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The Trust Fund Recovery Penalty

Defending Taxpayers Before the IRS

By Kevin M. Flynn

Under Internal Revenue Code (IRC) section 6672(a), an individual can be held personally liable for a penalty for the willful failure to collect, account for, and pay to the IRS the employment taxes of a business. This is known as the "trust fund recovery penalty" (TFRP). The TFRP is not a penalty in the traditional sense of being an amount added to a deficiency in tax due by an individual, corporation or other taxpayer. Rather, the TFRP is a collection device that permits the IRS to impose liability on a "responsible person" who "willfully" failed to remit the employment taxes that were held in trust for the government.

TFRP cases rely heavily upon the fact pattern, and a tax advisor's success in defeating the penalty depends on presentation of the evidence and knowledge of the IRS's TFRP procedures.

The Two Prongs of the TFRP

There are two statutory components that must be established under IRC section 6672(a) before a person can be held liable for the TFRP. First, the individual must be a "responsible person" for withholding and paying employment taxes to the IRS. Second, the person must have "willfully" failed to collect and remit the employment taxes due. For purposes of IRC section 6672(a), the liability of a responsible person who has acted willfully is equal to the federal income taxes withheld from the employees' wages and the employees' share of the Social Security and Medicare (i.e., FICA) taxes. These are the taxes that the employer is required by law to hold "in trust" and pay over to the government, hence the term "trust fund recovery."

Under IRC section 6671(b), a "responsible person" includes any officer or employee of a corporation, or member or employee of a partnership, who has the duty to collect or pay employment taxes. The mere holding of a corporate title, or the lack thereof, is not controlling on the issue of a person's liability; the test is one of substance that asks whether the person had the status, duty, and authority to control the company's financial affairs [*Godfrey v. U.S.*, 748 F.2d 1568, 1575-76 (Fed. Cir. 1984)].

IRC section 6672 requires significant control over the business' financial operations and the ability to decide which creditors will and will not be paid; therefore, if a person's financial authority is circumscribed by, for example, a senior officer who has the final say on which creditors will be paid, TFRP liability will not apply. The principal factor that the IRS considers when examining which individuals may or may not be liable for the TFRP is who signs company checks. The IRS also investigates whether the person is an owner, officer, or director of the company; has the right to hire and fire employees; signs contracts with lessors/vendors or otherwise is active to the day-to-day affairs of the business; makes payroll tax deposits; or is responsible for the disbursement of payroll. In defending putative responsible persons, it is crucial to demonstrate that they lacked the requisite financial control exhibited by the foregoing factors through such things as company business records, e-mails, court pleadings in litigation involving the business, and affidavits from third parties, combined with effective written and oral advocacy.

An individual who qualifies as a "responsible person" is not necessarily liable for the TFRP; it must also be established that the responsible person acted "willfully" in failing to collect, account for, or pay the employment taxes. Under IRC section 6672, willfulness has been defined as a "voluntary, intentional, and conscious decision" to pay other creditors rather than remit the trust fund taxes to the government (*Godfrey*). Courts have held that a reckless disregard of the duty to collect and pay employment taxes satisfies the willfulness prong, but mere negligence is never a sufficient basis for liability. An advisor must be prepared to prove with evidence and arguments that even if a client was a responsible person, she did not have knowledge that the taxes were not paid, did not have the authority to decide the priority of payments to creditors, or otherwise was not willful with respect to the nonpayment of the employment taxes.

The TFRP Investigation

The TFRP investigation is conducted by a revenue officer from the IRS's collection function. The revenue officer typically requests bank signature cards, cancelled checks, and other busi-

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ness records to identify potential responsible persons. If the company does not provide these documents voluntarily, administrative summons will be used to demand the records from the business or from third parties.

The revenue officer will examine the records and then schedule interviews with persons who may be responsible for the failure to pay the employment taxes. If a potentially responsible person does not voluntarily agree to appear before the revenue officer, he is likely to receive a summons to command his presence for an interview. The individual will be told that he can bring an attorney or other IRS-authorized representative to the meeting.

The purpose of this interview is to secure from the individual Form 4180, Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes. Form 4180 is a critically important document, and it can be perilous if an individual attends the interview or completes Form 4180 without legal representation and thorough preparation by counsel. The document contains direct questions specifically designed to elicit responses that show whether the individual was a responsible person and whether she acted willfully. It is often necessary for the individual and her counsel to provide the revenue officer with a full description of the individual's limited role and responsibilities in the business and to resist responding to questions in the "yes" or "no" format established by the interview form. The individual should also make certain that the Form 4180 includes an accurate written statement of the individual's defense to the TFRP. When the interview has been completed, the revenue officer will ask the individual to sign the Form 4180.

Challenging a Proposed TFRP Assessment

At the conclusion of the investigation, the revenue officer will decide which individuals will receive notices of their potential liability for the TFRP. Revenue officers are notoriously overbroad in their TFRP determinations, often including persons with marginal liability exposure. The revenue officer will mail Letter 1153(DO) and Form 5471, Proposed Assessment of Trust Fund Recovery Penalty, to the individuals determined to be liable for the TFRP. The TFRP notice must be sent to the individual's "last known address" to be enforceable [IRC section 6672(a)(2)].

An individual who qualifies as a "responsible person" is not necessarily liable for the TFRP; it must also be established that the responsible person acted "willfully."

An individual receiving Letter 1153(DO) and Form 5471 has 60 days to file a written protest with the IRS Appeals Office to challenge the TFRP determination. The protest should contain a complete discussion of the facts and legal authorities that show that the individual was not a responsible person for the company's employment taxes or that he did not act willfully. The protest, or a subsequent submission to the Appeals Office, should include documentary evidence, such as business records and affidavits, that supports the individual's case. At the conference, an authorized representative will present arguments that the individual should not be held liable for the TFRP or that the penalty should be compromised on the basis of hazards of litigation.

Post-Assessment Procedures

If the Appeals Office upholds the TFRP, the IRS will assess the penalty against the individual and issue notice and demand for payment of the trust fund taxes. The individual can dispute the IRS's decision in court, but first must pay a "divisible" portion of the penalty for each quarter of the employment tax assessment and file a claim for refund with the IRS.

The divisible amount of the tax is equal to the withholding taxes attributable to a single employee for each payroll tax quarter covered by the penalty assessment. If the IRS issues a Notice of Disallowance of the refund claim, or takes no action on the claim for a period of six months, the individual can commence a refund suit. The lawsuit must be initiated within two years of the date that the divisible tax was paid, or two years from the date that a Notice of Disallowance was issued. The action can be filed in the local United States District Court or the Court of Federal Claims.

Fighting the Law and Winning

Preparation is crucial to winning a TFRP case. A professional advisor must exhaustively develop the facts and review company business records, correspondence, and e-mails. These documents, together with affidavits from third parties, should be used to show the limitations on the authority and the lack of willfulness of the potential responsible person. The advisor's development of the facts, and knowledge of the law and IRS procedure, will advance the likelihood of a successful outcome. ❑

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