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More Tax Trouble for Small Firms

By Arden Dale

Lots of small companies are skipping their federal payroll taxes in this wobbly economy, and tax lawyers say the Internal Revenue Service has gotten more aggressive about penalizing executives, accountants or other individuals for the lapses.

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Among the IRS's tough tactics: freezing a company's accounts receivable, seizing assets and garnishing wages of responsible employees. It can assess substantial penalties and apply tax liens.

Payroll tax debt can "bring a company to its knees," says Caroline D. Ciraolo, a partner at Rosenberg Martin Greenberg LLP in Baltimore, Md. She sees cases more frequently now, citing the example of a tool company that suffered a fire and, struggling in the rocky economy, used money it should have spent on payroll tax as an emergency slush fund.

Other clients with payroll tax problems included a medical services company and a group of charter schools for at-risk children. Closely-held businesses like these may have revenue of several millions of dollars and may be owned by four or five people.

A government watchdog in July estimated that some $54 billion in employment taxes go underreported every year. The report by Treasury Inspector General for Tax Administration described a study the IRS has under way, in which it plans to audit payroll-tax compliance by some 6,600 randomly picked employers for recent years.

Chicago tax lawyer Robert E. McKenzie, a partner at Arnstein & Lehr LLP, describes the IRS's tactics as "harsh." In singling out people to penalize, it seems "more likely to shoot at the person on the sidelines" instead of those genuinely responsible for the arrears.

The tax code gives leeway to hold the company itself liable for employment tax errors, or to lay responsibility with a range of individuals or entities, from officers, owners, bookkeepers and treasurers to lenders that prevent companies from paying employment tax by seizing control of company accounts and dictating what debts can be paid.

Once the IRS adds its penalties, the debt can snowball. Companies can be fined for outright failure to pay or to report on the tax, and also for paying late — that is, if it misses by more than two-and-a-half days the deadline for depositing the funds with a bank or other authorized institution, which then forwards them to the IRS. Fines for late payment can go as high as 25% of the tax due. Sometimes employers hesitate to file a tax report when they have fallen behind on payments, and that just compounds their problems and triggers more penalties.

Typically, tax attorneys like Ciraolo and McKenzie get involved after a business has run into trouble. Often their help is sought by an individual whom the IRS has held personally liable.

Tom Nichols, a tax attorney in Milwaukee, Wis., advises new businesses on how to avoid trouble in the first place. The best plan: Meet the deadlines, he says. Short of that, pay taxes the IRS could make a personal liability for the person it targets.

The Federal Insurance Contribution Act (FICA) tax is equal to 15.3% of an employee's gross wages up to the FICA wage base of about $110,000, and consists of Social Security (12.4%) and Medicare taxes (2.9%). Half of the FICA tax is paid through an employee contribution (7.65%) and the other half is paid by the employer (7.65%); the latter can't trigger personal liability.

In hard times, businesses tend to look at payroll tax as their own money, and hang onto it or use it to pay "the squeakiest wheels first," Nichols says. Often, this is a supplier or someone else key to keeping the business running.

In the end, the IRS, not employees, stands to lose. Even employers who do not pay payroll tax report it on Forms W2 issued to employees, which keeps workers right with the IRS.