

Practice

Overview: Trust Fund Recovery Penalty

By Charles P. Rettig

Introduction

A Federal District Court recently held that the sole shareholder and president of a company that sold tractors was liable for federal income and Social Security taxes withheld from the wages of the employees finding that he (1) was a responsible person despite having delegated his authority to a manager who embezzled funds and failed to pay the company's taxes, and (2) willfully failed to pay over taxes.¹ The company manager had a verbal option to purchase the business and was responsible for every aspect of the business, including day-to-day operations, financial management, purchasing of product lines, paying all of bills and other duties required to run an equipment sales business. The company president had authority to sign checks on the company bank account and was listed on the bank signature card as an "owner" but did not write any checks on the account.

The Internal Revenue Code ("the Code") requires employers to withhold federal income and Social Security taxes from the wages of their employees.² An employer is deemed to hold the withheld taxes "in trust" for the United States and must pay them over to the government on a quarterly basis.³ The withheld amounts are known as trust fund taxes.⁴ If an employer withholds the taxes from its employees but fails to remit them, the government must nevertheless credit the employees for having paid the taxes, and seek the unpaid funds from the employer.⁵ Under Code Sec. 6672(a), the IRS may assess a penalty on responsible persons who willfully fail to collect, account for and pay over the taxes to the United States.⁶

In order for the United States to assess the penalty under Code Sec. 6672, two requirements must be met: (1) the party assessed must be a "responsible person," *i.e.*, one required to "collect, truthfully account for and pay over the tax," and (2) the party assessed must have "willfully refused to pay the tax." The individual against whom an assessment is made "bears the burden of proving by a preponderance of the evidence that one or both [of the elements of responsibility and willfulness] is not present."⁷

Responsible Person

For purposes of Code Sec. 6672, responsibility "is a matter of status, duty, and authority[.]"⁸ "Authority turns on the scope and nature of an individual's power



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to determine how the corporation conducts its financial affairs; the duty to ensure that withheld employment taxes are paid overflows from the authority that enables one to do so.”⁹ That an “individual’s day-to-day function in a given enterprise is unconnected to financial decision making or tax matters is irrelevant where the individual has the authority to pay or to order the payment of delinquent taxes.”¹⁰ Similarly, delegation of authority to pay taxes, alone, will not relieve a person of responsibility (although the fact of delegation may be relevant on issue of willfulness).¹¹

Code Sec. 6672 can lead to extremely harsh results for individuals involved in corporate entities that fail to pay over amounts deemed withheld from the employees.

In order to determine whether someone has the authority to pay taxes, and is thus “responsible” under Code Sec. 6672, courts have looked to a number of nonexclusive factors common in the Code Sec. 6672 case law, such as whether the taxpayer participated in day-to-day management of the company, determined which creditors to pay and when to pay them, had the ability to hire and fire employees, served as an officer of the corporation or a member of its board of directors, owned a substantial amount of stock in the company or possessed check writing authority.¹² Not every factor must be present; instead, the court must consider the totality of the circumstances to determine whether the potentially responsible person had the “effective power” to pay the taxes owed by the company.¹³

Persons who are neither corporation officers nor employees may be responsible for collecting and paying over trust fund taxes such as directors.¹⁴ Courts look at the scope of the authority to act, not the title. A person may be a director or corporate officer and have nothing to do with payroll, preparation and signing of checks, or the decision about what creditors to pay. Where these facts are present, a person might not be held responsible for purposes of the penalty.

Significantly, as more than one person may meet the foregoing criteria, “[t]here may be—indeed—there usually are—multiple responsible persons in any company.”¹⁵ Code Sec. 6672 “expressly applies to ‘any’ responsible persons, not just to the person most responsible for the payment of taxes.” As such, “[t]hat another

person in the company has been delegated the jobs of withholding and generally paying creditors is beside the point.” The “crucial inquiry” is whether a party, “by virtue of his position in (or *vis-à-vis*) the company,” could have had “substantial” input into such financial decisions, had he wished to exert his authority. A party “cannot be presumed to be a responsible person merely from titular authority, status as an officer or director is nevertheless material to this determination.”¹⁶

Willfulness

If a person is deemed a “responsible person,” the next issue to decide is whether that person “willfully” failed to collect, account for or remit payroll taxes to the United States.¹⁷ The Ninth Circuit has defined willfulness “as a voluntary, conscious and intentional act to prefer other creditors over the United States.”¹⁸ In order to satisfy the willfulness prong, “[n]o bad motive need be proved, and conduct motivated by reasonable cause, such as meeting the payroll, may be ‘willful.’”¹⁹ As the Ninth Circuit has explained:

If a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, even to meet the payroll out of personal funds he lends the corporation, our precedents require that the failure to pay withholding taxes be deemed “willful.” This may seem oppressive to the employer and employees, and amount to “unwittingly” willful, which seems an oxymoron, but the proposition is established law.²⁰

Willfulness is the attitude of a responsible person who with free will or choice either intentionally disregards the law or is plainly indifferent to its requirements. The Internal Revenue Manual identifies various factors to consider when determining willfulness including:

- whether the responsible person had knowledge of a pattern of noncompliance at the time the delinquencies were accruing;
- whether the responsible person had received prior IRS notices indicating that employment tax returns have not been filed, or are inaccurate, or that employment taxes have not been paid;
- the actions the responsible party has taken to ensure its Federal employment tax obligations have been met after becoming aware of the tax delinquencies; and
- whether fraud or deception was used to conceal the nonpayment of tax from detection by the responsible person.²¹

Further, the IRM identifies the following starting points for common willfulness issues²²:

- The government must show that the responsible party was aware of the outstanding taxes and either deliberately chose not to pay the taxes or recklessly disregarded an obvious risk that the taxes would not be paid.²³
- A responsible person's failure to investigate or correct mismanagement after being notified that withholding taxes have not been paid.²⁴
- The payment of net wages to employees when funds are not available to pay withholding taxes is a willful failure to collect and pay over under Code Sec. 6672. If funds are not available to cover both wages and withholding taxes, a responsible person has a duty to prorate the available funds between the United States and the employees so that the taxes are fully paid on the amount of wages paid. For purposes of determining willfulness, an employee owed wages is merely another creditor of the business, and preferences to employees over the government constitute willfulness.²⁵
- A mistaken belief that payments to other creditors were required to be made in preference to trust fund taxes does not make the failure to pay nonwillful.²⁶

After-Acquired Knowledge/Funds

A taxpayer may act "willfully" for purposes of Code Sec. 6672 even though he does not learn about unpaid taxes until after the corporation has failed to pay them.²⁷ When "a responsible person learns that withholding taxes have gone unpaid in past quarters for which he was responsible, he has a duty to use all current and future unencumbered funds available to the corporation to pay those back taxes."²⁸ If the taxpayer instead knowingly permits payments of corporate funds to be made to other creditors, a finding of willfulness is appropriated. "Even assuming ... that [the taxpayer] did not act willfully prior to learning of the full extent of the tax deficiencies ..., his conduct after that point unquestionably evidences willfulness as a matter of law."²⁹

In *I. Slodov*, the Supreme Court held new management of a corporation is not personally liable for a Code Sec. 6672 penalty upon using after-acquired revenue to satisfy creditors other than the United States, provided the new management assumes control when a delinquency for trust fund taxes already exists and the withheld taxes have already been dissipated by prior management.³⁰ The Supreme Court in *Slodov* based this holding in part:

[O]n the rationale that to hold a taxpayer personally liable to the extent of after-acquired funds for taxes owed during a time in which he was not a responsible person would be to discourage new investors from attempting to salvage a failing business, which, if the salvage effort were successful, would enable the government to collect more in delinquent taxes than if the business failed.³¹

Those involved in the operations of companies suffering from the recessionary economy should be careful in determining which creditors are to be paid and which are not to be paid ...

In *Shore*, the District Court noted that "allowing a responsible party to divert after-acquired funds to pay liabilities other than that owed for unpaid payroll taxes would in effect require the federal government to subsidize the corporation's recovery by foregoing collectible tax dollars."³² As numerous courts have counseled, "[T]he government cannot be made an unwilling partner in a business experiencing financial difficulties."³³

Right of Contribution

If more than one person is liable for the penalty under subsection (a) with respect to any tax, each person who paid such penalty shall be entitled to recover from other persons who are liable for such penalty an amount equal to the excess of the amount paid by such person over such person's proportionate share of the penalty. Any claim for such a recovery may be made only in a proceeding which is separate from, and is not joined or consolidated with (1) an action for collection of such penalty brought by the United States, or (2) a proceeding in which the United States files a counterclaim or third-party complaint for the collection of such penalty.³⁴

Exception for Voluntary Board Members of Tax-Exempt Organizations

The Code Sec. 6672 penalty shall not be imposed on any unpaid, volunteer member of any board of

trustees or directors of a tax exempt organization if such member (1) is solely serving in an honorary capacity, (2) does not participate in the day-to-day or financial operations of the organization, and (3) does not have actual knowledge of the failure on which such penalty is imposed.³⁵ However, the foregoing exception does not apply if it results in no person being responsible for the Code Sec. 6672 penalty.

ENDNOTES

¹ *W.R. Shore*, DC-ID, 2014-2 ustr ¶150,534; Code Sec. 6672(a) provides, "Any person required to collect, truthfully account for, and pay over any tax imposed by his title 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, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over."

² See Code Secs. 3102(a) and 3402(a).

³ Code Sec. 7501(a).

⁴ *D.O. Davis*, CA-9, 92-1 ustr ¶150,292, 961 F2d 867, 869.

⁵ *Id.*

⁶ *R.A. Jones*, CA-9, 94-2 ustr ¶150,448, 33 F3d 1137, 1138.

⁷ See *A. Hochstein*, CA-2, 90-1 ustr ¶150,205, 900 F2d 543, 547.

⁸ *Davis*, *supra* note 4, at 873 (citations omitted).

⁹ *J.F. Purcell*, CA-9, 93-2 ustr ¶150,460, 1 F3d 932, 937.

¹⁰ *Id.*

¹¹ *Id.*, at 936-37 (courts have uniformly and repeatedly rejected the theory that delegation of authority to pay taxes will relieve an individual from responsible person status).

¹² See, e.g., *M.J. Conway*, CA-5, 2011-2 ustr ¶170,304, 647 F3d 228, 233; *M. Johnson*, CA-4, 2013-2 ustr ¶150,578, 734 F3d 352, 361; *Jones*, *supra* note 6, 33 F3d, at 1140; *R.D. Barnett*, CA-5, 93-1 ustr ¶150,269, 988 F2d 1449, 1454 (noting "countless courts have found responsibility [for purposes of Code Sec. 6672] as a matter of law" because "certain facts will almost invariably prove dispositive of a finding of responsibility."); *C.B. Erwin*, CA-4,

2010-1 ustr ¶150,354, 591 F3d 313, 321 (affirming finding plaintiff was responsible person as a matter of law where plaintiff owned one-third interest in company and served as a corporate officer and director, selected business sites, hired and fired employees, and, within months of learning of the company's tax deficiencies, took complete control of the company's financial operations); *C.E. Jefferson*, CA-7, 2008-2 ustr ¶150,587, 546 F3d 477, 481 (board president was a responsible person as a matter of law because he secured loans and directed past payment of taxes for the corporation, reviewed financial reports, and had check-signing authority); *W.A. Kinnie*, CA-6, 93-1 ustr ¶150,311, 994 F2d 279, 284 (corporate vice-president and 50-percent shareholder was a responsible person as a matter of law because he had check-signing authority, hired an accountant to review the books and eventually took control of the business).

¹³ *Erwin*, *supra* note 12, 591 F3d, at 321.

¹⁴ *L.P. Graham*, CA-9, 62-2 ustr ¶9782, 309 F2d 210, a prospective purchaser (*J. Melillo*, DC-NY, 65-2 ustr ¶9446, 244 FSupp 323); *C.J. Caterino*, CA-1, 86-1 ustr ¶19452, 794 F2d 1, a surety (*Pacific National Insurance Co.*, CA-9, 70-1 ustr ¶9238, 422 F2d 26), a creditor (*Walker*, DC-OK, 68-1 ustr ¶9370), a trustee or other fiduciary (*National Bank of Commerce v. Phinney*, DC-TX, 65-2 ustr ¶9512; see also *Saltzman*, IRS PRACTICE AND PROCEDURE, ¶17.08[1], note 8 (2d ed. 1991)), or an attorney (*A.R. Brown, Jr.*, CA-5, 72-2 ustr ¶9568, 464 F2d 590, *cert. denied*, Sct, 410 US 908, 93 Sct 962 (attorney who became "nominal" president of his client's corporation); *G.F. Wyner*, DC-MI, 82-1 ustr ¶9341.

¹⁵ *Barnett*, CA-5, 93-1 ustr ¶150,269, 988 F2d 1449, 1455.

¹⁶ *Johnson*, *supra* note 12, 734 F3d, at 361.

¹⁷ Code Sec. 6672(a); See also IRM, 8.25.1.4.2 (Dec. 7, 2012).

¹⁸ *Davis*, *supra* note 4, 961 F2d, at 871; See also *S.R. Rykoff*, CA-9, 94-2 ustr ¶150,601, 40 F3d 305 and *A.A. Alsheskie*, CA-9, 94-2 ustr ¶150,387, 31 F3d 837, 838.

¹⁹ *H.D. Buffalow, Jr.*, CA-9, 97-1 ustr ¶150,290, 109 F3d 570, 573 (citing *M.E. Phillips*, CA-9, 96-1 ustr ¶150,057, 73 F3d 939, 942; *R.A. Jones*, CA-9, 95-2 ustr ¶150,373, 60 F3d 584, 587-88; *J. Klotz*, CA-9, 79-2 ustr ¶9552, 602 F2d 920, 923; *E.A. Teel*, CA-9, 76-1 ustr ¶9190, 529 F2d 903, 905).

²⁰ *Phillips*, *supra* note 19, 73 F3d, at 942.

²¹ IRM 8.25.1.4.2 (Dec. 7, 2012).

²² *Id.*

²³ *Phillips*, *supra* note 19.

²⁴ *E.J. Finley*, CA-10, 97-2 ustr ¶150,613, 123 F3d 1342.

²⁵ *A. Hochstein*, DC-NY, 89-2 ustr ¶9442, 713 FSupp 119.

²⁶ *E.B. Thomsen, Jr.*, CA-1, 89-2 ustr ¶9575, 887 F2d 12 [**17-18].

²⁷ *Johnson*, *supra* note 12, 734 F3d, at 364.

²⁸ *Erwin*, *supra* note 12, 591 F3d, at 326.

²⁹ *Id.*

³⁰ *Davis*, *supra* note 4, 961 F2d, at 871-72 (citing *I. Slodov*, Sct, 78-1 ustr ¶9447, 436 US at 259-60, 98 Sct 1778, 1978-2 CB 327).

³¹ *Kinnie*, *supra* note 12, 994 F2d, at 285 (citing *Slodov*, *supra* note 30, 436 US at 252-53).

³² *Shore*, *supra* note 1.

³³ *Id.* (quoting *J.A. Thibodeau*, CA-11, 87-2 ustr ¶9620, 828 F2d 1499, 1506; see also *I. Mazo*, CA-5, 79-1 ustr ¶9284, 591 F2d 1151, at 1154 ("[T]he United States may not be made an unwilling joint venture in the corporate enterprise.").

³⁴ Code Sec. 6672(d).

³⁵ Code Sec. 6672(e).

Summary

Code Sec. 6672 can lead to extremely harsh results for individuals involved in corporate entities that fail to pay over amounts deemed withheld from the employees. Those involved in the operations of companies suffering from the recessionary economy should be careful in determining which creditors are to be paid and which are not to be paid ...

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