

NEWS ANALYSIS

What to Look For in Enforcement

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Tax enforcement is driven at least to some extent by resources, but the two main priorities of the IRS and the Justice Department reveal the influence of budgetary pressure.

The twin areas of focus are employment taxes, particularly the employee FICA and income tax required to be withheld and paid over by employers, and undisclosed foreign bank accounts. Neither area is new, but both are expected to undergo a shift this year.

IRS budget cuts are in part responsible for the emphasis on those two areas. Particularly in the employment area, cases involving employers failing to pay trust fund taxes are believed to deliver higher returns for the government relative to the amount of work necessary to investigate them. "It is a very intelligent and rational approach to focus on an area where there is relatively low-hanging fruit. They can probably get a fair amount done per enforcement dollar," said Peter D. Hardy of Post & Schell PC. And although the IRS's budget has decreased, the Justice Department's has not, with the result that more of the government's enforcement efforts will be concentrated in the Justice Department, said Jeffrey Neiman of Marcus Neiman & Rashbaum LLP.

Employment Taxes

The Justice Department's plan to increase employment tax enforcement efforts was announced in May 2015 and emphasized by Caroline Ciruolo, acting assistant attorney general in the Tax Division, in October. (Prior coverage: *Tax Notes*, May 18, 2015, p. 767; and *Tax Notes*, Oct. 19, 2015, p. 360.) "She made it very, very clear that DOJ is not happy with the results of the historical approach to enforcement in this area," said James R. Malone Jr., also of Post & Schell. Instead of relying on civil enforcement for taxes that employers must collect and pay, criminal enforcement is being ramped up through a coordinated effort between the Justice Department Tax Division, the IRS Criminal Investigation division, and IRS revenue agents in the field.

The primary tool for enforcement is section 7202, a criminal statute similar to the trust fund recovery penalty provision, section 6672(a). Malone noted that the Justice Department has already sought indictments for failure to pay taxes under section 7202, and sometimes when no evasion is evident. Civil enforcement is also likely to be stepped up as

the Justice Department seeks injunctions against serial employment tax violators.

In order to uncover cases to refer for prosecution as well as help taxpayers come into compliance voluntarily, the government has said it will focus on identifying problems early, Malone said. By 2017 the IRS should be able to notify taxpayers within 48 hours that a deposit has been missed. "That's a good thing, because from the civil side we saw two main fact patterns — businesses with cash flow problems and businesses where there was an employee who shouldn't have been trusted [to handle the tax deposits], but the business owner was unaware of the problem," he said. The alerts for unremitted taxes in the planned "soft notice" program will help reduce the problems caused by dishonest employees by preventing the unremitted amounts and accompanying penalties from increasing over time, resulting in crippling financial burdens to the business owner, he added.

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The government's recent expression of interest in expanded criminal enforcement in the employment tax area could lead to increased voluntary disclosures on the domestic side, said James N. Mastracchio of Dentons. "A few years ago there was not as much risk, and we often only faced civil penalties," he said. In the past year, interest in domestic voluntary disclosures has picked up as taxpayers who find the promise of no criminal investigation appealing come forward, he said. Mastracchio noted that undocumented or imperfectly documented workers raise immigration issues that often go hand in hand with unpaid withholding taxes. He observed that while prosecutions of payroll service providers who failed to remit taxes to the trust fund have continued, in the past six years, the number of prosecutions of individual business owners who repeatedly failed to remit the taxes has increased substantially. "The possibility that the Justice Department would recommend prosecution for a payroll tax violation forces compliance," he said.

There has been increased interest from taxpayers in making voluntary disclosures of domestic tax issues in the last six months, according to practitioners. Domestic voluntary disclosures are similar to their offshore voluntary disclosure program cousins in that there is a pre-clearance process and taxpayers submit a letter detailing relevant facts, but the domestic version features a face-to-face meeting

with a revenue agent. Although the IRS has centralized the process, taxpayer uncertainty remains because there is no penalty structure on the domestic side, Neiman said. The domestic disclosure process has benefited from the IRS's experience with the OVDP in that it is more streamlined and easier to navigate today than it was five years ago. "From a policy perspective, it is in the IRS's interest to make it as easy as possible for people to take advantage of," he added. "At a time when resources are what they are, the IRS needs to depend more and more on individuals doing the right thing, and they will do the right thing with the aid of practitioners only if the practitioners believe that their clients will be treated fairly."

Worker classification is a perennial audit topic, and one that seems likely to receive increased scrutiny. Reclassifying independent contractors as employees could give the IRS relatively larger recovery amounts when workers suddenly become W-2 earners, Mastracchio said. "This issue raises an interesting systemic question in the 'gig economy' about whether employers who have many workers will start reconsidering how they classify some of the people who are currently classified as independent contractors as employees," Hardy said.

IRS budget constraints are probably a chief reason for the increased focus on employment tax cases. The withholding cases are simple, straightforward investigations, said Neiman. "From a time perspective, these investigations don't require even hundreds of man hours," he said. From the government's perspective, they are easy to bring on a mass scale, he said. They are also relatively easy to identify if W-2s or W-4s don't match up with payments into the trust fund. The standard argument for the government's position in failure-to-pay cases is simpler than in some other types of tax controversies because it involves only whether the employer was withholding and what was due to the IRS. "I hope they choose to go after more egregious ones criminally, but willfulness in employment tax cases is a much easier burden to satisfy" than in an unreported offshore account case, for example, he said.

International Enforcement

When the government brought the John Doe summons against UBS AG in 2008, it created a new template for pursuing unreported financial accounts that could be replicated around the world. To reinvigorate voluntary disclosures in the international context, the government should find a relatively dramatic prosecution involving a financial institution outside Europe, Hardy said. "In the absence of that, many account holders are not going to feel very motivated to come into compliance," he said. Although account holders have effectively had

notice for years about how to declare unreported accounts, and additional compliance measures such as the Foreign Account Tax Compliance Act are giving the government more information than it has ever had, another prosecution like UBS is likely the government's best bet for bringing more taxpayers into compliance. But despite the increased information, finding that next financial institution may be challenging, Hardy said. "As a practical matter, it may be harder to find those cases involving accounts, people, and banks in Asia or the Middle East," simply because of issues like travel and translation, he said. For a resource-strapped IRS, navigating the practical components of investigating those institutions could be slower.

If and when the next UBS is unveiled, the government's approach to the taxpayers who decide to come into compliance voluntarily will be instructive. The IRS views the OVDP and streamlined program as only temporary opportunities. (Prior coverage: *Tax Notes*, Jan. 18, 2016, p. 282.) The approach of offering significantly reduced penalties to those who make voluntary disclosures may not, as a matter of fairness, be available to the government, even if lower penalties would bring more taxpayers into compliance. For taxpayers considering future disclosures, "the government is sort of a victim of its own success; it might be forced to use sticks due to issues of fairness, even if carrots would be more effective," Hardy said.

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The Swiss bank program will be a source of additional enforcement leads. Once the flow of account information from the Swiss banks entering the program begins and noncompliant accounts are identified, criminal cases will follow, Neiman said. "Most people who are notified do come forward, but there are always some who will roll the dice," he said. The enormous amount of data collected from the program will have to be analyzed to yield useful information, and that poses another IRS resource problem.

Deterring bad behavior is a critical component of tax enforcement, and there are several areas in which an example case seems probable within the next year. Neiman said he expects to see a prosecution of a taxpayer who came forward under the OVDP or streamlined program who lied or left out facts. There is also likely to be increased scrutiny on

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exit taxes and the information that individuals provide when they give up their green cards or citizenship. “There are lots of disclosures there, and I wouldn’t be surprised to see the Justice Department go aggressively after individuals who weren’t forthcoming in those disclosures,” he said.

Other areas in which enforcement efforts can be expected to continue are abusive tax shelters and legal-source income cases.

Although IRS budget cuts are taking a toll, as seen by the decreased number of criminal cases being brought by the government, the emphasis on employment taxes and undisclosed foreign accounts indicates how agencies intend to do more with less. Some shifting of the workload from the IRS to the Justice Department may help the government advance its priorities. ■