PUBLICATION

A Trust Fund Penalty Recovery [Ober|Kaler]

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Employment Taxes

During poor economic conditions or other times when cash is short, business owners may implement cost-cutting procedures to free up capital, but, unfortunately, that may not be enough. To ease an immediate cash flow problem, cash-strapped businesses or other entities might tap into money withheld from their employees' wages for Social Security, Medicare, and income taxes and pay creditors instead of using the money to pay the IRS as intended. They mean to "borrow" this money temporarily, but in many instances the borrowing continues, and the business relegates the IRS to the back of the line of creditors or ignores it altogether.

To help ensure that taxpayers properly remit payroll taxes to the IRS, Sec. 6672(a) imposes a penalty on any person who is responsible for paying payroll taxes and willfully fails to do so. This is known as the trust fund recovery penalty (TFRP). Typically, the TFRP equals the amount of money the employer withheld from employees' wages (e.g., Social Security, Medicare, and income taxes) that was not remitted to the IRS.

The rationale for imposing this penalty at the individual level is that the individual held these taxes in trust for the government. While a corporate structure may generally shield individuals from personal liability, it does not shield individuals from the TFRP, and a "responsible person" may be personally liable for the TFRP if the business fails to properly remit the requisite amounts. This item discusses the basic mechanics of the TFRP, what qualifies someone as responsible for payroll taxes, and what constitutes willfulness. It also briefly describes the process and procedures of a TFRP assessment.

Responsible Person

Under Sec. 6671(b), a responsible person "includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty" to pay over taxes withheld. Courts have generally understood responsible person status to depend on the individual's control over corporate payments. Specifically, could the individual influence the decision to pay other creditors before the IRS? The IRS considers many factors in making this determination, including the individual's duties, corporate status, signature authority over the business's accounts, and ability to hire and fire employees. Ultimately, the determination rests on the facts and circumstances of each case.

"Control" in this context does not require the individual to have the final say about disbursing company funds. As long as the individual can exercise significant control over funds disbursement, he or she is a responsible person. For example, courts have found a controller who received funds from a financing company and paid the employees' wages but did not pay the IRS to be a responsible person, even though the financing company supplied funds only for the wages and refused to finance the taxes (Hochstein, 900 F.2d 543 (2d Cir. 1990)). However, having purely ministerial duties is not sufficient control, as in the case of a company bookkeeper who had check-signing authority but could pay bills only as directed by the treasurer.

Courts have generally taken a broad view when considering who is a responsible person. Even if an individual who is a responsible person delegates the responsibility to pay the IRS to another person, the individual generally remains a responsible person and potentially liable for the TFRP. According to the court in Davis,

961 F.2d 867 (9th Cir. 1992), the threat of being personally liable for the TFRP prevents other potentially responsible persons at other businesses from misusing the trust fund taxes.

What happens if an individual assumes responsible person status after the business incurs the trust fund debt? If this newly responsible person pays other creditors instead of the IRS from funds that the business acquires after the person assumes responsibility, he or she is not liable for the TFRP (Slodov, 436 U.S. 238 (1978)). However, if the individual uses funds that were available when he or she assumed the responsible person status to pay other creditors, then the IRS may be more successful in finding him or her responsible for the TFRP to the extent of the funds available to pay the trust fund taxes.

Willfulness

Once the IRS determines that the individual is a responsible person, the next step is to determine whether the individual was “willful” in failing to pay the taxes to the IRS. For these purposes, willful means that the responsible person chose to pay other creditors instead of the IRS, even though the individual knew, or recklessly disregarded, that the business was not paying the taxes. Willfulness does not require evil intent or bad faith. If a responsible person is aware that the business is or was delinquent in remitting its payroll taxes, he or she should not rely on assurances that the taxes are now being properly remitted but rather should fully investigate the issue and be certain that the taxes are being paid. As a practical matter, once an individual is established to be a responsible person, it is difficult to show that he or she should not have been aware of the tax issues or that the business was paying other creditors instead of the IRS.

The responsible person has limited defenses for a failure to pay. The IRS generally takes the position that even a genuine, yet mistaken, belief that the business was required to pay other creditors in preference to trust fund taxes does not make the failure to pay nonwillful (Internal Revenue Manual (IRM) §5.17.7.1.3(7)). The courts have recognized that reasonable cause is theoretically an acceptable excuse, but in practice it is unlikely that a taxpayer can establish a reasonable-cause defense. Even when the owner of a company ordered a responsible person to not pay the taxes, courts have held that the responsible person should have risked being fired rather than pay other creditors (Brounstein, 979 F.2d 952 (3d Cir. 1992)).

The TFRP Assessment Process

An IRS revenue officer begins the process of assessing the TFRP with an investigation to determine which individuals were responsible and willful. The revenue officer typically requests corporate records, bank documents, and other related documentation from the business and any other relevant documentation. If the business fails to provide the requested documentation, the IRS may serve a summons on the business, and possibly the business's bank or other relevant party, for it.

Prior to making a recommendation regarding a responsible and willful individual, the revenue officer must secure core documentation necessary to support the recommendation for each quarter being assessed. The necessary core documents include the articles of incorporation; bank signature cards or electronic PINs/passwords; and a sampling of canceled checks demonstrating payment to other creditors in preference to the government or, if the taxpayer predominantly uses electronic banking, bank statements demonstrating debit transaction payments to other creditors in preference to the government. If the revenue officer cannot secure all of the core documentation, he or she must record why the documentation was inaccessible and why the missing documentation was not necessary to support the recommendation.

Generally, the revenue officer interviews the individuals whom the preliminary investigation identified as potentially responsible and willful. The revenue officer uses Form 4180, Report of Interview With Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes, in the interview to record

detailed information about the business. The revenue officer asks detailed questions about the individual's role in the business and other individuals associated with the business. This means that the IRS will ask people to inform against their superiors and co-workers.

Form 4180 is evidence and, as such, needs to be taken very seriously. The individual's representative should ensure that the revenue officer accurately and completely records the answers given. Individuals may provide the revenue officer with affidavits from other company personnel to supplement the individual's testimony. Many of the questions on Form 4180 do not give room for explanation, and affidavits from other employees can be invaluable tools to supplement the “yes” or “no” answers on the form and give the revenue officer a complete picture. Additionally, affidavits help lay the groundwork if the case is forwarded to IRS Appeals.

The revenue officer may request that the potentially responsible individual complete a Form 433-A, Collection Information Statement for Wage Earners and Self-Employed Individuals, to determine potential collectability. However, the revenue officer may not have authority to insist on the form's completion unless there are already other assessments against the individual. If a successful collection from the responsible party is unlikely, either because there is no present or future collection potential or the responsible person and his or her assets cannot be located, the IRS generally will not assess the TFRP against that individual.

The actual collection of the TFRP begins with Letter 1153(DO) and Form 2751, Proposed Assessment of Trust Fund Recovery Penalty, notifying the individual that there will soon be a demand for payment of the TFRP. The individual usually has the right to appeal the proposed TFRP assessment for 60 days after the date of Letter 1153(DO). Unless the individual agrees with the revenue officer's determination and agrees to the assessment, it is advisable to file a written protest with the revenue officer. The protest should contain the individual's name, address, and Social Security number; a copy of the Letter 1153(DO); a request for an appeal conference; the tax periods involved; and a list of issues being contended, including citations to the legal authorities that support the protest.

Generally, assuming Forms 941, Employer's Quarterly Federal Tax Return, or comparable returns were timely filed, the IRS has three years to assess the TFRP from the April 15 that succeeded the return's due date (IRM §5.7.3.5). If the business's return was filed after the due date, the statute of limitation begins to run from either the April 15 that succeeded the return's due date or three years from when the return was actually filed, whichever is later. However, false or fraudulent returns and returns prepared by the IRS under Sec. 6020(b)(1) do not start the running of the statute.

The individual against whom the TFRP is assessed should note that the IRS applies payments in its best interest. This means that the IRS first applies a payment made from business assets to the non–trust fund portion of a company's tax liabilities, and only after that liability is satisfied does the IRS apply payments to the trust fund portion of the taxes. By following certain procedures, taxpayers generally can designate that the IRS apply the voluntary payments toward the trust fund taxes only. If the individual pays the assessed TFRP but does not agree with the assessment, he or she can then file a Form 843, Claim for Refund and Request for Abatement. A responsible person cannot file a refund suit until six months after the refund claim is filed unless the IRS denies the claim within six months. If the IRS denies the claim, the individual generally has two years to file a refund suit in U.S. district court.

An individual who has been assessed a TFRP should investigate the possibility that other employees are also liable for the TFRP and seek contribution from them. Sec. 6103(e)(9) authorizes the individual to request from the IRS the names of other persons the IRS has found liable, whether the IRS has attempted to collect the penalty from them, and any amount collected. However, a person is considered liable under Sec. 6103(e)(9) only once there is an assessment against him or her. If there is no assessment against the individual, there is no disclosure. Careful and competent representation can minimize a client's liability for TFRPs.