



Payment Encore: Liability of Taxpayer for Embezzlement by Payroll Service  
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## **Payroll Services and Payroll Tax Deposits**

The case we will look at this week breaks no new ground, but does offer a cautionary tale about the issues taxpayers need to consider to the extent they rely on others to fulfill various obligations—in this case, a taxpayer who used a payroll service to handle its payroll tax deposit responsibilities. The bad news in this case is that the service, while taking the funds from the taxpayer, did not actually forward the funds to the IRS, but rather kept them for personal use.

This week's case deals with the Third Circuit Court of Appeals recent rejection of the appeal of the U.S. District Court of New Jersey's 2006 decision in the case of *Pediatric Affiliates, P.A. v. United States*, (2007-1 USTC ¶150,477, affirming 2006-1 USTC ¶150,201). At the end of the day, the court ruled that even though all parties agreed that Pediatric Affiliates had properly withheld the funds from their employees payroll and transmitted those funds to the payroll service that then misappropriated the funds, they still owed the taxes, plus interest and penalties. The result, while harsh, is consistent with prior cases in this area.

## The Embezzlement

The basic facts in the case are outlined early in the District Court's decision. Pediatric Affiliates prior to 1998 had used a payroll service to prepare its payroll taxes but had made its own payroll tax deposits. However, when the rules were changed that required Pediatric Affiliates to make payroll taxes electronically, they made what turned out to be a very costly decision. As the court explained:

Pediatric asserts that around 1998, the IRS changed its payroll tax regulations to require businesses to electronically transfer their tax payments to a depository service or independent payroll tax service. ( *Id.* at ¶13.) Then, the service would submit the tax payments to the IRS. 1 ( *Id.*) Pediatric retained PAL to pay its payroll taxes. ( *Id.* at ¶17.)

Of course, Pediatric Affiliates could have simply signed up directly for the EFTPS service and continued to pay payroll taxes directly. However, at that time it would not have been usual for taxpayers and their bookkeepers to be wary about having to switch from taking a check and coupon down to their local bank and now needing to do some fancy “electronic” transfer.

To many that seemed complex and, frankly, the simplest solution clearly seemed to be to simply let the payroll service take care of the deposits from this point forward. In fact, payroll services actively marketed themselves at the time as simpler solution to the problem—something that was true and, in most cases, worked very well for the taxpayer. However, such would not be the result for Pediatric Affiliates who managed to find a bad apple for their payroll service.

Unknown to Pediatric, Menachem Hirsch (“Hirsch”), the founder of PAL, embezzled the tax payments that Pediatric and other clients transferred to PAL. 2 ( *Id.* at ¶14.) Hirsch would prepare and send to Pediatric a tax form that reflected Pediatric's actual tax liability. ( *Id.* at ¶15.) Pediatric then, would transfer money in the amount of its tax liability to Hirsch. ( *Id.*) Hirsch, however, would also prepare a tax form that reflected an understated tax liability. ( *Id.* at ¶15.) He sent the understated form and amount to the IRS, and invested the difference between the amount he received from Pediatric and the amount sent to the IRS in a personal hedge fund. ( *Id.*)

Unfortunately for Mr. Hirsch, the IRS did eventually notice that things weren't adding up—not an unexpected development since at some point the issue would arise that the payments transmitted were going to be too little to cover the withholdings reported on the Forms W-2. From the court opinion it's not clear how Mr. Hirsch thought he would be able to juggle things to keep this issue from arising—it's possible he believed he would make a fortune in the hedge fund, be able to then make deposits before year end that would “fix” the withholdings and keep them in line with the W-2s (many embezzlers do have grand plans that will get everything paid back before anyone notices). Or perhaps Mr. Hirsch simply hadn't factored this issue into his scheme.

But, in any event, the IRS started sending notices to Pediatric Affiliates who decided the IRS must be crazy. Since off the wall notices from the IRS are not unheard of, at least initially the explanation may have seemed plausible.

Pediatric received notice from the IRS in 2002 that it had underpaid its payroll taxes in 1999 and 2000. ( *Id.* at ¶19.) Pediatric (1) reviewed its withdrawal records, (2) found that there was no discrepancy between the amount of funds transferred and its tax liability, and (3) concluded that the IRS notice was an error. ( *Id.* at ¶¶19-20.)

However, it later became clear that something was seriously amiss as the situation was not remedied quickly with simple correspondence.

The IRS then sent second and third notices of delinquency to Pediatric. ( *Id.* at ¶¶21, 24.) Again, Pediatric checked its records and found no discrepancy between the amount owed and amount paid. ( *Id.* at ¶21-26.) The IRS finally sent Pediatric documents that reflected a discrepancy that was not apparent based on the information Pediatric was given by PAL. ( *Id.* at ¶27.) Pediatric contacted Hirsch and was told that Hirsch had misappropriated the funds Pediatric had transferred to Hirsch. ( *Id.* at ¶30.)

Mr. Hirsch now faced a number of legal problems, both civil and criminal.

The United States brought criminal charges against Hirsch in the United States District Court for the Southern District of New York in December 2004. (Pl. Ex. A.) He was charged with wire fraud and tax evasion. ( *Id.*) The indictment alleged that Hirsch converted over \$ 2,314,000.00 of over 50 clients' funds, and filed over 160 false and fraudulent tax forms. ( *Id.*) Hirsch (1) pled guilty to both counts, (2) was assessed monetary penalties, and (3) sentenced to serve thirty-seven months in prison. (Pl. Ex. 3.)

Pediatric brought an action in the District of New Jersey against PAL and Hirsch, on July 25, 2002. 3 (Dkt. no. 02-3589 (GEB).) Pediatric asserted claims for fraud and violations of the Racketeering Influenced and Corrupt Organizations Act ("RICO"), and sought monetary damages. (Compl., dkt no. 02-3589.) Default judgment was entered in Pediatric's favor in the amount of \$1,204,183.21, on August 21, 2003. (Dkt. no. 02-3589, entry no. 25.)

Rough math tells us that while Mr. Hirsch may have stolen from 50 clients, Pediatric Affiliates got hammered a bit more than the average Hirsch client. And, not unexpectedly, Pediatric Affiliates found that while they had a judgment, it ultimately wasn't collectible as the court noted in a footnote:

As to Samuel Hirsch, the action was stayed and administratively terminated because Hirsch filed for bankruptcy protection. (8-21-03, Order, Dkt. no. 02-3589.)

(Mr. Hirsch is also referred to as Samuel Hirsch, as the court points out in a footnote.)

So now the issue becomes—does Pediatric Affiliates have to come up with the payroll deposits, plus penalties and interest, to make up for Mr. Hirsch's embezzlement, or is the government the one that is out of luck? Pediatric argues that they should not be held liable for a number of reasons—all of which the court rejects.

## The Positions of the Parties

The District Court outlined a quick summary of each parties' position in the case:

Defendants argue the complaint should be dismissed because Pediatric is liable to pay (1) the taxes it owes as a matter of law, and (2) the interest it owes on its taxes because Pediatric's tax deficiency is not attributable to an error or delay of the IRS. (Defs. Br., at 1-2.) Pediatric argues that it is not responsible for the tax or interest at issue because (1) it paid the taxes it owed to PAL, (2) Pediatric is not responsible for Hirsch's subsequent embezzlement of those funds, and (3) the United States is judicially estopped from recovering payroll taxes from Pediatric. (Pl. Br., at 16-17.) It argues that the government's "recovery" in this matter was the conviction and incarceration of Hirsch. ( *Id.*) To enforce Pediatric's tax liability in addition to incarcerating Hirsch would amount to a double recovery for the United States. ( *Id.*)

The court then went on to consider these issues, eventually deciding in favor of the government.

## We Already Paid Them and Don't Owe Them Again

Pediatric pointed out that they already paid the taxes in question, and they assert they should not be held liable for Hirsch's failure to transfer those funds over to the IRS. The IRS asserts that the taxes were due and they were not paid.

The District Court outlines the following criteria that would have to be met to excuse Pediatric from being liable for the unpaid taxes.

To be excused for failure to timely pay taxes owed, a taxpayer must show that the failure (1) did not result from willful neglect, and (2) was due to reasonable cause. *United States v. Boyle*, 469 U.S. 241, 244 (1985); see also *Am. Biomaterials Corp. v. Creative Care Sys.*, 954 F.2d 919, 923 (3d Cir. 1992). Willful neglect is a "conscious, intentional failure or reckless indifference." *Boyle*, 469 U.S. at 245. Reasonable cause exists if the taxpayer exercised "ordinary business care and prudence, but nevertheless was unable to file the return within the prescribed time." *Id.* at 246 (internal quotes omitted); see also *Universal Concrete Prod., Corp. v. United States*, No. 89-7833, 1990 WL 106584, at \*3 (E.D. Pa. July 24, 1990) (noting that a company's "failure to implement internal checks and controls over the employee responsible for tax obligations demonstrates a lack of ordinary

business care” and is not reasonable cause to excuse tax liability).

The IRS did not allege that Pediatric Affiliates engaged in willful neglect, so the issue becomes whether Mr. Hirsch's actions under these facts, and Pediatric Affiliates supervision of his work, would amount to reasonable cause.

Pediatric Affiliates had delegated certain aspects of its tax compliance responsibilities to a third party, so the Court turned to the Supreme Court's analysis in the *Boyle* case to deal with this issue:

Late filings may be excused when the delay is due to circumstances beyond the taxpayer's control, including postal delays and illness. *Boyle*, 469 U.S. at 249. The Supreme Court, however, has established a bright-line rule that reliance on an agent is not a reasonable cause and does not excuse a taxpayer's failure to timely file a tax return. *Id.* at 252. In *Boyle*, the taxpayer relied on an attorney to prepare and file a tax return on behalf of the estate for which the taxpayer was the executor. *Id.* at 242. Holding that reliance on an attorney does not excuse a late filing, the Supreme Court emphasized that Congress has placed the burden on the taxpayer to ensure the timely filing of tax returns. *Id.* at 249. Reliance is not a substitute for compliance with the tax statutes. *Id.* at 251. The situation may differ if a taxpayer relies on the erroneous advice of counsel with respect to a question of law, but no special training or effort is needed to determine a tax deadline, and make sure that the deadline is met. *Id.* at 252.

The Court then looks at the specific issue of a payroll service and provides the following analysis.

A payroll service, while not an “employee” of a company like a bookkeeper or manager, is a third-party agent of the company. The Code allows an employer to designate agents to act on behalf of the employer to perform duties such as payment of employee wages, and company payroll taxes. See 26 U.S.C. §3504; 26 C.F.R. §31.3504. Section 3504 provides that “all provisions of law (including penalties) applicable in respect of an employer shall be applicable to a fiduciary, agent, or other person so designated.” 26 U.S.C. §3504. An agent, however, is only jointly and severally liable for a company's payroll taxes if the agent actually had “control, receipt, custody, or disposal of, or pays the wages of an employee or group of employees.” 26 U.S.C. §3504; see also *Morin v. Frontier Bus. Tech.*, 288 B.R. 663, 671-72 (W.D.N.Y. 2003) (holding that agent was not liable for payroll taxes because it never had actual control over the funds used to pay employee wages). Additionally, the form that a taxpayer must fill out to authorize an agent to make tax payments on its behalf contains an agreement that provides, “I understand that this agreement does not relieve me, as the taxpayer, of the responsibility to ensure that all tax returns are filed and that all deposits and payments are made.” (Tax Form 8655, Reporting Agent Authorization.)

Now that last line may strike more than a few clients as unfair, since all they knew was that

they were told they had to “sign this form” for the payments to be made, and it's unlikely they ever actually read the document in question. But such “mere paperwork” is not, despite our client's beliefs, irrelevant—and in this case it turned out to be very relevant.

## But Doesn't Embezzlement Change Everything?

While it may seem reasonable to presume that even if there is a general requirement to see that taxes are paid, a taxpayer shouldn't be held liable when this third party has actively mislead the entity about the payment of the taxes, as Mr. Hirsch did. However, that's not what the case law has provided. The Court points out that this case presents almost identical facts to those found in *Huffman, Carter & Hunt, Inc.*, 317 F.Supp.2d at 821-22 where a payroll service embezzled the tax payments. It considered this case along with the case of *Classic Printing* (No. 99-2015, 2001 WL 283799) where an employee embezzled the tax payments. The court notes:

In both cases, the tax-paying agent embezzled money from the taxpayer. Despite the criminal nature of the agents' conduct, the plaintiffs' failure to pay their taxes was not excused. The plaintiffs were responsible for overseeing the acts of their agents, and bore the ultimate responsibility and control over their tax obligations. *Huffman*, 317 F.Supp.2d at 822; *Classic Printing*, No. 99-2015, 2001 WL 283799, at \*6 (recognizing that although reliance on a trusted employee was understandable, and the betrayal “sad and unfortunate,” the company was not prevented from fulfilling its tax obligations because managerial control over the company did not rest with the employee).

Pediatric Affiliates retained the ultimate responsibility for the control of Hirsch's actions, and the fact they did not detect the fraud did not provide them with an excuse for the failure of the taxes to be paid.

Pediatric's situation is analogous to that of the plaintiff in *Huffman*. The plaintiff in *Huffman* relied on an outside payroll service. The service embezzled the plaintiff's funds, resulting in tax deficiencies and penalties. Similarly, Pediatric relied on Hirsch. Assuming, as the court did in *Huffman*, that Pediatric exercised prudence in selecting and monitoring Hirsch, Pediatric still bears the ultimate responsibility to ensure its taxes are properly paid. Reliance on Hirsch did not render Pediatric unable to fulfill its tax obligations.

In essence, Pediatric Affiliates could not delegate its responsibilities in this area, and if it does delegate the actions it bears the ultimate responsibility to assure that the delegated actions actually take place.

## But The IRS Already Has a Remedy

Pediatric Affiliates attempted to argue that the government should not be able to both claim that Mr. Hirsch “unlawfully, willfully, and knowingly, did attempt to evade and defeat a

substantial part of the federal payroll taxes due and owing by the corporate clients of PAL Data” in its criminal charges against him and still attempt to collect the taxes from Pediatric Affiliates. After all, if Mr. Hirsch evaded the taxes then it seems he's the one that owes the government.

However, the court held that the US position in the criminal case was not clearly inconsistent with its position in this case, and thus the doctrine of judicial estoppel did not apply in this case. The court notes that:

Liability for tax evasion, however, is not limited to the taxpayer. “Any person” who willfully attempts to evade or a defeat a tax obligation can be penalized. 26 U.S.C. §7201. Therefore, it is not contradictory for the government to seek to (1) criminally penalize Hirsch for evasion of payroll taxes including those of Pediatric, and (2) be paid the taxes it is owed by Pediatric.

The court goes on to make a statement I am sure that the shareholders of Pediatric Affiliates would strongly take issue with—but one which is arguably technically correct under the law:

Pediatric argues that it will suffer a detriment because it will be obligated to pay its payroll taxes twice. (Pl. Br., at 17.) This argument, however, is incorrect. Pediatric paid money to Hirsch to cover its tax liability, but due to Hirsch's embezzlement, Pediatric did not appropriately pay the IRS in full. Pediatric is not being forced to pay its taxes twice because the taxes the IRS seeks to collect now were not paid.

The court even goes on to note that Pediatric did have recourse against Hirsch to get repaid (though, as noted in a footnote, that turned out to be a theoretical fix since in the end it turned uncollectible).

## **But Appeals Said It Wouldn't Be Fair...**

Finally, Pediatric argued that it shouldn't have to pay the tax because they relied on representations of an Appeals Officer that they wouldn't have to pay the tax. The court summarized Pediatric's allegation this way:

In the complaint, Pediatric contends that the Appeals Officer said (1) he could not see how it could be determined that Pediatric owed money to the IRS, (2) Pediatric should not be held responsible if the money was stolen, and (3) either Pediatric owed the money or it did not and that he would check with others in the Appeals Office and then advise. (Compl., at 9.)

However, the court didn't buy the idea that these comments should be held to stop the government from being able to collect the tax. The court noted:

Even assuming the statements were a misrepresentation, Pediatric's reliance on them was not reasonable. The alleged statements are not documented in a writing. The statements were made in the context of a CDPH. The discussions in the

CDPH were preliminary and non-final in nature because the final outcome would be documented in a written determination that could be appealed to an appropriate court. As Pediatric alleges, the Appeals Officer said he would check with others and advise. Even accepting as true the factual allegations in the complaint, the statements of the Appeals Officer are mere erroneous advice, not affirmative misconduct. In the absence of reliance, detriment, and affirmative misconduct, applying equitable estoppel to the government in this action is not appropriate.

The panel in the Third Circuit even more strongly rejected this theory, noting in addition to the above that:

Moreover, appellant was represented by counsel and therefore, its “failure to decipher the Tax Code cannot be excused by its reliance on a government employee's error.” *Estate of Kunze v. Commissioner of Internal Revenue*, 233 F.3d 948, 952 (7th Cir. 2000).

In essence, the taxpayers' advisers could easily have advised them that the Appeals Officer was in error and that, in fact, they could be held liable for these taxes.

## What Does It All Mean?

Does this case mean that taxpayers should never use payroll services? No, that's not the lesson, just as it's not the lesson that taxpayers cannot allow advisers to file for extensions of time to file on their behalf (another item where responsibility to insure the action takes place stays with the taxpayer). However, they should be counseled that they bear the ultimate liability and that if they have any reason to believe there are problems they need to take immediate action.

As well, inquiries into the financial health of a payroll service may not be inappropriate, especially if the service in question does not have a long term track record or has recently changed owners. As well, taxpayers should remember that they can request from the IRS information about the actual deposits that have been made on their behalf.