

THE LIFE CYCLE OF AN IRS TRUST FUND TAX CASE

FROM THE FAILURE TO COLLECT AND PAY OVER TO LITIGATION

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I. Introduction

- A. According to the IRS Data Book (available online at <http://www.irs.gov/pub/irs-soi/10databk.pdf>), for the fiscal year ending September 30, 2010 the Service collected approximately \$2.35 trillion in taxes, with more than half of that amount being withheld by employers and other third parties (\$900 billion in withheld income taxes and \$380 billion in withheld Social Security and Medicare taxes).
- B. Section 6672 provides “[a]ny person required to collect, truthfully account for, and pay over any tax imposed by this 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.” IRC § 6672(a).
1. Section 6672 applies only to third-party taxes, i.e., those taxes imposed on a person other than the person required to collect, account for, and pay over the taxes. Treas. Reg. § 301.6672-1.
 - i. The penalty applies only to the employee income tax, Social Security and Medicare withholdings. The penalty is not imposed on the employer’s share of the Social Security or Medicare taxes, employment tax deposit penalties, etc.
 2. Although the tax theoretically applies to all taxes imposed under the Code¹ for which there is a withholding or collection obligation (e.g., gambling winnings, interest and dividends subject to backup withholding), the Service focuses its efforts on income tax, Social Security, and Medicare withholding because of the aggregate amount at issue when employers fail to pay over withheld taxes.
- C. The Service utilizes the Trust Fund Recovery Penalty to:
3. Enhance voluntary compliance; and
 4. Collect unpaid trust funds when employers fail to pay over withheld taxes. I.R.M. 5.7.3.1 (11-12-2010).
 - a. Employees are given credit for taxes that are withheld even if the employer does not remit the taxes. IRC § 31(a)(1); Treas. Reg. § 1.31-1(a); *Slodov v. U.S.*, 436 U.S. 238, 243 (1978).

¹ All references to the “Code” are to the Internal Revenue Code of 1986, as amended.

II. Employment Tax Deposit Requirements

- A. Generally, employers are required to deposit federal income tax withheld and both the employer and employee portions of Social Security and Medicare taxes under one of three timing rules:
1. *The monthly rule*, which requires deposit on or before the 15th day of the following month if the aggregate amount of employment taxes reported for the lookback period (i.e., the 12-month period ended the preceding June 30) is \$50,000 or less; or
 2. *The semi-weekly rule*, if the aggregate amount of employment taxes reported for the lookback period exceeds \$50,000; or
 - a. Under the semi-weekly rule, deposits are required to be made: (a) on or before the immediately following Wednesday if payment is made on a Wednesday, Thursday, or Friday; or (b) on or before the immediately following Friday if payment is made on a Saturday, Sunday, Monday or a Tuesday
 3. *The one-day rule*, (notwithstanding the above rules) if on any day an employer has \$100,000 or more of employment taxes accumulated, the accumulated taxes must be deposited by the close of the next banking day. Treas. Reg. §§ 31.6302-1(c).
- B. Deposit penalties are imposed against employers if deposits are not timely made:
1. 2% for deposits made 1 to 5 days late
 2. 5% for deposits made 6 to 15 days late
 3. 10% for deposits made 16 or more days late or within 10 days of the first notice
 4. 15% for amounts unpaid more than 10 days after notice. IRC § 6656.

III. Employment Tax Return Filing Requirements

- A. With certain limited exceptions, employers must file with the Service a quarterly return reporting withheld taxes on Form 941, *Employer's Quarterly Federal Tax Return*.
- B. Form 941 must be filed by Apr. 30, July 31, Oct. 31 and Jan. 31 for the calendar quarters ending Mar. 31, June 30, Sept. 30 and Dec. 31, respectively.
1. Returns may be filed ten days late if timely deposits were made.

IV. Overview of Section 6672.

- A. In order to establish an individual's liability under § 6672, the government must prove two elements:
1. The individual was responsible; and
 2. That he or she was acted willfully in failing to remit the funds.

B. Responsible Person

1. Responsibility is a matter of status, duty, and authority, not knowledge. *Quattrone Accountants, Inc. v. I.R.S.*, 895 F.2d 921, 927 (3d Cir. 1990). In determining whether an individual is a responsible person, courts have considered many factors, with the following factors often being examined or considered:
 - a. The authority granted to officers and employees in the employer's bylaws or similar documents;
 - b. The individual's ability to sign checks on the employer's bank accounts;
 - c. Whether the individual signed the employer's employment tax and other returns;
 - d. Whether the individual made payments to other creditors in lieu of the United States;
 - e. Whether the individual was an officer, director, or principal stockholder of the employer;
 - f. Whether the individual hired or fired employees; and
 - g. Whether the individual was in charge of the employer's financial affairs. *Brounstein v. United States*, 979 F.2d 952, at 954-55 (3d Cir. 1992).
2. Creditors and Others
 - a. While there is precedent in the Third Circuit and other circuits establishing that those who are not employees, officers, or directors can be considered responsible persons, *see, e.g., Quattrone*, the Third Circuit requires that such individuals have "significant, though not necessarily exclusive, control over the employer's finances." *United States v. Vespe*, 868 F.2d 1328, 1332 (3d Cir. 1989).
 - b. A person will be deemed to control an employer's finances "if he has the final or significant word over which bills or creditors will get paid." *Quattrone*, 895 F.2d at 927.
 - c. Courts have recognized that an employer's filing for bankruptcy relief under Chapter 11 generally affects the ability of a creditor to control the employer's finances. *Causey v. United States*, 683 F. Supp. 1381, 1386 (M.D. Ga. 1981).

D. Willfulness

1. In *Brounstein*, the Court articulated the Third Circuit's test for willfulness: "[a] responsible person acts willfully when he pays other creditors in preference to the [Service] knowing that taxes are due, or with reckless disregard for whether taxes have been paid." *Brounstein v. United States*, 979 F.2d at 956.

2. Responsible persons need not actually pay, or direct others to pay, creditors other than the Service. *See Cline v. United States*, 997 F.2d 191, 197 (6th Cir. 1993).
 - a. But, absent actual payment or the direction of payment, the responsible person must hold a “dominant position” with respect to the employer’s financial matters. *Id.*

E. Miscellaneous Issues

1. Statute of Limitations

- a. Assuming the employment tax returns were timely filed, the statute of limitations on assessment is generally three years from April 15th of the year following the year in which the taxes were required to be withheld and paid over.
- b. If the notice of proposed assessment required by § 6672(b) is issued before the expiration of the statute of limitations, the statute does not expire until the later of:
 - i. 90 days after the date of mailing or delivery of the notice; or
 - ii. If there is a timely protest, 30 days after the final administrative determination with respect to the protest.

2. Independent Contractors

- a. Employers are only required to withhold from employees and are not required to withhold from independent contractors.
- b. A responsible person may be held liable if the employer misclassifies workers as independent contractors and not employees. *See, e.g., In re Smith*, 1999 WL 164415 (Bankr. D. Haw. 1999).
 - i. However, if the employer had a reasonable basis for the treatment, section 6672 liability may be defeated on the grounds that the failure to collect was not willful. *See Crowd Mgmt. Services, Inc. v. U.S.*, 889 F. Supp. 1313 (D. Or. 1995).

3. Volunteers of Charitable Organizations

- a. The Code provides an exemption from liability for:
 - i. Unpaid board members of the board of trustees or directors of an organization that is exempt from tax who are serving in an honorary capacity;
 - ii. Who do not participate in day-to-day or financial operations of the organization;
 - iii. Who do not have actual knowledge of the organization’s failure to remit its trust fund taxes.
- b. IRS Policy Statement 5-14 (adopted and published in Internal Revenue Manual 1.2.14.1.3 (06-09-2003)) provides more liberal

relief stating that a volunteer may avoid trust fund recovery penalty if they establish (i), (ii), and/or (iii) above.

4. Treatment of Unpaid Trust Fund Taxes Upon Sale of Company
 - a. The seller of a company who fails to deposit prior to sale cannot avoid liability on the basis that the buyer agreed to assume the liability. *See, e.g., Collins v. U.S.*, 92-2 USTC 50,351 (E.D. Mo. 1992).
 - i. The seller of a company that has withheld but, as of closing date will not have deposited funds, should consider paying the withheld funds in advance of the closing.

V. Investigation of 6672 Cases

- A. Revenue officers are charged to conduct an investigation before proposing an assessment under § 6672. In routine investigations, revenue officers typically ask for the following documents by way of information document requests:
 1. Bank statements
 2. Cancelled checks
 3. Copies of bank signature cards
- B. Bank records are reviewed to determine:
 1. Authority of persons to sign checks and deposit funds
 2. Diversion of funds to officers
 3. Deposits and withdrawals of alleged loans between the company and officers, directors, and others
 4. Payment of other obligations.
- C. In large dollar cases, revenue officers may review:
 1. Articles of incorporation
 2. By-laws
 3. Minute books
 4. Employment and income tax returns
- D. Corporate records are reviewed:
 1. To review the duties (and changes to duties) of officers, directors, and others
 2. Appointments and resignations of officers, directors, and others
 3. Responsibilities of individuals to file and pay tax returns
- E. In addition to reviewing bank and corporate records, the revenue officer will conduct a Form 4180 interview for each potentially responsible person. The interview is conducted either in person or over the phone by the revenue officer. The interviewee will be asked to sign the document.
 1. Review of the document before signature is critical to ensure that revenue officer correctly captured responses.
- F. If the revenue officer determines that he needs to contact a third party, advance notice in the form of Letter 3164A is required. IRM 5.7.4.2.2.1 (04-19-2011).

- G. Revenue officer may request that the potentially responsible person execute Form 2750, *Waiver Extending Statutory Period for Assessment of the Trust Fund Recovery Penalty*.
- H. If an employer fails to voluntarily produce the requested documents, the revenue officer will issue summonses to the company and third parties. I.R.M. 5.7.4.2.4.2 (04-19-2011).

VI. Notice of Proposed Assessment

- A. After completing his or her investigation, the revenue officer will prepare Form 4183, *Penalty Assessment Recommendation*. After the form is approved by the group manager, the Service will issue Letter 1153(DO) (the “60 Day Letter”) and Form 2751, *Proposed Assessment of Trust Fund Recovery Penalty*.
 - 1. The notice must be mailed to the taxpayer’s last known address or hand delivered.
 - 2. Form 2751 lists the employer’s unpaid trust fund liability and includes a proposed consent to the immediate assessment.
 - i. Since interest does not begin to accrue on the trust fund recovery penalty until after assessment, no real incentive to consent to the assessment before the expiration of the 60-day period.
 - 3. No notice of proposed assessment required if the Service determines that the collection of the trust fund recovery will be jeopardized by delay; the penalty may be immediately assessed and immediately becomes due and payable. IRC §§ 6672(b)(4) and 6862(a).

VII. Appeal of Notice of Proposed Assessment

- A. The party that receives the 60 Day Letter has 60 days (75 days if the notice is addressed to a taxpayer outside of the United States) to file a formal written protest (if over \$25,000) requesting consideration by the Service’s Appeals Division.
- B. In advance of the hearing, the taxpayer should obtain copies of all Forms 4180 and request the same from the revenue officer or the appeals officer assigned to the case.

VIII. Collections

- A. Section 6672(c) provides that the Service may not levy against the unpaid portion of the trust fund recovery penalty if the taxpayer pays the portion of the trust fund recovery penalty attributable to one employee for each quarter, files a claim for refund, and furnishes a bond equal to 1.5 times the unpaid portion of the assessment.
 - 1. The stay on collection expires thirty days after the taxpayer has been notified that the claim for refund has been denied.
- B. The Service is prohibited from issuing a levy if the taxpayer files a refund suit. IRC § 6331(i)(2)(B).

1. However the Service may offset, file liens, and continue levies issued prior to the filing of the complaint (i.e., wage and similar levies). IRC § 6331(i)(3)(A)(ii).
- C. The ten-year statute of limitations on collection is suspended during refund proceedings. IRC § 6502(a).
 1. A taxpayer can waive the suspension of collection in writing, which authorizes the Service to proceed with enforced collection activity. IRC § 6331(i)(3)(A)(i).

IX. Refund Suit

- A. The Tax Court does not have jurisdiction to determine whether the Service's assessment of the trust fund recovery penalty is correct. *Medelros v. Comm'r*, 77 T.C. 1255 (1981).
 1. However, the Tax Court may review such a determination if it is before the court on a review of a collection due process notice of determination. See IRC § 6330(d).
- B. In order to contest the Service's determination, the party assessed the penalty must:
 1. Pay the portion of the trust fund recovery penalty attributable to one employee for each quarter at issue;
 - a. Employment taxes and the trust fund recovery penalty are "divisible" taxes and therefore are not subject to the *Flora* full payment rule. *Steele v. U.S.*, 280 F.2d 89, 90-91 (8th Cir. 1960).
 2. File a claim for refund on Form 843, *Claim for Refund and Request for Abatement*, for each tax period and type of penalty. IRC § 7422; Treas. Reg. § 301.6402-2(d); IRM 34.5.2.1 (08-11-2004); and
 - a. Form 843 serves as both a claim for refund and a request to have the unpaid portion abated
 3. When that claim is denied, or deemed denied if the Service fails to respond within 6 months, file a refund suit in the federal district court in which the taxpayer resides or the Court of Federal Claims.
 - a. A taxpayer has two years from the date of payment to file a refund claim. IRC § 6511(a).
 - b. A taxpayer may waive the Notice of Claim Disallowance under IRC § 6532. Treas. Reg. § 301.6532-1(c)(4).
 - c. Upon denial, the responsible person has two years in which to bring a refund suit. IRC § 6532(a)(1).
 - d. Taxpayer and the Service may execute Form 907, *Agreement to Extend the Time to Bring Suit*.
- C. Choice of Forum and Venue

1. Taxpayers should consider the precedent in their district and circuit and compare that precedent with the precedent in the Court of Federal Claims and the Federal Circuit Court of Appeals.
2. Jury trials are only available in district court.
3. Venue is appropriate in the federal district court where the taxpayer resides. 28 U.S.C. §§ 1391(e) and 1396.

D. Counterclaim and Answer to Counterclaim

1. With its answer, the government will file a counterclaim for the unpaid balance of trust fund liabilities. IRC § 7401; IRM 25.3.1.4(3) and (4) (04-20-2010); Fed. R.C.P. 13; Ct. Fed. Cl. R. 13.
 - a. The taxpayer must file an answer to the government's counterclaim within 21 days of the date of service.
2. The government may also file third party complaint against other individuals who have been assessed the § 6672 penalty. IRM 25.3.1.4(4) and (6) (04-20-2010); Fed. R.C.P. 13(h) and 20; Ct. Fed. Cl. R. 14.

E. Affirmative Defenses

1. Government may raise various affirmative defenses, including lack of standing, lack of subject matter jurisdiction, variance, setoffs and equitable recoupment.
 - a. There is a variance when the complaint is materially different from the refund claim.
 - i. A court may permit the plaintiff to amend his complaint and/or if the statute of limitations on the refund claim has not expired, the taxpayer may file an amended refund claim.
 - b. Setoffs and equitable recoupment may reduce the amount that may be recovered, but cannot result in a judgment in favor of the government.

F. Cross Claims

1. Taxpayer has a statutory claim for contribution, but is prohibited from bringing that claim in the refund litigation. IRC § 6672(d)(1) and (2).
 - a. However, taxpayer may bring a claim for fraud or breach of contract. *See* 28 U.S.C. § 1367(a).

G. Discovery

1. Both the Federal Rules of Civil Procedure and the Rules of the Court of Federal Claims impose mandatory initial disclosures regarding identification of witnesses and documents. Fed. R.C.P. 26 and 20; Ct. Fed. Cl. R. 26.

H. Motions

1. Government may file a motion to dismiss if the taxpayer:
 - a. Failed to pay the divisible tax
 - b. Failed to timely file the refund claim or complaint
 - c. Filed a complaint that goes beyond the scope of the refund claim
2. Either side may file a motion for summary judgment at the conclusion of discovery.

- a. Because of the fact-intensive nature of the trust fund recovery penalty refund disputes, motion for summary judgment may not be advised.

I. Burden of Proof

1. Taxpayer bears burden of establishing that jurisdictional requirement have been satisfied and that the taxpayer has a right to the refund by a preponderance of the evidence.
2. For the counterclaim, the government need only prove that the assessment was in fact made and that an unpaid balance remains in order to shift the burden of proof to the taxpayer.
 - a. Both can be proven with a certified copy of the taxpayer's transcript. IRC § 7422(e).

J. Standard of Review

1. Standard of review is de novo. The court is charged to independently determine whether the taxpayer is entitled to a refund. *R.E. Dietz Corp v. U.S.*, 939 F.2d 1, 4 (2nd Cir. 1991).

X. Additional Considerations

A. Right of contribution under IRC § 6672(d)

1. If more than one person is liable for the penalty, each person who paid such penalty shall be entitled to recover from other responsible 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.
 - a. The federal cause of action for right of contribution may not occur at the determination of the liability or during an action brought by the United States or a proceeding in which the United States files a counterclaim or third-party complaint for collection of the penalty.
2. In order to qualify for contribution, actual payment of the tax to the Service is a prerequisite.
 - a. It is unclear whether the entirety of the penalty amount must be paid, but actual payment must occur in order to pursue a federal right of contribution cause of action against another individual determined liable for the § 6672(a) penalty.

B. Designation of Payment

1. Any voluntary payment, excluding electronic deposits, may be designated by the company and/or the responsible person to be applied to the trust fund portion.
 - a. If assessment has been made when the taxpayer tenders a voluntary payment and the taxpayer provides specific written instructions as to the designation of the payment, the Service will apply the payment as designated by the party making the payment. Rev. Proc. 2002-026.

C. Criminal liability under IRC § 7202