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An Overview of the Trust Fund Recovery Penalty and Other Third Party Liability

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To protect government revenue derived from payroll taxes withheld from employees, Congress created Internal Revenue Code ("IRC") § 6672, which allows the Internal Revenue Service to recover the withheld portion of an employee's payroll taxes, referred to as "trust funds," from any person or entity deemed to be a "responsible person."

As small businesses begin to fail due to the recent economic downturn, the withheld payroll taxes, and the recovery of them from business owners and officers, will take on ever more importance. This article reviews the basic rules of IRC § 6672, IRC § 3505, and case law with which practitioners should be familiar when advising small businesses and their owners.

IRC § 6672

IRC § 6672 allows the Internal Revenue Service to recover "trust funds" withheld from an employee's pay from "any person required to collect, truthfully account for, and pay over any tax imposed" and "who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof."

What are "trust funds"? Trust funds are the portion of the Social Security and Medicare tax withheld from an employee's pay (7.65%) and income tax withheld from the employee's pay. However, such funds do not include fed-

eral unemployment taxes, the employer's match of the 7.65% for Social Security and Medicare taxes, or accrual of interest and penalties of the employer (which often are quite substantial).

The employer is deemed to be holding these funds "in trust" for the U.S. Government, hence the name "trust funds" for that portion of the payroll taxes.

The penalty is referred to as a "100% penalty." This does not mean that the IRS can collect twice as much tax as that withheld by the employer, but rather that the entire amount can be recovered against anyone determined to be a "responsible person" who willfully fails to collect and pay over such tax.

Who is a "Responsible Person"?

Any and all of the following may be a "responsible person": sole proprietors, partners, corporate officers, employees, bookkeepers, accounting firms, parent companies, lenders/creditors, and purchasing companies.

The term "responsible person" is broad, encompassing anyone responsible for collecting, accounting, and paying over taxes to the government. The test is a functional one, focusing on the individual's or entity's status, duty, and authority.

The IRS Interview

An IRS Revenue Officer will seek interviews from all potential responsible people he or she can locate. Form

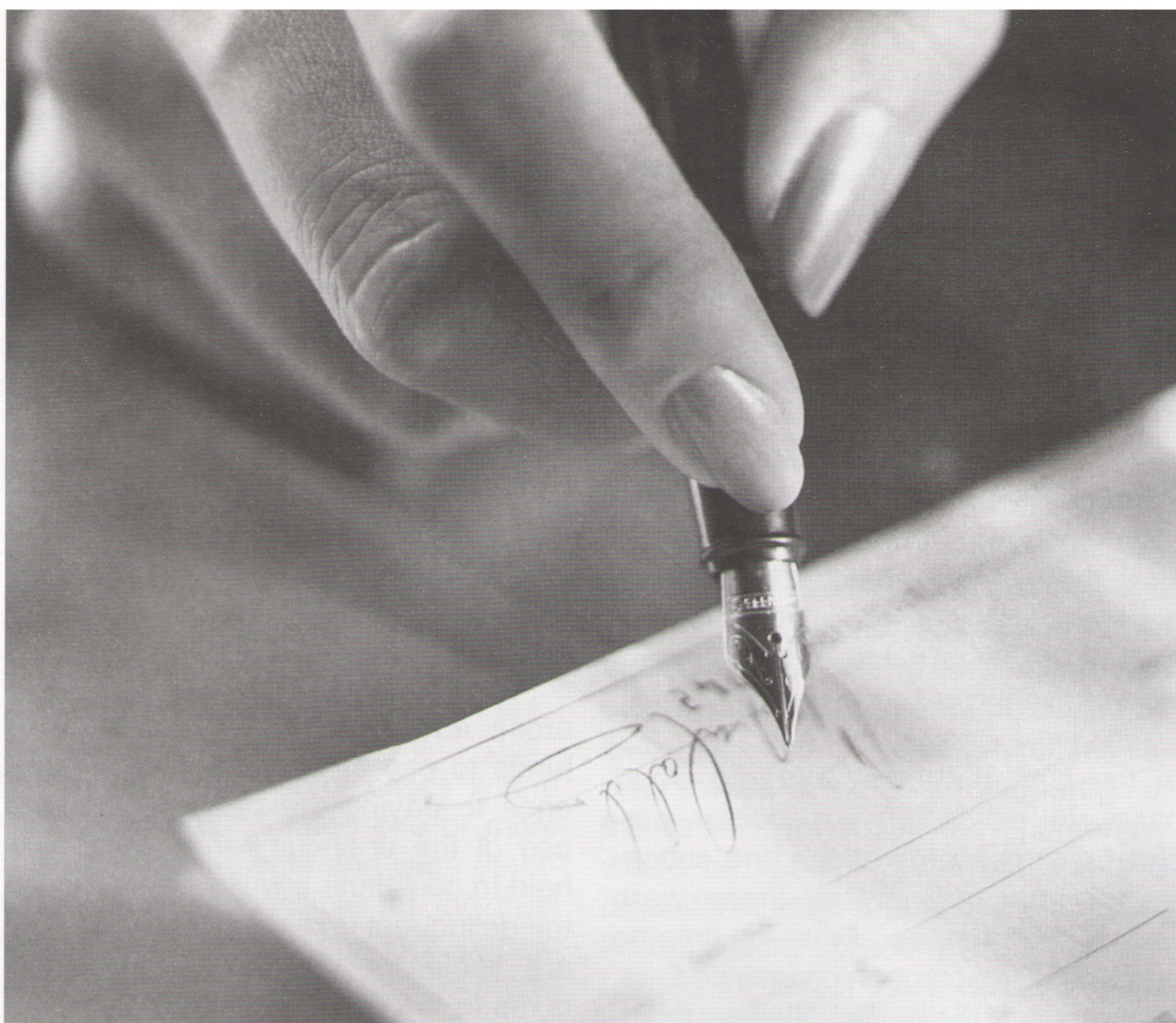
4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes*, will be used for the interview, and based upon the interview and available documentation, such as bank statements and cancelled checks, the Revenue Officer will seek to assess the trust fund recovery penalty against the individuals or businesses he or she deems responsible.

Those individuals and entities determined to be responsible are jointly and severally liable for the tax.¹ Pursuant to IRC § 6672(d), each responsible taxpayer has a right of contribution from the other responsible parties. This is important because, though the parties may be jointly and severally liable, the IRS is under no requirement to collect from each party equally. In practice, the government will seek to recover everything from whomever it can and let the responsible parties fight it out amongst themselves. IRC § 6103(e)(9) allows the IRS to disclose to anyone determined to be a responsible person for the unpaid trust funds taxes others determined to be responsible, what collection action it took against those parties, and how much the IRS collected from them.

There is no legal requirement that the IRS pursue collection from the employer first. In the case of *United States v. Huckabee Auto Company*,² the company had filed for bankruptcy and IRS collection action was stayed under the Bankruptcy Code. The IRS then assessed and pursued the trust fund

¹ *McCray v. U.S.*, 60 F.3d. 584 (9th Circuit 1995).

² *U.S. v. Huckabee Auto Co.*, 783 F.2d. 1546 (11th Circuit, 1986).



recovery penalty against the individual owners and officers of the company. The owners argued that, because the company was in bankruptcy, all IRS collection action was automatically stayed under the Bankruptcy Code. In addition, the owners argued that the IRS had to pursue collection against the company first before pursuing the individual owners.

The court stated that, though the company was in bankruptcy, the individual owners were not, and that there was no requirement for the IRS to pursue an employer first before pursuing other parties for the trust fund taxes.³

Indicators of Responsibility

The following, though not conclusive evidence, are indicators of responsibility:

- a) Holding corporate office
- b) Ownership
- c) Authority in the bylaws

- d) Hiring and firing authority
- e) Check signing authority
- f) The authority to sign and file payroll returns

Check-signing authority alone is not sufficient to establish responsible person status. In fact, if the person had authority but did not sign any checks or payroll tax returns, the absence of a signature can support that individual's claim he or she is not a responsible party.

The Willfulness Requirement

Though an individual may have failed to collect and pay over trust fund taxes, he or she will not be deemed a responsible person unless the IRS can show the failure to collect and pay over the trust funds was willful. If the failure to collect and pay over the tax was not willful, the individual or entity will not be held personally liable under IRC § 6672.

The IRS's view, stated in Revenue Ruling 54-158, is that willfulness exists where "money withheld from employees as taxes, in lieu of being paid over to the Government, was *knowingly* and *intentionally* used to pay the operating expenses of the business, or for other purposes." [emphasis added]. The fact that there are insufficient funds to pay both employees and the taxes is not a defense. In cases where there are not enough funds to pay both the employees and the payroll withholding taxes, the IRS position is that in such a case the employer should prorate the payments so that the employees get a portion of their pay and the IRS obtains the proper amount of withholding for the pay distributed.

Having control over the mechanical disbursements, even if the person does not have the ultimate authority, has been held sufficient control for purposes of IRC § 6672. In *Hochstein v. United States*⁴ the taxpayer was the

(continued on next page)

³ Most district courts seem to follow the reasoning discussed in *Huckabee*, though some courts have concluded the IRS may not pursue the collection activity against the officers and owners if the IRS's collection action would undermine the Bankruptcy Court's reorganization plan.

⁴ *Hochstein v. United States*, 900 F.2d 543 (2nd Circuit, 1990).

controller of a corporation that was in financial trouble. An outside lender agreed to advance the money for operations in exchange for the company's receivables and equipment. As the company wound down operations, the outside lender reduced its advances, allowing the taxpayer to only pay for the bare essentials, including fuel and net payroll, despite requests to the lender by the taxpayer for sufficient funds to cover the payroll tax deposits.

When the IRS pursued Mr. Hochstein personally for the trust fund taxes, he argued that he did not have the ultimate authority to determine whether the funds advanced could be used for the payroll deposits. The court held that for a taxpayer to be subject to the liability, it is not necessary for such individual to have ultimate decision-making authority, but, rather, just have "significant control" over the disbursements. This should be a significant warning to mid-level employees who believe that fol-

lowing a superior's directives provides immunity from liability.

Prior Liabilities

Whether a person may be held personally responsible for trust fund tax liabilities that existed before he or she became aware of the liability will turn on that individual's role in the company when the liability was created.

In the United States Supreme Court case, *In re Slodov*,⁵ a doctor purchased three corporations and subsequently became aware there were unpaid payroll taxes. From the time he purchased the companies until he finally dissolved them, Dr. Slodov maintained tax compliance and used any available funds to pay his ongoing vendors and creditors.

When the companies were dissolved, the IRS pursued Dr. Slodov personally for the unpaid trust fund liability that existed when he bought the company, arguing that a trust is created on the unencumbered funds to be used solely for the unpaid payroll taxes, and that Dr. Slodov should have used the unencumbered funds to pay such taxes.

Rejecting the government's argument, the Court stated a trust was created on unencumbered funds only if those funds could be traced back to the employee's withholding, and that a trust is not imposed on after acquired funds. Because Dr. Slodov was not a responsible party for the trust fund tax liability created before he purchased the companies, and no trust was created on after acquired funds, he was not held liable.

However, individuals have been found to be responsible persons in cases where the individual was an officer of the company, later discovers the trust fund tax liability, and then uses unencumbered funds to pay vendors. In such cases courts have held the *Slodov* decision does not protect them.

Because the individuals were in a position of responsibility when the liabilities arose and then used unencumbered funds to pay other creditors in preference to paying the back taxes, such use of the unencumbered funds was held to constitute a willful failure to pay the delinquent taxes.⁶ Such individuals are liable for the unpaid trust fund taxes to the extent they use unencumbered funds to pay other creditors in preference to the government.

IRC § 3505

Pursuant to IRC § 3505, third parties may become responsible for the trust fund taxes if they lent money to cover net payroll. This may occur when the business cannot cover the net payroll so a spouse, family member, or other creditor lends the company the net payroll so the employees can be paid.

Pursuant to IRC § 3505(b), that lender will be deemed to be a responsible person and liable if he or she had actual notice or knowledge that the employer would not make timely payroll deposits of the withholding taxes. If the outside lender is determined to be liable, the liability is limited to 25 percent of the funds lent to the employer.

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⁵ *In re Slodov*, 436 U.S. 238 (1978).

⁶ *Purcell v. United States*, 1 F.3d. 932 (9th Circuit, 1993) and *Honey v. US*, 963 F.2d 1083 (8th Circuit, 1992).

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Charitable Organizations

In general, the IRS policy is not to impose the trust fund recovery penalty against board members of tax-exempt charitable organizations if:

- a) they serve in an honorary capacity (unpaid)
- b) do not participate in the day-to-day or the financial operations of the organization, and
- c) do not know of the organization's failure to remit the trust fund taxes.

There are a number of cases where individuals have violated one or more of these requirements and were determined to be responsible for the trust fund portion of the charity's unpaid payroll taxes. In a recent case, a member of the board of directors of a charitable hospital was held liable for the unpaid payroll taxes after he became involved in the day-to-day operations of the hospital, and drew a salary from the institution for his efforts.⁷

Designating Payments

A useful strategy for companies and their owners wishing to make voluntary tax payments is to designate those payments to the trust fund portion of the payroll tax liability. Voluntary payments may, according to Internal Revenue Code Section 7122(c)(2)(A), be designated toward the trust fund portion of a debt.⁸

If payments are made that are not designated toward the trust fund portion of the tax liability, they will be applied to non-trust fund debts first according to IRM Section 8.23.1.4.1.1(1)(F). For businesses that are in decline and whose closure appears to be a possi-

bility, any voluntary tax payments made to the IRS should be designated against the trust fund portion of the payroll taxes to reduce the owner's and officers' exposure personally if the company has to shut down.

Final Regulation § 301.7701-2(c)(2)(iv)(B)

Historically, because corporations are deemed to be separate entities from their shareholders, a corporation with payroll tax liabilities could be closed by its owners and have the payroll tax liability limited to the trust fund portion of the liability, for which they personally would be liable. Given that the IRS regulations state that a single-member limited liability company (LLC) is disregarded for taxes, there was confusion of whether the owner of a single-member LLC would be responsible for the entire payroll tax liability or just the trust fund portion.

In August 2007, the IRS finalized its proposed regulation which states that, though a single member LLC may be disregarded for income tax purposes, it will be treated as a corporation for purposes of employment taxes for liabilities arising after January 1, 2009.⁹ Consequently, only the trust fund portion of the payroll taxes will attach to a member-owner of an LLC if such member meets the definition of a responsible party under § 6672 and possesses the requisite willfulness.

The impact of the final regulation is that even with a single-member limited liability company, closing the business to reduce the payroll tax liability to only the trust fund portion will be a viable defense strategy.



Eric L. Green is Of Counsel to Convicer & Percy, LLP in Glastonbury, where he represents individuals and businesses in criminal

and civil tax proceedings before the IRS and the Connecticut DRS, and advises in the areas of business tax planning and estate planning for individuals and closely held businesses.

Attorney Green is currently the Vice Chair of the Closely Held Business Tax Committee of the American Bar Association, and has been quoted in several national publications, including USA Today, Consumer Reports Financial, National Underwriter and CreditCard.com.

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*The U.S. Treasury Dept. has
confirmed Atty. Seaman's
selection as the CT
Alternate Member of the
Taxpayer Advocacy Panel, an
advisory group to the IRS.*

⁷ *Stephen K. Verret, Plaintiff v. United States of America*, U.S. District Court, East. Dist. Texas; CIV. 1:06-CV-636, February 14, 2008.

⁸ See also IRS Notice 2006-68 and IRM Section 8.23.1.4.1.1(1)(E).

⁹ Regulation § 301.7701-2(c)(2)(iv)(B) and Regulation § 301.7701-2(e)(5).