TRUST FUND RECOVERY PENALTY

PRIMER

Overview

Most employers must withhold Social Security, Medicare and federal income taxes from their employees' wages. Businesses generally must collect and remit excise taxes from their customers. These withholdings are often referred to as "trust fund taxes" because the employers or businesses, as the case may be, hold them in trust for the United States until they pay them to the Treasury, pursuant to § 7501(a) of the Internal Revenue Code (IRC).[1]

If and when employers or businesses fail to pay their trust fund taxes on time, IRC § 6672[2] permits the government to impose the "Trust Fund Recovery Penalty" ("TFRP") on persons (usually individuals) other than those employers or businesses. The amount of the TFRP is 100% of the delinquent trust fund taxes. It is distinct from and in addition to the original tax liability; and it is a personal liability, not limited by any corporate liability of the original employer or business.

The Legal Test

In determining whether the § 6672 TFRP applies to a person other than the relevant employer or business, courts focus on:

i) whether the person is responsible for collecting the trust fund taxes in question; and
ii) whether the responsible person *willfully* failed to pay the taxes. In some circuits, this can include a consideration of whether there was "reasonable cause" for the failure.

Key Concepts

Responsible Persons

"Responsible person" is the shorthand phrase for a "person required to collect, truthfully account for, and pay over any tax imposed by this title" as described in § 6672. In the Supreme Court decision of *Slodov v. United States*, it was clarified that a person does not have to be in a position to perform all three of these duties with respect to the tax dollars in question to be a responsible person; it is sufficient that they are required to collect third-party taxes.[3] This person can be an officer of a corporation, a member of a partnership, a corporate director, a shareholder, or any other person, including another corporation. The key consideration is whether they have significant influence and control over the financial affairs of the business or employer who was supposed to collect the taxes in the first place – especially the disbursement of funds and the priority of payments to creditors.[4] There can be more than one responsible person. The statute does not require the government, in seeking to satisfy the TFRP, to limit its target to the highest-ranking responsible person or, conversely, to pursue every responsible person.[5]

Willfulness

The responsible person must have also acted "willfully" for the TFRP to apply. Absent a definition in the Code, the courts have defined willfulness in the context of § 6672 as a "voluntary, conscious and intentional decision to prefer other creditors over the Government."[6] No evil or fraudulent motive is required. If the responsible person knew, or ought to have known, that trust fund taxes were owed, and then deliberately chose to pay others first, or recklessly disregarded an obvious risk that the trust fund taxes would not be paid, willfulness exists.[7] In the situation where 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. Doing otherwise would constitute preferring employees to the government and would be considered willful.[8]

Reasonable Cause Defense

The circuit courts do not agree as to whether the defense of "reasonable cause" is available in the TFRP context. Although other penalty provisions in the Internal Revenue Code specifically permit this defense, § 6672 does not. Some circuits have taken this to mean it is simply not available.[9] Others have ruled that reasonable cause, in limited circumstances, can be a part of the willfulness analysis[10] and still other circuits have not explicitly rejected or accepted the reasonable cause defense.[11]

Concepts in Action: Case Law Examples

Factors Going to Responsibility: Status, Duties and Authority

The test for determining a "responsible person" is one of substance and not form. In *Godfrey v. United States*,[12] for example, Mr. Godfrey's status as Chairman of the Board provided him with a great deal of broad, top-level formal authority. Everyone looked to him for ultimate decisions on financial, personnel and management decisions. However, his actual duties did not include any participation in the business' day-to-day financial operations and decisions. He did not sign, or have authority to sign, checks; he did not control payroll or decide which creditors would be paid; and he did not own a significant number of voting shares. He was held not to be a responsible person as he could not be seen, in all the circumstances, as a person who had any control over the collection, accounting for, and payment over of trust fund taxes.

On the other hand, in *Gephart v. United States*,[13] Mr. Gephart was found to be a "responsible person" even though he was neither a director nor an officer and did not own any shares. His title was General Manager and his authority was subordinate to that of the company's executive officers. However, Mr. Gephart performed many day-to-day administrative, accounting and operating functions of the business involving financial knowledge, judgment and discretion. This included writing to customers and suppliers, participating in financial meetings, dealing with creditors or debtors, determining the priority of bills to pay and having general responsibility over payroll.

Factors Going to Willfulness: Knowledge, Reckless Disregard of Known Risk, and Preference of Other Creditors and Payment Attempts

For a person to "consciously" choose to prefer creditors other than the tax authorities, they must have had knowledge, actual or constructive, that the trust fund taxes were owing in the first place. As for the choice being "intentional," a reckless disregard of an obvious risk that the trust fund taxes would not be paid can show intention to prefer creditors just as much as a deliberate action.

In *Jenkins v. United States*,[14] the court found that, despite Mr. Jenkins' claim that he only knew about the tax delinquencies relatively recently, the company's past tax problems and installment agreement to pay back taxes, along with the fact that the company's President had been unreliable in this regard, pointed to a conclusion that he knew about the risk of non-payment for quite some time previously, but ignored the situation. It was no defense that he trusted the company's President—as soon as he had this knowledge, he ought to have been monitoring the situation to make sure the payments were being made and taking corrective action if they were not. Finally, apart from the reckless disregard of the risk of non-payment, even when Mr. Jenkins admitted he fully realized the tax problem, he clearly preferred other creditors by writing checks to others with unencumbered funds, instead of immediately using all unencumbered funds available to pay the trust fund taxes owing.

The Limited Availability of "Reasonable Cause"

The circuit courts that have held that "reasonable cause" can negate willfulness have also held that the application of this defense is extremely limited. While other tax penalties might be avoided with reasons such as the illness of the taxpayer, an inability to obtain records, or undue hardship, such excuses they have little to no significance in the TFRP context. Reliance on a third-party professional's tax advice, however, might constitute reasonable cause,[15] as might circumstances beyond the taxpayer's control that frustrated a taxpayer's reasonable efforts to protect the trust funds.[16]

Roadmap

The following list is a potential guide to considering liability for the TFRP:

1. Is the person responsible for collecting taxes to be remitted to the government?

a) What was the person's status and role in the business?
b) Did the individual's day-to-day duties involve disbursing funds on behalf of the company, or reviewing and approving payroll?
c) Did the person have authority to direct financial policy, hire and fire employees, negotiate contracts or sign tax returns?

2. Did the responsible person willfully fail to remit the taxes?

a) Was the tax delinquency a one-time event?
b) Was the business or employer having difficulties meeting financial obligations?
c) Had the IRS already contacted the person with a concern?
d) Did the person lack knowledge of the non-payment due to the deception or fraud of another person?
e) Was there actual or attempted partial payment of overdue amounts in a prompt manner?

3. What jurisdiction governs? Does it reject or accept the "reasonable cause" defense to negate willfulness?

a) What efforts did the person make to protect the trust funds?
b) Were there circumstances preventing payment outside the person's control?
c) Did the person rely on third-party professional advice that the taxes were being treated appropriately?

Tax Foresight

Tax Foresight's **Trust Fund Related Penalty Classifier** can assist you in predicting court outcomes based on your specific set of facts.

Tax Foresight's Trust Fund Related Penalty Case Finder can save you valuable research time and find you the most relevant cases based on particular factors present in your situation.

Endnotes

1 § 7501(a) states: "Whenever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States…"
2 § 6672(a) states: "Any person required to collect, truthfully account for, and pay over any tax imposed by this title [such as payroll withholdings or excise taxes] 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…"
3 *Slodov v. United States*, 436 U.S. 238 (1978), at 250.
4 *Gephart v. United States*, 818 F.2d 469 (6th Cir. 1987), at 473.
5 *Howard v. United States*, 711 F.2d 729 (5th Cir. 1983), at 734-5.
6 *Denbo v. United States*, 988 F.2d 1029 (10th Cir. 1993), at 1033.
7 *Phillips v. United States*, 73 F.3d 939 (9th Cir. 1996)), at 942.
8 See *Hochstein v. United States*, 713 F. Supp. 119 (S.D.N.Y. 1989), at 548.
9 See *Harrington v. United States*, 504 F.2d 1306 (1st Cir. 1974) and Olsen v. United States, 952 F.2d 236 (8th Cir. 1991).
10 See *Winter v. United States*, 196 F.3d 339 (2nd Cir. 1998); *Newsome v. United States*, 431 F.2d 742 (5th Cir. 1970); *Byrne v. United States*, 857 F.3d 319 (6th Cir. 2017); *Myers v. United States*, 307 F. Supp.3d 1349 (N.D. Ga., 2018); and *Finley v. United States*, 123 F.3d 1342 (10th Cir. 1997).
11 *Wall v. United States*, 592 F.2d 154 (3rd Cir. 1979); *Erwin v. United States*, 591 F.3d 313 (4th Cir. 2010).
12 *Godfrey v. United States*, 748 F.2d 1568 (Fed. Cir. 1984).
13 *Supra*.
14 *Jenkins v. United States* (Fed. Cl. 2011).
15 See, for example, *Newsome, supra*.
16 As noted in *Finley*, supra, although a new trial had to be ordered and there was no adjudicated result as to whether this test was met.