

MLI #10 Trust Fund Recovery Penalty (TFRP) Under IRC § 6672

SUMMARY

The trust fund recovery penalty (TFRP) (also known as the 100 percent penalty) applies to a person who has a responsibility to collect, truthfully account for, and pay over “trust fund” taxes imposed on another person that he or she willfully fails to remit such taxes to the IRS.¹ Typically, a TFRP arises when a struggling business fails to remit withheld income taxes, Social Security and Medicare taxes, railroad retirement taxes, or collected excise taxes to the IRS.² To establish liability under IRC § 6672, the IRS must conclude a person was responsible for withholding and paying over to the IRS payroll taxes and that the failure to do so was willful.³ The statute does not contain a reasonable cause exception.⁴ Whether a person actually had the responsibility to withhold payroll taxes and whether he or she willfully failed to do so are mixed questions of law and fact frequently litigated in United States district courts, bankruptcy courts, and the Court of Federal Claims. The TFRP has not been a most litigated issue since 2005.⁵

TAXPAYER RIGHTS IMPACTED⁶

- *The Right to Be Informed*
- *The Right to Pay No More Than the Correct Amount of Tax*
- *The Right to Challenge the IRS’s Position and Be Heard*
- *The Right to Appeal an IRS Decision in an Independent Forum*
- *The Right to Finality*
- *The Right to a Fair and Just Tax System*

- 1 Internal Revenue Code (IRC) § 6672(a). IRC § 7501 provides that taxes withheld from others, which are to be paid to the United States, are held in a special fund in trust for the United States. Thus, these amounts are referred to as the “trust fund” taxes.
- 2 See generally IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (Federal Insurance Contributions Act (FICA)); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (Railroad Retirement Tax Act (RRTA)); IRC §§ 3301-3311 (Federal Unemployment Tax Act (FUTA)); IRC §§ 3401-3407 (collection of income at source on wages). For excise taxes, see, e.g., IRC §§ 4251; 4261; 4271. IRC § 6672 applies to taxes collected and paid over by a third party. It does not apply to taxes directly imposed on the person or entity required to pay them, e.g., it does not apply to the employer’s share of FICA or FUTA. IRC §§ 3101 and 3301. See also National Taxpayer Advocate 2007 Annual Report to Congress 395-410 (Most Serious Problem: Assessment and Processing of the Trust Fund Recovery Penalty (TFRP)).
- 3 See *Cline v. U.S.*, 997 F.2d 191 (6th Cir. 1993); *McGlothin v. U.S.*, 720 F.2d 6 (6th Cir. 1983).
- 4 There is a split in circuits on the issue of whether reasonable cause could have an effect on a willfulness determination. The Courts of Appeals for the Second, Fifth, Tenth, and Eleventh Circuits have determined that the reasonable cause defense could apply to willfulness determinations under IRC § 6672, but in very limited circumstances. See *Smith v. U.S.*, 555 F.3d 1158, 1170 (10th Cir. 2009); *Thosteson v. U.S.*, 331 F.3d 1294, 1301 (11th Cir. 2003); *U.S. v. Winter*, 196 F.3d 339, 345 (2d Cir. 1999); *Logal v. U.S.*, 195 F.3d 229, 233 (5th Cir. 1999). The Eighth and First Circuits have determined that reasonable cause is not a defense. See *Olsen v. U.S.*, 952 F.2d 236 (8th Cir. 1991); *Harrington v. U.S.*, 504 F.2d 1306 (1st Cir. 1974).
- 5 See National Taxpayer Advocate 2005 Annual Report to Congress 543-48 (Most Litigated Issue: *Trust Fund Recovery Penalty under Internal Revenue Code Section 6672*).
- 6 See Taxpayer Bill of Rights (TBOR), www.TaxpayerAdvocate.irs.gov/taxpayer-rights. The rights contained in the TBOR are now listed in the Internal Revenue Code (IRC). See Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, Division Q, Title IV, § 401(a) (2015) (codified at IRC § 7803(a)(3)).

PRESENT LAW

Internal Revenue Code (IRC) § 6672 provides for assessment of the TFRP against those deemed responsible persons who fail to withhold and remit to the IRS income taxes, employment taxes and certain types of excise taxes, often referred to as the “trust fund” taxes, from payments to employees.⁷ To establish liability under IRC § 6672, the IRS must conclude a person was responsible for collecting, accounting for, and paying over payroll taxes to the IRS and have willfully failed to perform any of these activities, or willfully attempted to evade or defeat any such tax or its payment.⁸ The term “person” in IRC § 6672 includes, but is not limited to, the following:

- Officer or employee of a corporation;
- Partner or employee of a partnership;
- Member or employee of a Limited Liability Corporation (LLC);
- Corporate director or shareholder;
- Another corporation;
- Surety or lender;
- Payroll Service Provider (PSP);
- Responsible parties within a PSP;
- Professional Employer Organization (PEO);
- Responsible parties within a PEO; and
- Responsible parties within the common law employer (client of PSP/PEO).⁹

TFRP is equal to 100 percent of the trust fund portion of the taxes that were not remitted.¹⁰ TFRP is not dischargeable in bankruptcy.¹¹ Whether a taxpayer can obtain relief from the TFRP typically depends on whether the taxpayer can demonstrate that he or she was not a “responsible person” or did not act “willfully” under IRC § 6672.¹²

⁷ See generally IRC §§ 3101, 3102, 3111-3113, and 3121-3128 (FICA); IRC §§ 3201, 3202, 3211, 3221, 3231-3233 and 3241 (RRTA); IRC §§ 3301-3311 (FUTA); IRC §§ 3401-3407 (collection of income at source on wages). For excise taxes, see, e.g., IRC §§ 4251; 4261; 4271. IRC § 7501 provides that taxes withheld from others, which are to be paid to the United States, are held in a special fund in trust for the United States. These taxes are often referred to as the “trust fund” taxes.

⁸ *U.S. v. Carrigan*, 31 F.3d 130, 133-34 (3d Cir. 1994). See also *Cline v. U.S.*, 997 F.2d 191 (6th Cir. 1993); *McGlothlin v. U.S.*, 720 F.2d 6 (6th Cir. 1983).

⁹ Internal Revenue Manual (IRM) 5.17.7.1.1, *Persons Subject to the Trust Fund Recovery Penalty* (July 18, 2012). Consistent with recommendations by the National Taxpayer Advocate, the IRS has issued internal guidance stating that it can assess the TFRP against third-party payers and updated several IRMs. See also IRM 5.7.3.3.3, *Pre-levy Notice and Collection Due Process (CDP)* (July 19, 2012); Small Business/Self-Employed (SB/SE), *Interim Guidance for Conducting Trust Fund Recovery Penalty Investigations in Cases Involving a Third-Party Payer*, SBSE-05-0711-044 (July 1, 2011). See National Taxpayer Advocate 2007 Annual Report to Congress 337, 538 (Most Serious Problem: *Third Party Payers*; *Legislative Recommendation: Taxpayer Protection from Third Party Payer Failures*); National Taxpayer Advocate 2004 Annual Report to Congress 394-99.

¹⁰ IRC § 6672. TFRP assessments do not include the interest and penalties owed on the underlying employment tax liabilities owed by the employer. See *Williams v. U.S.*, 330 F.2d 960 (2d Cir. 1991). However, interest will begin to accrue on the TFRP if it is not paid within twenty-one days from the date of the notice and demand. IRC § 6601(e)(2).

¹¹ See 11 U.S.C. §§ 523(a)(1)(A); §507(a)(8)(C).

¹² The IRS also considers collection potential before assessing the TFRP. IRM 5.7.5.1.1(2) (Nov. 12, 2014) states that the penalty will “normally not be assessed when: [t]here is no present or future collection potential” or “[n]either the responsible person nor his or her assets or income sources can be located.”

Who Is a Responsible Person?

A “responsible person” is someone with significant, not necessarily exclusive, control over the company’s finances.¹³ Significant control is the final or significant word over which bills or creditors get paid.¹⁴ The determination of whether one is a responsible person within the meaning of IRC § 6672 is a matter of status, duty, and authority. Courts have recognized the following non-exhaustive five characteristics as being indicative of a person’s status as a “responsible person”:

- Employment as a corporate officer;
- Control over financial affairs;
- The authority to disburse corporate funds;
- Ownership of stock; and
- The ability to hire and fire employees.¹⁵

In general, the IRS will not seek to assess the penalty against non-owner employees of the business entity who act solely under the control of others and are not in a position to act independently of others.¹⁶ On the other hand, instructions from a superior to not pay taxes do not immunize a person who is otherwise responsible.¹⁷ In addition, the term “responsible person” can include corporations and other artificial entities.¹⁸ More than one person may be determined to be responsible.¹⁹ Each responsible person is jointly and severally liable for the penalty.²⁰ Even though the IRS may make TFRP assessments against more than one responsible person, it ultimately collects the total amount only once.²¹ Responsible persons may seek contribution to allow jointly liable responsible persons to recover a proportionate share from other responsible persons.²²

Willfulness

The willfulness component of the statute is satisfied if the person had knowledge of the employer’s obligation to pay withholding taxes and knew the funds were being used for other purposes.²³ Willfulness requires a voluntary, conscious and intentional act but does not require specific criminal intent or evil

13 This control does not need to be absolute. *U.S. v. Carrigan*, 31 F.3d 130, 133 (3d Cir. 1994) (citation omitted).

14 *Quattrone Accountants, Inc. v. IRS*, 895 F.2d 921, 927 (3d Cir. 1990).

15 *E.g., George v. U.S.*, 819 F.2d 1008 (11th Cir. 1987); *Smith v. U.S.*, 555 F.3d 1158 (10th Cir. 2009). When conducting trust fund responsibility interviews with potentially responsible persons, the IRS uses Form 4180, *Report of Interview with Individual Relative to Trust Fund Recovery Penalty*, in order to make a determination regarding responsibility. See IRM 5.7.4.2, *TFRP Interviews and Investigations* (Nov. 12, 2015).

16 IRM 5.7.3.3.1.2, *Non-Owner Employees* (Nov. 12, 2010) (noting that “[i]n general, non-owner employees who act solely under the dominion and control of others, and who are not in a position to make independent decisions on behalf of the business entity, will not be assessed the TFRP”). See also IRM 1.2.14.1.3, *Policy Statement 5-14 (Formerly P-5-60)* (June 9, 2003). “Non-owner employees” are those who do not own any stock, interest, or other “entrepreneurial stake” in the company. IRM 5.7.3.3.1.2(1) (Nov. 12, 2010). See also *U.S. v. Rem*, 38 F.3d 634 (2d Cir. 1994).

17 *E.g., Brounstein v. U.S.*, 979 F.2d 952, 955 (3d Cir. 1992) (citations omitted).

18 *Pac. Nat’l Ins. Co. v. U.S.*, 422 F.2d 26, 30 (9th Cir. 1970).

19 See *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied* 400 U.S. 821 (1970); *Gephart v. U.S.*, 818 F.2d 469 (6th Cir. 1987).

20 *Brown v. U.S.*, 591 F.2d 1136 (5th Cir. 1979).

21 IRM 1.2.14.1.3, *IRS Policy Statement 5-14 (Formerly P-5-60)* (June 9, 2003).

22 IRC § 6672(d).

23 See *Hochstein v. U.S.*, 900 F.2d 543, 548 (2d Cir. 1990), *cert. denied*, 504 U.S. 985 (1992). A person has acted with willfulness if his or her actions were voluntary, conscious, and intentional as opposed to being merely negligent. See also *Kalb v. U.S.*, 505 F.2d 506, 511 (2d Cir. 1974).

motive.²⁴ The responsible person bears the burden to prove that his or her actions were not willful.²⁵ The courts apply these general standards to determine whether a responsible person acted willfully:

- *Deliberate choice* – Willfulness exists where the responsible person knows of the obligation to pay the withholding taxes and makes the deliberate choice to pay the withheld tax funds to other creditors, instead of paying the taxes over to the IRS;²⁶
- *Knowledge of nonpayment of taxes* – Willfulness exists if the responsible person obtains knowledge of a withholding tax delinquency and continues to permit payments to be made to other creditors;²⁷ and
- *Reckless disregard* – Willfulness exists where the responsible person acts with a reckless disregard of a known or obvious risk that withholding taxes will not be remitted, including failing to investigate or correct mismanagement after being notified that withholding taxes have not been paid.²⁸ Any voluntary act to prefer any creditor over the United States fulfills this criterion.²⁹

Procedural Issues

The IRS conducts an investigation, including interviewing potentially responsible persons, before making an assessment.³⁰ The period in which the IRS may assess the TFRP against a responsible person is the same period during which the IRS may assess against the employer for the underlying employment tax liability.³¹ The responsible person and the IRS may agree to extend the period for assessing the TFRP by executing a Form 2750, *Waiver Extending Statutory Period for Assessment of Trust Fund Recovery Penalty*.³²

Before the IRS can assess the penalty, however, it must send Letter 1153 (DO), *10-Day Notification Letter, 100% Penalty Proposed Against Filer for Corporation*, to the taxpayer informing him or her of the proposed assessment.³³ In the Letter 1153, the IRS encloses Form 2751, *Proposed Assessment of Trust Fund Recovery Penalty*, setting forth the periods and amounts of the proposed TFRP assessment, and offering the taxpayer an opportunity to appeal the proposed assessment to the Office of Appeals.³⁴ The taxpayer has 60 days from the date of the letter to submit a written request for appeal.³⁵ If the taxpayer

24 See, e.g., *Thomas v. U.S.*, 41 F.3d 1109 (7th Cir. 1994); *Barnett v. I.R.S.*, 988 F.2d 1449, 1457 (5th Cir. 1993).

25 See, e.g., *Morgan v. U.S.*, 937 F.2d 281, 286 (5th Cir. 1991).

26 See *Howard v. U.S.*, 711 F.2d 729 (5th Cir. 1983); *Mazo v. U.S.*, 591 F.3d 1151 (5th Cir. 1979).

27 See, e.g., *Gephart v. U.S.*, 818 F.2d 469 (6th Cir. 1987); *Stettler v. U.S.*, 98-1 U.S.T.C. ¶ 50,136 (10th Cir. 1998); *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), *cert. denied*, 400 U.S. 821 (1970); *Thosteson v U.S.*, 331 F.3d 1294 (11th Cir. 2003), *cert. denied*, 540 U.S. 1105 (2004).

28 See, e.g., *George v. U.S.*, 819 F.2d 1008 (11th Cir. 1987); *Denbo v. U.S.*, 988 F.2d 1029 (10th Cir. 1993); *Honey v. U.S.*, 963 F.2d 1083 (8th Cir. 1992), *cert. denied*, 506 U.S. 1028 (1992); *Godfrey v. U.S.*, 748 F.2d 1568 (Fed. Cir. 1984); *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir. 1979).

29 See *Hochstein v. U.S.*, 900 F.2d 543, 548 (2d Cir. 1990), *cert. denied*, 504 U.S. 985 (1992). Funds that are legally obliged to be paid to another creditor do not fulfill this.

30 IRM 5.7.4.2, *TFRP Interviews and Investigations* (Nov. 12, 2015). The plain language of § 6672 does not oblige the IRS to attempt to collect trust fund taxes from the employer before assessing the TFRP penalty against a responsible person.

31 *Lauckner v. U.S.*, 68 F.3d 69 (3d Cir. 1995), *acq.* 1996-2 C.B. 1.

32 See also Treasury Inspector General for Tax Administration (TIGTA), *Revisions to Trust Fund Recovery Penalty Procedures Are Warranted*, 2016-30-046 (June 30, 2016) (discussing the IRS procedures on TFRP and recommendations).

33 IRC § 6672(b)(1). The IRS's policy is not to pursue the TFRP so long as there is an installment agreement (IA) in place with the business, unless there are statute of limitations issues or a default on IA is entered. IRM 1.2.14.1.3(8) (June 9, 2003).

34 See IRS Letter 1153, *10-Day Notification Letter, 100% Penalty Proposed Against Filer for Corporation* (Mar. 2002).

35 IRM 5.7.6.1.3(2) (Dec. 7, 2012). See also IRC § 6672(b)(2) (providing that the IRS has must send a preliminary notice 60 days prior to the assessment of the penalty). If the penalty per period is over \$25,000, the taxpayer must submit a formal written protest. See 5.7.6.1.5, *Formal Written Protest* (Apr. 13, 2006). Additionally, if the letter is addressed outside of the United States, the taxpayer has 75 days to request an appeal. IRM 5.7.6.1.3(2) (Dec. 7, 2012).

and the IRS still cannot agree on the proposed assessment after the appeals conference, the taxpayer can pay a specified portion of the liability and file a claim for refund in the Court of Federal Claims or the appropriate district court.³⁶ When the government produces a certificate that the penalty assessments for failure to pay withholding taxes were made, the government is entitled to a presumption of correctness in the courts, while the person challenging the assessment bears the burden of proving by a preponderance of the evidence that he or she was not liable.³⁷

ANALYSIS OF LITIGATED CASES

We reviewed 21 opinions issued by federal courts in which the TFRP was an issue. Taxpayers prevailed in whole or in part in four of the 21 cases. In one of these cases the court denied the IRS's motion for summary judgment, thereby requiring the parties to go to trial on any remaining contested issue.³⁸ In the remaining cases, the taxpayer prevailed for procedural reasons.³⁹

Pro Se Analysis

Only six of the 21 (29 percent) of the taxpayers in TFRP cases were *pro se*, or unrepresented by counsel. Of these six cases, taxpayers prevailed in one of the cases (approximately 16 percent). Those who were represented for this reporting year actually fared worse than those who represented themselves; they prevailed in whole or in part in only two of the 15 cases (approximately 13 percent). While the issues related to IRC § 6672 are procedurally and substantively complex, and generally require competent counsel, *pro se* taxpayers fared better overall due to the success of two litigants in a substantially smaller pool of cases than the represented taxpayers.

The IRS Failed to Follow Proper Procedures

In both cases in which the taxpayer prevailed, the IRS failed to follow the pre-assessment procedures for TFRP depriving taxpayers of the *right to challenge the IRS's position and be heard*. In *United States v. Appelbaum*, the court found that the IRS failed to mail the defendant Letter 1153, *10-Day Notification Letter, 100% Penalty Proposed Against File for Corporation*.⁴⁰ Because of this failure, assessments made by the IRS prior to the mailing of the letter were not valid. The three year statute of limitations for the IRS to make a valid assessment had already run by the time the case was decided, and so the taxpayer prevailed.

In *Romano-Murphy v. Commissioner*, the court likewise found in favor of the taxpayer because of procedural errors made by the IRS.⁴¹ In this case, the taxpayer was the Chief Operating Officer of Nurses PRN, LLC from July 2002 until June 2005. The IRS sent Romano-Murphy a Letter 1153, *Notice of*

36 IRC § 6672(c) provides that if the taxpayer makes the required payment within 30 days of notice and demand for payment and files suit within 30 days of the IRS denial of refund, levy action will be stayed until the conclusion of the court proceedings. IRS Letter 1153 instructs taxpayers who wish to contest the IRS assessment that they can appeal the assessment without paying the entire TFRP by: (1) paying the contested payroll tax for at least one employee for each period of liability that the taxpayer wishes to contest; (2) filing a claim for refund for the amounts paid using IRS Form 843, *Claim for Refund and Request for Abatement*; and (3) posting a bond with the IRS for 1.5 times the amount of the penalty that is left after making the payment for one employee. As the Trust Fund Recovery cases demonstrate, once the case is filed, the IRS typically counterclaims for the balance of the unpaid liability, thereby placing the entire TFRP liability at issue.

37 *E.g.*, *Fidelity Bank v. U.S.*, 616 F.2d 1181, 1186 (10th Cir. 1980); *Barnett v. U.S.*, 988 F.2d 1449, 1453 (5th Cir. 1993).

38 *Wallis v. U.S.*, 117 A.F.T.R.2d (RIA) 583 (W.D. Va. 2016).

39 *Romano-Murphy v. Comm'r*, 816 F.3d 707 (11th Cir. 2016), *rev'g and remanding* T.C. Memo. 2012-330; *U.S. v. Appelbaum*, 117 A.F.T.R.2d (RIA) 633 (W.D.N.C. 2016), *appeal docketed*, No. 16-1949 (4th Cir. Aug. 19, 2016).

40 *U.S. v. Appelbaum*, 117 A.F.T.R.2d (RIA) 633 (W.D.N.C. 2016), *appeal docketed*, No. 16-1949 (4th Cir. Aug. 19, 2016).

41 *Romano-Murphy v. Comm'r*, 816 F.3d 707 (11th Cir. 2016), *rev'g and remanding* T.C. Memo. 2012-330.

Proposed Assessment, in July 2006. In September 2006, Romano-Murphy responded to the letter to request “a conference to discuss the supporting documents contained with her formal written protest.” The IRS did not respond to the letter and the letter was never forwarded to the appeals department. Following a decision in November 2012 by the Tax Court, Romano-Murphy appealed to the Court of Appeals for the Eleventh Circuit. This was the first time that Romano-Murphy raised the issue of the IRS’s failure to provide her with a pre-assessment determination following her response to Letter 1153. The court found that a taxpayer who submitted a timely and written protest to Letter 1153 was entitled to a pre-assessment conference or a final administrative determination to that protest. The court rejected the IRS’s view that it has “unfettered discretion to resolve (or not resolve) timely pre-assessment protests,” and held that the IRS cannot “ignore, disregard, or discard” a timely protest. Because the IRS had never provided a pre-assessment conference and determination to the taxpayer, the taxpayer prevailed and the case was remanded to the Tax Court to determine whether this error was harmless. This is an extremely important decision for taxpayers who seek to resolve TFRP-related disputes pre-assessment because there is no prepayment judicial forum for the trust fund penalty.⁴² This case is relevant to protecting the taxpayers’ *right to challenge the IRS’s position and be heard* and the *right to appeal an IRS decision in an independent forum*, specifically the right to participate in the independent administrative appeals process.

Taxpayer Was a Responsible Person

An individual can be held personally liable under IRC § 6672 if (1) he or she is a “responsible person” and (2) he or she willfully failed to pay over to the government the amount of taxes otherwise due, or willfully attempted in any manner to evade or defeat any such tax or the payment thereof.⁴³ Once the IRS has made a TFRP assessment, the burden shifts to the taxpayer to disprove one or both elements. As discussed above, a “responsible person” is one who has significant, but not necessarily exclusive, control over a company’s finances and this determination, under IRC § 6672, looks to status, duty, and authority. Specifically, courts look at five, non-exhaustive, characteristics as being indicative of a person’s status as a “responsible person”: (1) employment as a corporate officer; (2) control over financial affairs; (3) the authority to disburse corporate funds; (4) ownership of stock; and (5) the ability to hire and fire employees.⁴⁴ There can be more than one “responsible person” for the purposes of IRC § 6672 liability. For example, in *Waterhouse v. United States*, the taxpayer, former vice-president and current 40 percent owner of company, alleged that he was not a “responsible person” since his role was not in the “administrative end of the business.”⁴⁵ Despite the court’s acknowledgment that he was not the “primary party responsible for administering [the company’s] finances,” the taxpayer was found a “responsible person” due to his authority to sign checks, history of making financial decisions regarding production and payroll, authority to hire and fire employees, and equal owner of the company.⁴⁶

42 See IRC § 6672(a) (stating that the penalty for TFRP is a “penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.”).

43 IRC § 6672; *McGlothlin v. U.S.*, 720 F.2d 6, 8 (6th Cir. 1982).

44 *E.g.*, *George v. U.S.*, 819 F.2d 1008 (11th Cir. 1987); *Smith v. U.S.*, 555 F.3d 1158 (10th Cir. 2009).

45 *Waterhouse v. U.S.*, 122 Fed. Cl. 276 (2015).

46 *Waterhouse v. U.S.*, 122 Fed. Cl. 276 (2015). See also *Godfrey v. U.S.*, 748 F.2d 1568, 1576 (Fed. Cir. 1984) (stating “where a person has authority to sign the checks of the corporation or to prevent their issuance by denying a necessary signature or where a person controls the disbursement of the payroll or controls the voting stock of the corporation he will generally be held ‘responsible.’”).

The Availability of Unencumbered Funds Affecting Willfulness

In four cases, taxpayers argued that the willfulness element of the TFRP liability test could be rebutted because TFRP is limited to unencumbered funds.⁴⁷ In *Schiffmann v. United States*, taxpayers, the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of a corporation, argued that they could not be liable for the corporation's unremitted payroll taxes because its funds were "largely encumbered."⁴⁸ The court held otherwise, stating that "funds are deemed encumbered only if the taxpayer is legally obligated to use them for some other purpose."⁴⁹ Likewise, in *In re Cherne*, the court held that the mere existence of an informal arrangement between the taxpayer's company and a financing company that resembled a "lock box" agreement was not sufficient to hold that those funds were encumbered.⁵⁰ In *Ruscitto v. United States*, the taxpayer also unsuccessfully argued that a third party's control of his company's finances under a surety agreement negated a finding of willfulness on his part.⁵¹

Conduct Is Willful When the Taxpayer Acted Recklessly

In three cases, the IRS did not show that the taxpayer had actual knowledge of their corporation's failure to remit the proper amount of employment taxes to the IRS.⁵² Rather, the IRS showed that the individual had behaved recklessly. For example, in *Byrne v. United States*, the court found the taxpayers liable for the respective corporate payroll taxes for the third and fourth quarters of 2000.⁵³ Because the taxpayers knew that the fellow investor they entrusted with the responsibility to remit the payroll taxes for 1999 and the first and second quarters of 2000 had not actually done so, their failure to verify that he was performing his duties in the third and fourth quarters of 2000 was reckless.

Willfulness Is Not Negated Because the Action Is Taken Based on the Directions of Superiors

Taxpayers also argued they are not responsible because the corporate form deprived them of the ability to make the outstanding tax payments. In *Schiffmann v. United States*, for instance, taxpayers (the CEO and CFO of a corporation) argued that their ability to pay the outstanding taxes in particular was not recognized by their board of directors. The court rejected this claim, and found that it was relevant that no resolution was made to this effect by a majority of the board members.⁵⁴

-
- 47 *In re Cherne*, 116 A.F.T.R.2d (RIA) 6235 (D. Idaho 2015), *aff'g* 514 B.R. 616 (Bankr. Idaho 2014), *appeal docketed*, No. 15-35802 (9th Cir. Oct. 19, 2015); *Karban v. U.S.*, 117 A.F.T.R.2d (RIA) 1214 (E.D. Mich. 2016), *appeal docketed*, No. 16-1606 (6th Cir. May 11, 2016); *Ruscitto v. U.S.*, 629 F. App'x 429 (3d Cir. 2015), *aff'g* 111 A.F.T.R.2d (RIA) 2166 (W.D. Pa. 2014); *Schiffmann v. U.S.*, 811 F.3d 519 (1st Cir. 2016), *aff'g* 114 A.F.T.R.2d (RIA) 6241 (D.R.I. 2014). When a responsible person is not aware of a tax delinquency, but subsequently becomes aware of the delinquency, he or she is required to use all "unencumbered funds" available to the corporation, including unencumbered funds acquired thereafter, to pay the back taxes. See *Garsky v. U.S.*, 600 F.2d 86, 91 (7th Cir. 1979) (citations omitted).
- 48 *Schiffman v. U.S.*, 811 F.3d 519 (1st Cir. 2016), *aff'g* 114 A.F.T.R.2d (RIA) 6241 (D.R.I. 2014). For funds to be considered "encumbered," the taxpayer must be legally obligated to use the funds for a purpose other than satisfying the preexisting employment tax liability and the legal obligation is superior to the interests of the IRS in the funds, such as a secured creditor. See *Honey v. U.S.*, 963 F.2d 1083, 1090 (8th Cir. 1992), *cert. denied*, 506 U.S. 1028 (1992); *U.S. v. Kim*, 111 F.3d 1351 (7th Cir. 1997).
- 49 *Schiffman v. U.S.*, 811 F.3d 519 (1st Cir. 2016), *aff'g* 114 A.F.T.R.2d (RIA) 6241 (D.R.I. 2014) (citing *Nakano v. U.S.*, 742 F.3d 1208, 1212 (9th Cir. 2014), *cert. denied*, 134 S.Ct. 2680 (2014)).
- 50 *In re Cherne*, 116 A.F.T.R.2d (RIA) 6235 (D. Idaho 2015), *aff'g* 514 B.R. 616 (Bankr. Idaho 2014), *appeal docketed*, No. 15-35802 (9th Cir. Oct. 19, 2015).
- 51 *Ruscitto v. U.S.*, 629 F. App'x 429, 432 (3d Cir. 2015), *aff'g* 111 A.F.T.R.2d (RIA) 2166 (W.D. Pa. 2014).
- 52 *Byrne v. U.S.*, 116 A.F.T.R.2d (RIA) 5502 (E.D. Mich. 2015), *appeal docketed*, No. 15-2396 (6th Cir. Nov. 16, 2015); *Troost v. U.S.*, 116 A.F.T.R.2d (RIA) 6043 (N.D. Tex. 2015), *adopting* 116 A.F.T.R.2d (RIA) 6039 (N.D. Tex. 2015); *U.S. v. Sabaratnam*, 116 A.F.T.R.2d (RIA) 6459 (C.D. Cal. 2015), *appeal docketed*, No. 15-56463 (9th Cir. Sept. 23, 2015).
- 53 *Byrne v. U.S.*, 116 A.F.T.R.2d (RIA) 5502 (E.D. Mich. 2015), *appeal docketed*, No. 15-2396 (6th Cir. Nov. 16, 2015).
- 54 *Schiffman v. U.S.*, 811 F.3d 519 (1st Cir. 2016), *aff'g* 114 A.F.T.R.2d (RIA) 6241 (D.R.I. 2014).

CONCLUSION

The TFRP cases reviewed often involved officers of small businesses, such as CEOs or CFOs, who had a key role in determining financial expenditures. Often the TFRP liability arose when these companies experienced difficulties, and faced a choice between “borrowing” the trust fund monies, or being unable to remain open. Where the taxpayer made this choice, and the struggling business ultimately failed, the taxpayer faced TFRP under IRC § 6672.

To avoid TFRP liability, a responsible person must use all unencumbered funds to pay the back taxes after he or she obtains knowledge of a trust fund tax delinquency.⁵⁵ This duty extends not only to funds available at the time the responsible person becomes aware of the delinquency, but also to any funds acquired thereafter regardless of why the delinquency occurred.⁵⁶ This outcome does not change if the delinquency resulted from a third party bad act, such as mismanagement, embezzlement by a trusted employee, or by a third party payer.⁵⁷ Sometimes, a responsible person must timely resign to eliminate liability for trust fund taxes collected but not remitted to the IRS after the date of resignation.⁵⁸

The courts’ interpretation of TFRP may cause unjust results when a responsible person of a struggling business tries to resolve past tax delinquency, which resulted from an intervening bad act, and agrees to repay the liability in installments instead of liquidating the business.⁵⁹ In order to prevent business owners from facing the dilemma of whether to resign or to attempt to keep the business afloat while repaying the IRS debt, the National Taxpayer Advocate has previously recommended amending IRC § 6672 to provide

55 *Monday v. U.S.*, 421 F.2d 1210 (7th Cir. 1970), cert. denied, 400 U.S. 821 (1970) (the responsible party knew those taxes were due but nevertheless wrote checks to other creditors and suppliers); *Wright v. U.S.*, 809 F.2d 425 (7th Cir. 1987); *Howard v. U.S.*, 711 F.2d 729 (5th Cir. 1983); *Mazo v. U.S.*, 591 F.2d 1151 (5th Cir. 1979). Encumbered funds are money that the taxpayer is legally obligated to use for a purpose other than satisfying the preexisting tax liability. The claim of the other creditor must be superior to the IRS. *Honey v. U.S.*, 963 F.2d 1083 (8th Cir. 1992), cert. denied, 506 U.S. 1028 (1992); *U.S. v. Kim*, 111 F.3d 1351 (7th Cir. 1997).

56 *Garsky v. U.S.*, 600 F.2d 86 (7th Cir. 1979); *U.S. v. Kim*, 111 F.3d 1351 (7th Cir. 1997). Even if money intended for payment of taxes was embezzled, the responsible party remains liable for the penalty. *Anuforo v. Comm’r*, 106 A.F.T.R.2d (RIA) 5596 (8th Cir. 2010). See also *Purcell v. U.S.*, 1 F.3d 932 (9th Cir. 1993); *Buffalow v. U.S.*, 109 F.3d 570, 573 (9th Cir. 1997).

57 *Anuforo v. Comm’r*, 106 A.F.T.R.2d (RIA) 5596 (8th Cir. 2010); *McCloskey v. U.S.*, 104 A.F.T.R.2d (RIA) 6378 (W.D. Pa 2009). See also National Taxpayer Advocate 2007 Annual Report to Congress 337, 538 (Most Serious Problem: *Third Party Payers*; *Legislative Recommendation: Taxpayer Protection from Third Party Payer Failures*). See National Taxpayer Advocate 2010 Annual Report to Congress 400, 405 (Legislative Recommendation: *Revise the Willfulness Component of the Trust Fund Recovery Penalty Statute to Encourage Business Owners to Continue Operation of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act*) (recommending that Congress amend IRC § 6672 to provide that the conduct of a responsible person who obtains knowledge of trust fund taxes not being timely paid because of an intervening bad act shall not be deemed willful if the delinquent business: (1) promptly makes payment arrangements to satisfy the liability based upon the IRS’s determination of the minimal working capital needs of the business, and (2) remains current with payment and filing obligations).

58 See *Maggy v. U.S.*, 560 F.2d 1372 (9th Cir. 1977), cert. denied, 439 U.S. 821 (1978).

59 For example, in *Baimbridge v. United States* the potentially responsible person attempted to address the willfulness component of the TFRP liability test by arguing that the corporation had entered into an IA for the repayment of the delinquent tax, and therefore, the IRS should be estopped from assessing the penalties because it was fully aware that the business was going to continue operation and satisfy non-IRS creditors. *Baimbridge v. U.S.*, 335 F. Supp. 2d 1084 (S.D. Cal. 2004). The court noted “that serious injustice may result from a penalty assessment being predicated on non-IRS payments which were contemplated by the installment agreement” and denied the IRS’s motion for summary judgment on the issue of willfulness, thereby requiring the parties to go to trial.

businesses with “working capital” to keep their doors open, while entering into payment arrangements with the IRS.⁶⁰

The IRS assessment of TFRP impacts several important taxpayer rights including the *right to challenge the IRS’s position and be heard*, the *right to appeal an IRS decision in an independent forum*, and the *right to fair and just tax system*. As discussed in *Romano-Murphy v. Commissioner*, taxpayers have the *right to challenge the IRS’s position and be heard*, including the right to a pre-assessment conference and administrative determination on their timely protest of the proposed TFRP. Additionally, taxpayers have the *right to a fair and just tax system* which takes into consideration all the facts and circumstances that may affect a taxpayer’s underlying liability for TFRP, including if they are a “responsible person,” if they acted willfully, if funds were encumbered or not, and for the IRS to take into consideration any factors that would negate willfulness.

60 See National Taxpayer Advocate 2010 Annual Report to Congress 400-05 (Legislative Recommendation: *Revise the Willfulness Component of the Trust Fund Recovery Penalty Statute to Encourage Business Owners to Continued Operations of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act*). In cases where the delinquency is due to third party bad acts, such as embezzlement by an employee or third party payer, the courts have not provided any relief to these business owners who opt to spend even a single penny on operating costs rather than providing all available funds to pay back trust fund taxes. See, e.g., *Anuforo v. Comm’r*, 614 F.3d 799 (8th Cir. 2010); *McClouskey v. U.S.*, 104 A.F.T.R.2d (RIA) 6378 (W.D. Pa. 2009). The U.S. Supreme Court has allowed this “minimum working capital,” used to maintain operations and avoided liquidation of the business, and limited the application of the TFRP in cases where a financially troubled company changed ownership and an individual became a responsible person after the liability accrued. See *Slodov v. U.S.*, 436 U.S. 238 (1978). Additionally, the National Taxpayer Advocate recommended that the IRS be given authority to determine “minimal working capital” needs of a financial struggling company, which would be modeled off of the IRC § 7122(d)(2) requirement for allowable living expense analysis, and would require the IRS to conduct a thorough analysis of all facts and circumstances of each taxpayer and ensure that its determination will not leave the taxpayer without adequate funds to meet its basic operating expenses, including current and future tax obligations. National Taxpayer Advocate 2010 Annual Report to Congress 400-05 (Legislative Recommendation: *Revise the Willfulness Component of the Trust Fund Recovery Penalty Statute to Encourage Business Owners to Continued Operations of Financially Struggling Businesses When the Tax Liability Accrues Due to an Intervening Bad Act*).