

Employment Taxes & the Trust Fund Recovery Penalty

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Every employer is responsible for withholding the appropriate amount of income taxes, social security taxes (Federal Insurance Contribution Act, or "FICA" taxes) and Medicare taxes from each of its employees' paychecks. These withholdings, along with the employer's share of FICA taxes, are then remitted to the IRS. Until the withholdings are remitted to the IRS, they are considered to be held by the employer in trust for the benefit of the employees. But what happens when an employer fails to remit its employees' withholding taxes to the IRS?

Many years ago, Congress enacted a law that if an employer fails to remit the withheld taxes to the IRS and is unable to pay these taxes over time, the IRS can collect those taxes personally from one or more persons with power over the employer's finances by assessing a Trust Fund Recovery Penalty (TFRP). Individuals who can be held liable for the TFRP are known as the "responsible person" and typically include the officers or key persons of an employer, partners in a partnership or members in an LLC with the duty to collect and pay over withholdings.

The penalty only includes taxes withheld from employees and does not include the employer's share of withheld taxes, interest and penalties. However, if the employer is a sole proprietorship, the owner is liable for not only the employees' withholding tax, but also the employer's share of taxes, interest and penalties.

During economic slowdowns, when receivables are aging longer than usual and when creditors are demanding to be paid, employers are often tempted to draw on the funds withheld from employees' paychecks to pay creditors. This is effectively "robbing Peter to pay Paul" and the IRS will eventually demand that the delinquent taxes be paid. If the employer cannot pay in full, or does not have enough funds to make monthly payments, the IRS will look to the responsible person to pay the TFRP.

As mentioned, a responsible person is someone who has the duty and the authority to see that taxes are paid or someone who pays other creditors rather than the IRS. Generally, the responsible person must be an individual who signs the employer's checks and decides which creditors get paid. In some cases, even an officer who can only direct which creditors get paid but cannot sign checks has been deemed a responsible person.

The reverse, however, is not true. An individual who signs checks, but does not determine which creditors get paid, is not a responsible person because he or she lacks the authority to direct payments. Typically, the responsible person is an owner, director, officer, key employee or accountant. In extreme cases, even a creditor may be a responsible person if the creditor knows that the employer is paying off its debts with withholding taxes.

In addition to having the authority to direct which creditors get paid, a responsible person must act willfully in failing to pay the IRS to be held responsible for the TFRP. A willful act is one that is intentional, deliberate and voluntary. To act willfully, an individual must know or be in a position where he or she should know of the delinquency. Payment of other creditors is a presumptively willful act.

Once the IRS determines the responsible person or persons, it will assess the TFRP against all responsible persons. Any payments made by the responsible person(s) will be credited against the trust fund recovery penalty and the employer's tax liability. The IRS can only assess and collect the TFRP to the extent the employer has unremitted withholding, such that the TFRP is not actually a penalty, but a mechanism to collect the unremitted withholding.

If one person of several responsible persons pays the penalty, then he or she can try to recover some of that payment from the other responsible persons. However, the IRS is not required to collect a pro-rata share from each responsible person. Indeed, the IRS will usually go after the person with the deepest pockets first.

The following tips can help employers or responsible persons avoid or reduce the TFRP:

- Pay the IRS before other creditors, even if additional funds need to be borrowed from outside sources. By doing so, an employer will avoid the 10 percent late deposit penalty and the failure to pay penalty of 0.5 percent per month, as well as professional fees for dealing with the IRS.
- If partial payments of employment taxes are sent to the IRS, include a cover letter directing that those payments be applied first to reduce employee withholdings due. The IRS will apply the taxes as requested, reducing the TFRP that can be assessed against responsible persons.
- Contact the IRS and enter into an installment agreement to pay any delinquent taxes over time, preferably over a period no longer than five years. Once the IRS accepts an installment agreement, it may assess the TFRP against the responsible person(s) but will withhold collection activities so long as the employer makes regular monthly payments and stays current.
- Make sure that withholding taxes (as well as federal income taxes, including estimated taxes where applicable) are paid currently in order maintain eligibility for an installment agreement.
- If the IRS proposes a trust fund recovery penalty assessment and a deemed responsible person believes that he or she is not actually a responsible person, that individual should file a protest to appeal the IRS's decision.