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Employment Tax Fraud in Construction—How to Avoid Accidentally Crossing the Line

By Gregory Seador[*]

Tax fraud in the construction industry has caught the attention of federal and state tax authorities across the nation. Recently, a Long Island construction business owner failed to pay nearly $1 million in payroll tax withholdings and now faces a maximum five-year prison sentence.

Although most employers do not intentionally break the law, employment tax compliance is often a focus for tax authorities, and in addition to incarceration of responsible persons, construction companies can face thousands of dollars in penalties for failure to comply with tax laws. Construction businesses can reduce the risk of an audit by understanding employment tax rules and avoiding common pitfalls.

EMPLOYMENT TAX BASICS

Construction companies, like most businesses, are generally required to withhold from their employees' paychecks and pay to the IRS federal employment taxes. The term ''employment taxes'' generally is used by the IRS to refer to:

- Amounts withheld from employees' paychecks for federal income taxes;
- Amounts withheld from employees' paychecks for Federal Insurance Contribution Act (FICA) taxes, which are Social Security and Medicare taxes that are matched by amounts employers are required to contribute for Social Security and Medicare; and
- Federal Unemployment Tax Act (FUTA) taxes, which are taxes paid by employers into workers' compensation and unemployment funds.

These taxes are commonly referred to as ''trust fund'' taxes because the money withheld is being held in trust by the employer for the benefit of government. Employers generally must electronically deposit these taxes with the IRS either monthly or semiweekly and file a Form 941 or Form 944. The IRS's employment tax rules can be found in IRS Pub.15. State employment tax laws vary by jurisdiction and construction companies should consider any local laws as well.

EMPLOYMENT TAX PITFALLS TO AVOID

The penalties for failing to accurately and timely withhold and remit trust fund taxes to the IRS can be steep. If the taxes are not deposited when due, the Trust Fund Recovery Penalty (TFRP) may apply. The TFRP is 100% of the unpaid trust fund tax and is often referred to as the ''100% penalty.'' If the unpaid trust fund taxes cannot be immediately collected from the business or employer, the TFRP can be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, or paying over these taxes and acted willfully in not doing so. It is therefore important that practitioners be aware of some common employment tax pitfalls.

Pyramiding. Pyramiding of employment taxes occurs when a business withholds taxes from its employees' paychecks but fails to pay over the withheld taxes to the IRS. For example, if a business is short on cash, it may be tempting to ''borrow'' money from the taxes withheld from employees' wages with the intention of paying the money back later. Businesses should resist the temptation to engage in this practice

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as the IRS takes pyramiding seriously and often aggressively prosecutes offending businesses. Amounts withheld from employees' paychecks should not be comingled with operating funds. Rather, a dedicated payroll account should be used for tax withholdings and accurate records should be maintained of all tax deposits to the IRS.

Cash payments. While it is not illegal to pay construction workers in cash, it is generally not a good business practice. Often, when workers are paid wholly or partially in cash, the correct amount of employment tax is not withheld, or no tax is withheld at all, potentially resulting in civil or criminal penalties. Careful attention should be paid to whether workers are classified as employees or as independent contractors. Workers are generally considered employees when they perform duties dictated or controlled by the employer. On the other hand, workers are generally considered independent contractors when the workers are free to control the details of how they perform and complete the work.

Failing to timely file. Businesses should ensure that all employment taxes are timely remitted to the appropriate tax agency on time. Do not be late! Missing the deadline by even one day can result in costly penalties and interest being assessed. The IRS's late deposit penalty ranges from 2% to 15% of the amount of the deposit. The later the payment, the greater the penalty.

EMPLOYMENT TAX BEST PRACTICES

Strong internal controls should be implemented to prevent tax fraud and ensure employment taxes are accurately and timely paid. Employers should maintain a bank account that is dedicated to payroll and employment tax payments, separate from operating funds. Every time payroll is processed, or employment taxes are remitted, the funds should come from this dedicated account. In addition, construction businesses should routinely perform internal payroll audits to make sure employees are being paid correctly and the appropriate amount of taxes are being withheld and timely paid to tax authorities.

Accurate employment tax records should be maintained to substantiate that employment taxes were paid. Procedures should be in place so that tax payments are not missed, and employees should be trained to catch errors before payroll is processed. One employee should prepare payroll, a different employee should authorize the payroll, and a third employee should make the payments. Using a three-tier system such as this will reduce the risk of fraud because no one person has control of the payroll and tax deposits.

Consider outsourcing payroll rather than doing it in-house. Payroll service providers are not all created equal and should, therefore, be chosen very carefully. Most traditional payroll services are ill-equipped to handle the unique nature of construction payroll where employees may work in several different states and localities throughout the year and on many different construction projects. There are a number of companies that specialize in construction payroll and are familiar with the nuances of federal and state employment tax obligations.

As federal and state tax authorities continue to scrutinize the employment tax practices of construction businesses, it is imperative that businesses focus their attention on ensuring compliance and timely and accurately paying employment taxes. Paying careful attention to how employees are paid, as well as keeping good payroll records, is a sure way to reduce the risk of costly penalties, taxes, and interest.

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