

THE TRUST FUND RECOVERY PENALTY

Cincinnati Bar Report

Published April, 2006

By Howard S. Levy

To the IRS, not all taxes are necessarily created equal.

The failure to pay over employee withholding taxes raises the ire of the IRS like few other issues. Employee withholding tax defaults are different from most tax disputes - it involves a business using the tax withholdings of its' employees for operating expenses.

Betting against the IRS with other people's money is dangerous proposition.

The problem invariably arises when a business is running short on cash flow. It has a stack of invoices to pay and payroll to make. Suppliers are waiting at the door to get paid. Management realizes that if the suppliers are not paid, the supplies stop. The business has enough money to pay the suppliers and make net payroll, but not enough to pay the IRS the employee withholding taxes.

As the IRS may not come around for many months, sometimes years, management chooses to play IRS roulette. It pays the invoices from withholding money belonging to the IRS.

The Consequences of IRS Roulette

The consequences of not making employment tax deposits will resonate throughout the company for years to come. Owners, investors, management, lenders and even certain employees will find themselves under investigation by the IRS for their part in the decision to use the withholding money for operating expenses. Although severe employment tax plots carry criminal ramifications, the IRS investigation will primarily be focused on financial recovery from every party involved.

The business will come to realize just how dangerous their operating assumptions were when an IRS Revenue Officer makes an unannounced visit at its business. Management will come to that same realization when the IRS individually contacts them to determine their role.

The problem grows when the IRS completes the investigation and commences to collect the liability from the targets. Owners and management may suddenly find their homes encumbered by tax liens and threatened by garnishment. The employee withholding taxes cannot be eliminated in bankruptcy, and can be by nature difficult to settle by offer in compromise. IRS debtor's prison is the result.

Trust Fund Recovery Penalty

The liability of owners, management and employees is commonly referred to as a Trust Fund Recovery Penalty. The penalty is the amount of the withholding taxes that the business deducted from its employees' paychecks but failed to pay over to the IRS.

A business is required to deduct 7.65% of an employee's paycheck for Social Security and Medicare taxes and any required Federal income tax withholding, hold that money, and then pay it over to the IRS. Section 6672 of the Internal Revenue Code codifies the Trust Fund Recovery Penalty against owners, managers and employees for their role in failing to pay the withholdings to the IRS.

The penalty is referred to as a trust fund penalty as the taxes are held in trust by the employer for the benefit of the government.

Common targets for the Trust Fund Recovery Penalty are those who influenced or could have influenced the financial decisions of the company. The IRS will routinely propose liability to owners, investors, officers and directors of the business. Banks and lenders who loan money to a business for the purpose of making payroll can also be IRS targets if the business does not pay the withholding taxes from the proceeds of the loan. In that sense, the bank becomes a partner of the business in payroll taxes.

The corporate form does not protect owners from individual IRS assessments of unpaid withholding taxes.

Determining Management's Exposure

In addition to the virtually automatic inclusion of owners as targets of the Trust Fund Recovery Penalty, an IRS investigation will focus on who signed or could have signed bank checks, participated in financial decisions, signed for loans on behalf of the business, made bank deposits, prepared financial statements or tax returns, hired and fired employees, prepared payroll and negotiated contracts.

The IRS's all-encompassing approach to the Trust Fund Recovery Penalty often will leave a silent, minority investor with no day-to-day managerial responsibilities in the throngs of an IRS investigation. The position of ownership, even though small, will still require a defense as to control over financial decisions.

Individuals listed as signatures on corporate bank cards will draw scrutiny as having the ability to control and direct cash flow. An employee signing checks may find himself having to prove to the IRS that he did not have any managerial authority over paying the bills but merely signed checks as a convenience for management. The IRS generally will not pursue financial staff employees unless there is some indication of control over funds, such as signature authority.

Responsible persons may not even know they have that status or that the company's payroll taxes are delinquent. And if they do know, do they object and lose their jobs or continue to assist the company in accruing tax deficiencies?

Personal Liability for Withholding Taxes

To have individual liability for unpaid employee withholding taxes, the IRS must prove that there was (1) responsibility over the tax withholdings and (2) willfulness in failing to ensure that the money was paid to the IRS.

To be responsible, there must be a duty to perform the act, as well as the power and authority to direct that the act take place. Financial managers directing subordinates to pay suppliers over the IRS arguably have the duty and power. The subordinate following directions without any power or authority would argue against liability.

Willfulness requires a showing that the individual was aware, or should have been aware, that withholding taxes were not being paid. A failure of a minority owner to investigate or step in to correct a problem may be considered to be willful.

An individual can be responsible, but defend on the basis that the actions were not willful.

Protecting Management from the Trust Fund Penalty

The following steps can protect management and minimize the personal financial exposure to the trust fund recovery penalty:

- Watch the Timelines. Trust fund assessments must be made within three years from April 15 of year after the returns were due or when the returns were actually filed, whichever is later. The IRS is barred past three years.
- Voluntary Payments. Efforts should be made to ensure that any payments made on withholding tax liabilities are voluntary (meaning without levy or formal IRS agreement). The IRS should be directed to apply voluntary payments to pay off the individual trust fund taxes first. This works to minimize the personal financial exposure.

Without any designation, the IRS will apply payments on the withholding tax liability in its own best interest, which is to the non-trust fund tax liability. This leaves the business owners on the hook to fight over the trust fund portion. It also preserves the IRS's ability to collect the tax from the most sources possible.

- Lack of Collectibility. In certain situations, the IRS may withhold a trust fund assessment if it is clearly established in advance that there are minimal prospects for collection.
- Business Installment Agreement. An ongoing business that can demonstrate a substantial ability to repay the tax may defer the trust fund

investigation if waivers of the statute of limitations on assessment are provided by the targets.

- **Implement Procedures.** To limit future exposure, only those actually signing checks should be listed on the corporate bank cards, including minority owners. The number of employees approving invoices and controlling financial decisions should be monitored.

The IRS Investigation

The IRS investigation of the trust fund recovery penalty will usually commence when it becomes apparent that the business cannot immediately repay the taxes. The IRS will seek to enhance its collection prospects by quickly turning to the individuals.

The process will start with the IRS issuing a summons to the corporation's bank for its bank records. The summons will seek information reflecting who signed checks and bank signature cards indicating who could have signed checks. The summons will generally cover the timeframe the liability was incurred. The IRS will often give the business the ability to provide these documents voluntarily before the summons is issued.

Once the IRS identifies the trust fund targets, it will make contact for each target to schedule an interview with a Revenue Officer. The Revenue Officer interviews the target using a standardized questionnaire, the IRS Form 4180. The questionnaire is geared towards determining financial control, authority and knowledge. A target will also be asked to disclose any knowledge of others who may have possibly had decision-making authority in the company.

Litigating the Trust Fund Penalty

If the IRS determines that an owner, manager or employee is responsible for the trust fund penalty, a notice will be issued proposing liability and stating the amount. This notice is known as Form 2751, Proposed Assessment of Trust Fund Recovery Penalty.

If the target does not agree with the proposed liability, an administrative IRS appeal must be filed within sixty days of issuance of the notice. The IRS cannot assess the liability and commence collection while a timely filed appeal is pending.

If the satisfactory resolution cannot be reached in appeals, a complaint may be filed in U.S. District Court disputing the proposed trust fund assessment. Before filing the complaint, a deposit must be made equal to 25% of the employment taxes for one quarter's liability. The case file will then be forwarded to the Department of Justice for litigation of whether the IRS is correct in its proposal of individual liability.

In 2005, District Courts decided 34 Trust Fund Recovery Penalty cases. Of these, 13 were decided for the taxpayer in whole or in part, with 21 being decided in favor of the government. Taxpayers represented themselves in 7 of the government's

favorable decisions. Conversely, taxpayers retained counsel in all but one of the decisions in their favor.

A business that pays suppliers before the IRS is operating on a prayer that business will be better tomorrow. Unfortunately, tomorrow never comes, and the IRS shows little mercy for this decision making process. Unpaid withholding taxes will filter down, burdening not only the business but ownership, management and employees with IRS tax problems.

TABLE

Questions To Expect From the IRS in a Trust Fund Investigation

1. Describe your duties and responsibilities.
2. Did you have the ability to hire, fire and manage employees?
3. Did you direct or authorize the payment of bills?
4. Did you deal with suppliers, customers or negotiate contracts?
5. Did you open or close bank accounts?
6. Did you sign checks?
7. Did you guarantee bank loans?
8. Did you make or authorize bank deposits or payroll checks?
9. Did you prepare or review tax returns?
10. Did you authorize the payment of federal tax deposits?

Source: IRS Form 4180, Report of Interview with Individual Relative to Trust Fund Recovery Penalty
