro Bono and Tax Clinics Committee and a current member of the ABA Tax Section governing council.
taking money from the businesses with which it has contracted.

When a payroll service provider fails to perform as it promised to do and either purposefully cheats the business or simply fails to file the necessary returns out of incompetence or for other reasons, the problem will usually manifest itself in the tax area and not the payroll area. The failure to make payroll or to make proper payroll payments will immediately come to the attention of the business as employees make their displeasure known. If the payroll tax providers makes payroll but fails to pay over the required taxes, the visit from the IRS to the business to discuss the failure to pay the taxes usually comes as the first indicator of trouble and that visit may not come until several months of taxes have gone unpaid. The business is a victim that has had money stolen from its account; however, from the perspective of the IRS the business remains liable for the tax because the failure to pay the taxes results from actions of the agent of the business and not through any action or inaction by the IRS. So, the business must quickly find the money to pay the taxes a second time or face the filing of a notice of federal tax lien and other collection action by the IRS. Additionally, it faces penalties and interest for its failure to timely file and pay the taxes. The situation makes many business owners frantic and could lead to bankruptcy or the dissolution of the business. By the time of the discovery, the payroll services provider has typically become insolvent or otherwise judgment proof. So, the defrauded business cannot realistically look to the payroll services provider for the funds necessary to pay the IRS.

AN EXAMPLE

A major example of the problems for taxpayers and the IRS created by payroll providers exists on public display through the case of FirstPay, a payroll provider in the Washington, D.C. area. The FirstPay case involved about 2,000 small businesses and non-profit organizations in the D.C. metro area. The business model of FirstPay was to undercut competitors in the charges that it made for its services which resulted in it obtaining contracts with many small, non-profit companies. These types of companies run on very narrow margins and having to pay their taxes twice, over a period that involved several quarters, was not a realistic possibility. Many of the customers of FirstPay faced bankruptcy or closure if the IRS aggressively sought to collect the payroll taxes from them. The case presented problems for the IRS in dealing with the many customers of FirstPay as well as in the bankruptcy case of FirstPay where the trustee sought to force the IRS to return about $28 million to the bankruptcy estate as a preference.¹

FirstPay ran a Ponzi type scheme with the businesses with whom it contracted. It would take payments from a later company and send those monies to the IRS to pay off a delinquent debt where the IRS collection function had begun to take action in a way that might expose the scheme. To keep the businesses with whom it contracted from learning of the tax problem, FirstPay changed the address at the IRS of all of the businesses with which it contracted. This ensured that all collection notices sent by the IRS came to FirstPay and not to the business and allowed the fraud to go undetected for much longer. One story about FirstPay was that when the IRS finally came to the company it found a room full of unopened correspondence because of all of the correspondence it had coming in on collection cases of its clients.

The businesses that had hired FirstPay to perform payroll services had varying states of tax problems as you might expect from a Ponzi type scheme. Some businesses had their taxes paid, some had a portion paid, and some had none paid. Because many of the businesses were non-profits, the IRS looked for ways to avoid shutting down very sympathetic businesses caught up in the massive theft. Some of the work it did on that case, informed its approach to later cases. These businesses wanted their liabilities compromised for a small payment or wanted, at the least, the penalties for non-payment abated. The problems faced by the businesses that had contracted with FirstPay were typical of the problems faced by any business served by a bad payroll service provider.

These problems drive the businesses to seek one of two strategies in trying to resolve the problem. One strategy is to seek to reduce the penalties imposed for non-payment and, in some cases, non-filing. The other strategy is to seek to compromise the liability even in situations in which the taxpayer has the financial ability to fully pay the tax a second time. The strategies are not mutually exclusive and some taxpayers will try both. Of course, the expensive professional fees the company must expend in order to resolve the problem is just another cost of the ill-fated decision to hire the fraudulent payroll services provider.
PENALTIES
When the business fails to pay the employment taxes, the IRS imposes penalties for failure to file and failure to pay. The IRS may also seek to assess the trust fund recovery penalty against one or more of the officers of the business because of the failure to pay over the collected payroll taxes. The defenses that the taxpayer needs to raise depends on the type of penalty the IRS seeks to impose. While reasonable cause may provide a sufficient defense to failure to file and failure to pay, it will not work for TFRP. Several cases have explored both types of penalties and provide guidance to taxpayers seeking to remove a penalty assessment.

The number of cases that have arisen have also caused the IRS to address the issue in the Internal Revenue Manual. IRM 5.1.24.5.5, which was updated in August of 2012, provides the IRS employee with several factors to consider in making the penalty abatement determination. Despite the seemingly helpful language of the Manual provisions which suggest taxpayer may obtain abatement if they had the payroll taxes timely withdrawn from their account, if they did not know about the fraudulent practices of the provider and if they worked quickly to correct the issue once they found out, the cases discussed below show that getting the penalty abated is not a simple process.

LATE FILING AND LATE PAYMENT PENALTIES
Taxpayers whose money has been stolen by a payroll tax provider have been penalized for their failure to file and pay the employment taxes. This seems like a really harsh result and one that the more recent Manual provisions would discourage; however, the relatively recent case of Kimdun v. United States suggests the IRS will not only impose these penalties but will defend them vigorously (and successfully) in court. The cases discussed below show that the IRS will succeed in almost all case in which it pursues the failure to file penalty when the taxpayer relies on a third party to prepare and submit its tax returns.

The Kimdun case involves a taxpayer with sufficient resources to pay the tax again after the theft by the payroll provider. Kimdun, and the three related corporations, paid the tax to the IRS shortly after finding out about the problems created by the payroll tax provider; however, the related corporations argued that the IRS should not impose the late filing penalty. The IRS imposed the penalty and the district court sustained the imposition of the penalty. The case seems to cut against the kinder approach that the IRS announced with respect to payroll provider victims and the sustaining of the penalty by the district court seems an ominous result for taxpayers seeking to contest the imposition of this penalty.

Where the theft of the payroll taxes occurred in-house rather than with the assistance of a payroll provider, the IRS took a similarly hard stand regarding the penalty. Even though the taxpayer was the victim of embezzlement by its bookkeeper the money set aside to pay its payroll taxes which also failed to file returns in order to further perpetrate the scheme, the IRS sought penalties from the taxpayer for the late filing. The taxpayer in Bogarts submitted an offer in compromise as a part of the requested remedy in a Collection Due Process (“CDP”) case. Making the offer in that context allowed the taxpayer to seek Tax Court review when the IRS rejected the offer. The Tax Court ended up denying the parties cross motions for summary judgment and remanding the case for the IRS to give further consideration. The docket entries after the remand indicate that the parties reached a basis for settlement. Petitioner’s counsel advises that in the resolution of the case penalties and interest were removed and the taxpayer agreed to pay the tax that never made it to the IRS. Such a resolution seems a fair division of the pain caused by the payroll provider (or in the case the in-house employee.) As is discussed below, the IRS has now adopted this type of resolution for companies who have had their payroll stolen and who file a specific type of offer in compromise.

Another case in which taxpayers litigated the penalty issue after theft from a payroll provider is Huffman, Carter & Hunt, Inc. v. United States. In Huffman, as in Bogarts, the taxpayer litigated the issue in the CDP context based on an offer in compromise. Because the case pre-dated 2006, the case was litigated in district court. As in Kimdun, the taxpayer did not fare well. Huffman ran a number of General Nutrition franchises. It switched its payroll provider from ADP to a smaller operation. Huffman had an unblemished record of payroll tax compliance until the new payroll tax provider embezzled the money entrusted to it and did not pay it over to the IRS. The IRS not only pursued Huffman for the tax which it never received but also sought failure to file and failure to pay penalties. Huffman sought the removal of these penalties in its offer. Citing Boyle, the court sustained the imposition of the