

Practical Tax Strategies



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**Taxation of
Digital Assets**

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THE TRUST FUND RECOVERY PENALTY: WHO IS RESPONSIBLE TO PAY?

JULIET L. FINK

If an employer willfully fails to withhold or remit payroll taxes, the IRS can impose a Trust Fund Recovery Penalty against every individual who is determined to be a “responsible person” of the employer. The overbreadth within which the IRS may determine individuals to be “responsible persons” should make employees cautious when taking on any accounting or banking responsibilities within their employment.

Introduction

Federal employment taxes arise under the Federal Insurance Contributions Act (“FICA”) and the Federal Unemployment Tax Act (“FUTA”). FICA is comprised of Social Security and Medicare taxes (collectively “FICA taxes” or “payroll taxes”), and is imposed 50% on the employer and 50% on the employee (an equivalent tax is imposed on the self-employed).

The Internal Revenue Code (IRC) requires employers to collect and withhold income taxes together with their employees’ share of FICA taxes from their employees’ paychecks.¹ These taxes are referred to as trust fund taxes because employers hold their employees’ money in trust until they make a federal tax deposit of those funds to the IRS. Conversely, only employers pay FUTA tax, which is not withheld from employees’ wages.

Generally, employers must report wages, tips, and other compensation paid to an employee by filing the required form(s) with the IRS. Every quarter, employers must report all income taxes and FICA taxes withheld from employee wages by filing IRS Form 941 and make federal tax deposits (“FTD s”) of income

taxes withheld together with both the employer’s and employee’s portion of FICA taxes.

FUTA taxes are reported by filing Form 940. In addition, an employer may be required to file Form 943, if they are filing to report agricultural wages; Form 944, which is designed so the smallest employers (those whose annual liability for FICA taxes and withheld federal income taxes is \$1,000 or less) will file and pay those taxes annually rather than quarterly; or Form 945, if they are filing to report backup withholding.

The failure to file these forms may result not only in liability to pay over all delinquent employment taxes but also the imposition of civil penalties and interest, and, in cases involving willful filing violations, may result in criminal prosecution.²

Enforcement

Civil and criminal employment tax enforcement is among the highest priorities of the Tax Division of the Department of Justice (the “Tax Division”). The Tax Division pursues civil litigation to enjoin employers who fail to comply with their employment tax obligations and to collect outstanding amounts assessed against entities and responsible persons. The Tax Division also pursues criminal

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investigations and prosecutions against those individuals and entities who willfully fail to comply with their employment tax responsibilities, as well as those who aid and assist them in failing to meet those responsibilities.³

Employment tax fraud includes cases involving employee leasing, paying employees in cash, filing false payroll tax returns, failing to file payroll tax returns, and “pyramiding.” Pyramiding occurs when a business withholds taxes from its employees, but intentionally fails to pay over those tax payments to the IRS; the in-

States government. The reason for the failure to withhold or remit employment taxes is irrelevant to the imposition of the TFRP. (In addition to willfulness, the assessment of a TFRP requires an employer-employee relationship; if the employer can establish that the worker was in fact an independent contractor, and not an employee, the TFRP cannot be assessed.) The TFRP authorizes the IRS to essentially “pierce the corporate veil” and assess 100% personal liability against any individual it deems to be a “responsible person.”

If an employer willfully fails to withhold or remit payroll taxes, the IRS can impose a Trust Fund Recovery Penalty against every individual who is determined to be a “responsible person” of the employer, including certain shareholders, partners, members, managers, officers, and employees.

dividual then starts a new business and begins to accrue a new liability under the new entity.⁴

The Tax Division has increasingly emphasized its commitment to the criminal prosecution of employment tax evasion. Employers should therefore be mindful that the failure to comply with employment tax obligations is not always just a civil matter.

Trust Fund Recovery Penalty

If an employer willfully fails to withhold or remit payroll taxes, the IRS can impose a Trust Fund Recovery Penalty (“TFRP”) against every individual who is determined to be a “responsible person” of the employer, including certain shareholders, partners, members, managers, officers, and employees.⁵ (While the TFRP most commonly applies to employment taxes, it also applies broadly to all taxes under the IRC where there is a withholding or collection obligation.)

The TFRP is not a penalty in the traditional sense in that it is not designed to be a penalty over and above the amount of unpaid taxes, rather it is a collection device to ensure that withheld taxes are properly remitted to the IRS—in essence, therefore, the TFRP is essentially a tax. Accordingly, it is the IRS’s policy to assess the TFRP only in cases where the tax cannot be collected directly from the business entity.⁶

It is important to note that willfulness in the context of the TFRP does not require bad or malicious motive. Rather, willfulness means a deliberate, voluntary, conscious choice to prefer another creditor over that of the United

The amount of the TFRP is equal to the balance of unpaid trust fund taxes, which is the unpaid income taxes and employees’ share of FICA taxes withheld. (It does not include the employer’s share of FICA taxes.)

The liability for the TFRP is joint and several, and liability is not limited to *the most* responsible person. That means that *all persons* deemed a “responsible person” against whom the TFRP is assessed are liable for the full payment of taxes owed. However, the IRS may only collect the TFRP once for a business’s unpaid payroll taxes.⁷ Thus, if one responsible person pays the penalty in full, any other responsible persons need not pay that amount.

The investigation and assessment of the TFRP is the responsibility of the Collection Division of the IRS. A Revenue Officer will usually initiate the investigation by interviewing potential responsible persons.⁸ After investigation of all potentially responsible persons and review of all pertinent documentation, including banking and other business records, the Revenue Officer recommends whether to assert the TFRP against any of the potential responsible persons.⁹ The penalty is then assessed and collected in the same manner as a tax.

¹ See generally IRC Section 3102; Section 3402.

² See IRC Section 6651(a)(1); Section 6656(a)-(b).

³ See IRC Section 7201, Section 7202.

⁴ See IRS CI Annual Report 2021 at p. 5.

⁵ See generally IRC Section 6672.

⁶ See IRM 5.17.7.1.9(2) (8/1/2010).

⁷ See IRM 5.17.7.1.9 (8/1/2010); IRC Section 6672(d).

⁸ See IRM 5.7.4.2.3 (6/29/2017).

⁹ See IRM 5.7.4.5 (6/29/2017).

Responsible person: who is liable?

The IRS casts a broad net when determining who constitutes a “responsible person.” A “responsible person” is anyone who has the duty to perform and the power to direct the collecting, accounting, and paying of trust fund taxes, with the exception of voluntary, unpaid, honorary directors or trustees of tax-exempt organizations who do not participate in the day-to-day finances of the organization and do not have actual knowledge of the failure to pay over taxes.

A “responsible person” need not be the ultimate owner of the business. Any person who has the authority to sign checks, control finances, or had any other input in making the decision to pay other creditors while employment taxes remained unpaid, can be deemed a “responsible person.”

Put simply, a “responsible person” may be anyone, whether an insider or outsider to the business, with control or influence over the business’s finances.

Importantly, an employee may be deemed a “responsible person” if they were responsible for paying other creditors of the business even if they were not responsible for paying the business’s employment taxes. Even those with no knowledge that the IRS is not being paid may be deemed a “responsible person” if the IRS determines that the person *should* have been aware of the outstanding taxes.

A responsible person can be any of the following:

- An officer or an employee of a corporation.
- A member or employee of a partnership.
- A corporate director or shareholder.
- A member of a board of trustees of a nonprofit organization.
- Another person with authority and control over funds to direct their disbursement.
- Another corporation or third-party payer.
- Payroll Service Providers (PSPs) or responsible parties within a PSP.
- Professional Employer Organizations (PEOs) or responsible parties within a PEO.
- Responsible parties within the common law employer (client of PSP/PEO).¹⁰

Put simply, a “responsible person” may be anyone, whether an insider or outsider to the business, with control or influence over the business’s finances. While the Internal Revenue Manual (IRM) states that that control should be “significant,” in practice, that is often not the case.¹¹ Further, a “responsible person” need not have exclusive control over the business’s finances.

As illustrated by the list above, a business owner cannot avoid liability for the TFRP by simply delegating payroll responsibilities to a third-party, such as a payroll service provider. One must remember that more than one individual may be held personally liable for the TFRP. Accordingly, while a payroll service provider that failed to remit taxes on behalf of a business may be deemed a “responsible person,” that does not mean that the business owner, bookkeeper, or other individuals are off the hook.

The IRS determines whether a person is a “responsible person” for purposes of employment taxes on a case-by-case basis. The determination of who is a “responsible person” is a question of fact. The IRS looks at the totality of circumstances to determine whether a person was authorized within a business to collect, account for, or remit taxes. Common factors considered include whether a person:

- Was an officer, director, or principal shareholder of the corporation, a partner in a partnership, or a member of an LLC.
- Had authority to sign checks.
- Controlled the financial affairs of the business.
- Determined which creditors were paid or exercised that authority.
- Managed payroll disbursements;
- Controlled the voting stock of a corporation.
- Signed the employment tax returns.¹²

The checklist above combines elements of “duty, status, and authority.”¹³ No single factor is determinative of whether or not a person is “responsible.” However, the IRS considers the ability to sign checks and the actual signing of the business’s checks to be an especially significant factor in concluding that an individual is a “responsible person” for purposes of the TFRP.¹⁴ An employee who had signature authority on the business’s bank account and who signed checks on behalf of the business is often deemed a “responsible person” for purposes of the TFRP. Conversely, if that employee merely had the authority to sign checks, but he or she never actually exercised that authority, the IRS is unlikely to hold the em-

¹⁰ See IRM 5.17.7.1.1(1) (7/18/2012); IRC Section 6671(b).

¹¹ See IRM 5.17.7.1.2(5) (8/1/2010).

¹² See IRM 5.17.7.1.2(4) (8/1/2010).

¹³ *Gustin*, 876 F.2d 485, 491 (CA-5, 1989).

¹⁴ See e.g. IRM 5.17.7.1.4 (8/1/2010).



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ployee responsible absent the existence of additional factors.

Limited exception when a business is under new management

There does exist a narrow *per se* exception to TFRP liability when a change in management of a business takes place. Specifically, a person is not personally liable if they become a “responsible person” when the business does not have the funds to pay an employment tax liability that arose under previous management and then uses funds acquired *after* becoming a “responsible person” to pay the operating expenses of the business.¹⁵

The reasoning behind this limited exception is that a person should not be liable for the TFRP if they had no personal fault in the failure to pay the taxes.¹⁶ Accordingly, a person will be held liable to the extent that funds were available to pay employment taxes if, at the time the responsible person assumed control of the business, they failed to use those funds to pay the delinquent tax.

Conclusion

Many people will find it unfair that the TFRP can be assessed on a “responsible person” irre-

spective of whether or not they benefited from the failure to remit tax. This, of course, can place “responsible persons” in precarious situations where they have an inability to pay but nonetheless must make collection arrangements with the IRS.

The overbreadth within which the IRS may determine individuals to be “responsible persons” should make employees cautious when taking on any accounting or banking responsibilities within their employment. Merely having check signing authority can render an employee a “responsible person” if that business is failing to collect or remit employment taxes, irrespective of the employee’s knowledge of that fact.

Of course, business owners must be cognizant of the importance of timely paying employment taxes, even when circumstances might suggest holding off until other critical expenses are paid. A business may be struggling and the owner, in good conscience, may opt to pay payroll or suppliers rather than taxes in an effort to keep the business afloat on the theory that the taxes can be paid at a later time. However, that decision could lead not just to civil liability but might also result in a criminal investigation despite the business owner’s good intentions. ■

¹⁵ See IRM 5.17.7.1.2(2) (8/1/2010).

¹⁶ See *Slodov*, 436 U.S. 238, 254 (1978).