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Employment Agency Assessed \$5.8 Million in Employment Taxes and Penalties

The U.S. Tax Court has upheld an IRS assessment of federal income and FICA tax deficiencies and fraud penalties totaling more than \$5.8 million against an employment agency that failed to report wages of nearly \$15 million on up to 90% of its temporary laborers [*Hi-Q Personnel, Inc. v. Commissioner*, 132 T.C. No. 13, 2009 U.S. Tax Ct. LEXIS 12 (5-4-09)].

Background

Hi-Q Personnel, Inc. supplied temporary laborers to more than 250 client companies for a fee. Clients were not allowed to pay any money, goods, or services to the laborers without Hi-Q's prior consent. Hi-Q agreed to: pay the laborers; withhold and deposit federal, state, and local payroll taxes; and provide workers' compensation insurance for the laborers. Hi-Q billed clients \$9 per hour for the services of its laborers, payable in full by check within seven days of Hi-Q's invoice. This rate included not only gross wages, but also a fee for Hi-Q.

When Hi-Q hired temporary laborers to work for client companies, it gave them the choice of being paid by check on its regular payroll (treated as employees, and subject to employment tax withholding and reporting) or in cash (off the company's payroll with no withholding or reporting of employment taxes). Up to 90% of the temporary laborers chose to be paid in cash and off the books.

The IRS issued a notice of determination of worker classification and assessed employment taxes (federal income and FICA taxes) and fraud penalties against Hi-Q.

Officer of employment agency was responsible for paying employment taxes

In 2002, Luan Nguyen, the president and sole shareholder of Hi-Q from 1995 to 1998 (the tax years in question), was criminally indicted on multiple charges, including conspiracy to defraud the U.S. and willful failure to collect and pay over taxes due the U.S.

In 2003, Nguyen agreed to a plea bargain in which he admitted guilt to all counts of the indictment in exchange for a sentence of 150 months in prison and \$1,000 in special assessments. The IRS argued that Nguyen's plea determined the issue of Hi-Q's responsibility to pay employment taxes and the court agreed.

In Nguyen's criminal case the ultimate issue was whether Hi-Q filed false or fraudulent Forms 941 for 16 calendar quarters between 1995 and 1998 because it failed to pay employment taxes to the laborers paid in cash. The court explained that a corporation can only act through its officers, and Nguyen's duty to file accurate Forms 941 grew out of his position as Hi-Q's president.

Employment agency was the employer

The Internal Revenue Code (IRC §§3102, 3111, and 3402) requires employers to withhold FICA and federal income taxes from wages paid to employees, and to pay the employer's share of FICA taxes. An "employer" is the person for whom an individual performs services; however, if the person for whom the services are performed does not



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control the payment of wages for those services, the employer is the person having control over the payment of wages (IRC §3401(d)).

Here, Hi-Q set and paid the wages of its temporary laborers. Therefore, said the court, the company was the employer of the temporary laborers and liable for all employment taxes associated with those payments. Clients did nothing more than pay Hi-Q according to rates set in their contracts, for the services performed by the temporary laborers.

Assessment: withholding rate for unpaid employment taxes

The IRS assessed employment taxes based on the same withholding rate the company used when filing Forms 941 for its employees paid by check, and the court said this approach was reasonable. Given Hi-Q's failure to secure Forms W-4 from the temporary laborers, a rate of 28% could have been proposed, so the rate used on the Forms 941 was more favorable to the company.

Assessment: penalties for fraud

If fraud is involved in the underpayment of tax, a penalty equal to 75% of the underpayment due to fraud is imposed (IRC §6663(a)). Here, the entire underpayment was attributable to fraud.

The court explained that even without Nguyen's conviction for conspiracy to defraud the U.S., the facts independently supported a finding of fraud. Hi-Q, acting through its agents, paid temporary laborers cash wages without deducting employment taxes. The company clearly understood its tax obligations because it met them with respect to workers paid by check. To hide client payments covering cash-paid workers, the company had some checks cashed at check-cashing establishments and failed to record them on its books. In this way, the company evaded its share of FICA taxes for the cash-paid laborers.