

Lesson 18

TRUST FUND RECOVERY PENALTY (§ 6672) & LIABILITY OF LENDERS OR SURETIES (§ 3505)

(March 2012)

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I. INTRODUCTION

The trust fund recovery penalty (TFRP) under section 6672 and the lender/surety liability provisions of section 3505 hold certain third parties liable for “trust fund” taxes that a primarily liable taxpayer (usually an employer) failed to withhold and/or pay over to the Service. The Service uses these provisions as a “collection device” for the underlying unpaid trust fund taxes; the trust fund taxes, interest, and penalties due are ultimately collected only once from the taxpayer (employer) and/or liable third parties. While the persons potentially liable under sections 6672 and 3505 are frequently different, there are some cases where the Service may simultaneously pursue liability against a person under both sections. The Service relies on the TFRP more often than on section 3505 because the TFRP may be assessed and collected administratively, while an unagreed section 3505 liability can only be established through a court proceeding and judgment.

II. OBJECTIVES

- Define “Trust Fund Tax” and identify the two types of trust fund taxes.
- Identify the elements of the Trust Fund Recovery Penalty (TFRP).
- Describe the procedures for the Service to assert the TFRP and for a taxpayer to challenge the TFRP administratively or in court.
- Know the elements for the two categories of persons liable under I.R.C. § 3505.

III. TRUST FUND RECOVERY PENALTY

A. Overview

The trust fund recovery penalty (TFRP) under section 6672, formerly referred to as the “100% penalty,” holds third party “responsible persons” liable for 100% of the unpaid trust fund taxes owed by the taxpayer (business) primarily liable for paying over the trust fund taxes to the Service. Each responsible person is jointly and severally liable for the entire unpaid trust fund tax liability, plus interest and penalties; however, the liability, interest, and penalties may be collected only once, whether from one or more of the

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business's responsible persons or from the business and one or more of its responsible persons. Trust fund taxes are those federal taxes that are required to be collected, withheld, accounted for, and paid over to the government, such as employment taxes and certain types of excise taxes.

The Service assesses the TFRP against persons who are responsible for collecting and paying over withheld income and employment (social security and railroad retirement) taxes and willfully fail to do so. "Responsible persons" often are corporate officers but may include others who are responsible for collecting, withholding, or paying over the withheld income and employment taxes. The TFRP also applies to responsible persons who fail to pay over collected excise taxes.

B. Statutory Provisions

1. Duty of Business to Withhold or Collect Taxes

a) Employment Tax Withholding:

- (1) I.R.C. § 3102 – employee's FICA share.
- (2) I.R.C. § 3202 – employee's railroad retirement tax share.
- (3) I.R.C. § 3402 – employee's income tax withheld.

b) Collected Excise Taxes by Business from Customers:

- (1) I.R.C. § 4251 – customer's telecommunications service tax.
- (2) I.R.C. § 4261 – customer's airline ticket tax (on persons).
- (3) I.R.C. § 4271 – customer's airline transport tax (on freight).

Note: For certain other types of unpaid federal excise taxes, including the taxes on diesel fuel, gasoline, and other fuels, the Service may impose personal liability on third parties via section 4103, which is not discussed in this lesson.

2. Special Fund in Trust for the United States

- a) I.R.C. § 7501(a) – federal taxes required to be collected or withheld from other persons (e.g., employees or customers) represent a "special fund in trust for the United States," and the amount of such trust funds shall be assessed, collected, and paid in the manner applicable to the taxes (owed by the employer) from which the trust fund arose.

b) I.R.C. § 7501(b) – cross-references to civil and criminal penalties for a third party’s failure to treat collected or withheld taxes as a special fund in trust for the United States. I.R.C. §§ 6672 and 7202

3. Rules for Application of Assessable Penalties, including the TFRP

a) I.R.C. § 6671(a) – assessable penalties, including the TFRP, are paid upon notice and demand and are assessed and collected in the same manner as taxes.

b) I.R.C. § 6671(b) – responsible person includes an officer or employee of a corporation or partnership who is under a duty to perform the act for which a violation occurs.

Note: Though described as an assessable “penalty,” courts treat the TFRP as a “tax.” United States v. Sotelo, 436 U.S. 268, 275 (1978) (TFRP not treated as a “penalty” for purposes of the Bankruptcy Act). The TFRP should not be treated as a “penalty” for purposes of new burden of proof/production rules of I.R.C. § 7491(c).

4. Liability for Failure to Collect and Pay over Trust Fund Taxes

a) I.R.C. § 6672(a) describes three duties --“to collect, truthfully account for, and pay over” any trust fund tax. A responsible person may be held 100% liable if such person “willfully” fails to perform **any one** of the three duties. The three duties are read disjunctively so that willful violation of any one may subject a responsible person to TFRP liability. Slodov v. United States, 436 U.S. 238, 246-50 (1978).

b) I.R.C. § 6672(b) establishes a 60-day preliminary notice requirement applicable to proposed TFRP assessments. The Service may not send a notice and demand for payment of the penalty until at least 60 days after a preliminary notice of assessment is issued. If the Service issues the preliminary notice within the § 6501 period of limitations on assessment, the assessment period will not expire until the later of 90 days after the date on which the Service gave the 60-day notice or the date 30 days after the conclusion of any timely administrative protest of the proposed assessment (including any appeal to the Service’s Appeals function).

c) I.R.C. § 6672(c) provides a special bond procedure that a taxpayer may follow in the first 30 days after notice and demand is made for the tax. If within the 30 day period the taxpayer pays a certain minimum amount, files an administrative claim for refund, pays a bond, and timely

files a refund suit if the Service denies the administrative claim, enforced collection actions (such as the filing of a NFTL) will be suspended until the timely refund suit is resolved. If a responsible person timely files a TFRP refund suit in federal court for a tax quarter ending after December 31, 1998, § 6331(i) also will limit enforced collection actions by the Service.

d) I.R.C. § 6672(d) provides a right of contribution from one responsible person to another responsible person for TFRP assessments made after July 30, 1996. This contribution issue may not be litigated as part of a case in which the United States is a party, such as a refund suit or a suit to reduce the unpaid TFRP assessment to judgment.

Note: The “least” responsible person is no less liable to the United States for the unpaid trust fund taxes than the “most” responsible person; the TFRP applies to all responsible persons, not just the most responsible person. Erwin v. United States, 591 F.3d 313, 324 (4th Cir. 2010); Taylor v. IRS, 69 F.3d 411, 416 (10th Cir. 1995); Denbo v. United States, 988 F.2d 1029, 1033 (10th Cir. 1993); Turnbull v. United States, 929 F.2d 173, 178 (5th Cir. 1991); Gephart v. United States, 818 F.2d 469, 476 (6th Cir. 1987); Howard v. United States, 711 F.2d 729, 737 (5th Cir. 1983).

e) Section 6672(e) provides a special exception to TFRP liability for voluntary board members of a tax exempt organization. The exception does not apply if it results in no person being liable for the TFRP.

C. “Responsible Persons” for the TFRP

1. In General

a) Section 6672 does not refer to a “responsible person;” however, the courts and the Service use the shorthand phrase to describe a person required to collect, truthfully account for, or pay over trust fund taxes. Slodov v. United States, 436 U.S. 238, 246 n.7 (1978).

b) Section 6671(b), which defines a “person” for purposes of section 6672, does not limit the definition to a natural person; so an outside entity (such as a corporate shareholder, creditor, bank or surety) may qualify as a person required to collect and pay over an employer’s trust fund taxes. Merchs. Nat’l Bank of Mobile v. United States, 878 F.2d 1382, 1386 (11th Cir. 1989); Caterino v. United States, 794 F.2d 1, 6 (1st Cir. 1986); Commw. Nat’l Bank of Dallas v. United States, 665 F.2d 743, 755 (5th Cir. 1982); Fid. Bank, N.A. v. United States, 616 F.2d 1181, 1185 (10th Cir. 1980); Mueller v. Nixon, 470 F.2d 1348, 1350-51 (6th Cir. 1972); Pac. Nat’l Ins. Co. v. United States, 422 F.2d 26, 30 (9th Cir. 1970).

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c) More than one person may be a responsible person with respect to the same business entity's unpaid trust fund taxes, with each such person being jointly and severally liable. Moore v. United States, 648 F.3d 634, 637 (8th Cir. 2011); Erwin v. United States, 591 F.3d 313, 320 (4th Cir. 2010); Lubetzky v. United States, 393 F.3d 76, 80 (1st Cir. 2004); Brown v. United States, 591 F.2d 1136, 1142 (5th Cir. 1979).

d) Responsibility generally is a matter of a person's status, duty, and authority in the context of a business which has failed to collect, truthfully account for, or pay over trust fund taxes to the Service. Colosimo v. United States, 630 F.3d 749, 752 (8th Cir. 2011); Thosteson v. United States, 331 F.3d 1294, 1299 (11th Cir. 2003); Davis v. United States, 961 F.2d 867, 873 (9th Cir. 1992); Thomsen v. United States, 887 F.2d 12, 16 (1st Cir. 1989); Mazo v. United States, 591 F.2d 1151, 1153 (5th Cir. 1979).

e) Those performing ministerial acts without exercising independent judgment will not be deemed responsible. In general, non-owner employees of the business entity, 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 pursued by the Service for a TFRP liability. See Policy Statement 5-14, IRM 1.2.14.1.3.

f) An officer or employee of a company may be a responsible person of the company even if he is not responsible for paying tax at the end of the quarter. Jean v. United States, 396 F.3d 449, 456 n.15 (1st Cir. 2005); Roth v. United States, 779 F.2d 1567, 1573 (11th Cir. 1986); Brown v. United States, 591 F.2d 1136, 1140 (5th Cir. 1979).

2. Relevant Factors Showing "Responsibility"

a) A determination of "responsibility" depends upon the facts and circumstances of each case. Common factors considered by the courts include: (i) identity of the person as an officer, director, or shareholder of the corporation; (ii) duties of the officer as set forth in the by-laws; (iii) authority to sign checks; (iv) identity of the person as the one in control of the financial affairs of the business; (v) identity of the person as the one who hired and fired employees; (vi) identity of the person as the one who had authority to determine which creditors would be paid and those who exercised that authority; (vii) identity of the person as the one who controlled payroll disbursements; (viii) identity of the person as the one who had control of the voting stock of the corporation; and (ix) identity of the person as the one who made the federal tax deposit. Vinick v. United States, 205 F.3d 1, 7 (1st Cir. 2000); Plett v. United States, 185 F.3d 216,

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219 (4th Cir. 1999); United States v. Landau, 155 F.3d 93, 100-01 (2d Cir. 1998); Greenberg v. United States, 46 F.3d 239, 243 (3d Cir. 1994); Hochstein v. United States, 900 F.2d 543, 547 (2d Cir. 1990).

b) Although no one factor is controlling, the single most important factor is a person's control over a company's finances. Most of the federal appellate circuits have concluded that a person is "responsible" for purposes of the TFRP if the person has "significant control" over a company's finances. Vinick v. United States, 205 F.3d 1, 9 (1st Cir. 2000); Winter v. United States, 196 F.3d 339, 345 (2d Cir. 1999); United States v. Carrigan, 31 F.3d 130, 133 (3d Cir. 1994); Kinnie v. United States, 994 F.2d 279, 283 (6th Cir. 1993); Denbo v. United States, 988 F.2d 1029, 1032 (10th Cir. 1993); Donelan Phillips & Co. v. United States, 876 F.2d 1373, 1376 (8th Cir. 1989); Ruth v. United States, 823 F.2d 1091, 1094 (7th Cir. 1987); Neckles v. United States, 579 F.2d 938, 940 (5th Cir. 1978) (also binding precedent in the Eleventh Circuit, via the Bonner v. City of Prichard rule). No circuit has specifically rejected the "significant control" test so the government applies the standard in all cases.

c) However, "significant control" means more than having the mechanical duty of signing checks, preparing tax returns, or having mere titular authority. Vinick v. United States, 205 F.3d 1, 8 (1st Cir. 2000); O'Connor v. United States, 956 F.2d 48, 50 (4th Cir. 1992); Godfrey v. United States, 748 F.2d 1568, 1575 (Fed. Cir. 1984).

3. "Responsibility" Standards Opposed by the United States

a) Actual, Exercised Authority – the Service disagrees with the First Circuit's position that a showing of actual, exercised authority is necessary to show "responsibility" for the TFRP, even where the person clearly possessed the authority (albeit, unexercised during the quarter at issue) to exert significant financial control over the business in the time period at issue. Vinick v. United States, 205 F.3d 1 (1st Cir. 2000), non acq., 2001-9 I.R.B. 719, action on dec., 2001-02, (Feb. 26, 2001). Other circuits and earlier panels of the First Circuit (in still valid cases) have ruled that a showing of actual, exercised authority in each quarter is not required to be a "responsible person" for the TFRP. United States v. Kim, 111 F.3d 1351 (7th Cir. 1997); Barnett v. IRS, 988 F.2d 1449, 1455 (5th Cir. 1993); Denbo v. United States, 988 F.2d 1029, 1032-33 (10th Cir. 1993); Thomsen v. United States, 887 F.2d 12, 16 (1st Cir. 1989); Harrington v. United States, 504 F.2d 1306, 1315 (1st Cir. 1974); United States v. Graham, 309 F.2d 210, 212 (9th Cir. 1962).

b) “Final Word” Regarding the Payment of Creditors – some courts have indicated that a person may be responsible for the TFRP only if the person had the final word regarding the payment of creditors. Maggy v. United States, 560 F.2d 1372, 1374-75 (9th Cir. 1977); Adams v. United States, 504 F.2d 73, 75 (7th Cir. 1974). However, the weight of authority and the position of the United States is that only significant control, not the “final word,” is required. Winter v. United States, 196 F.3d 339, 344 (2d Cir. 1999); Hochstein v. United States, 900 F.2d 543, 547 (2d Cir. 1990); Gephart v. United States, 818 F.2d 469, 475 (6th Cir. 1987); Caterino v. United States, 794 F.2d 1, 5 (1st Cir. 1986); Neckles v. United States, 579 F.2d 938, 940 (5th Cir. 1978); Brown v. United States, 464 F.2d 590, 591 n.1 (5th Cir. 1972).

D. “Willfulness” Element of the TFRP

1. In General

a) TFRP liability is a civil penalty, not a criminal penalty; so it is not necessary to show that a responsible person's failure to pay over trust fund taxes resulted from any bad purpose or evil motive. Colosimo v. United States, 630 F.3d 749, 753 (8th Cir. 2011); Winter v. United States, 196 F.3d 339, 345 (2d Cir. 1999); Vinick v. Commissioner, 110 F.3d 168, 173 (1st Cir. 1997); Phillips v. U.S. IRS, 73 F.3d 939, 942 (9th Cir. 1996); Thomas v. United States, 41 F.3d 1109, 1114 (7th Cir. 1994); Barnett v. IRS, 988 F.2d 1449, 1457 (5th Cir. 1993).

b) In the TFRP context, “willfully” generally means a voluntary, conscious, and intentional decision not to turn over trust fund taxes to the United States. Colosimo v. United States, 630 F.3d 749, 753 (8th Cir. 2011); Winter v. United States, 196 F.3d 339, 349 (2d Cir. 1999); Phillips v. U.S. IRS, 73 F.3d 939, 942 (9th Cir. 1996); Greenberg v. United States, 46 F.3d 239, 244 (3d Cir. 1994); Domanus v. United States, 961 F.2d 1323, 135 (7th Cir. 1992); Denbo v. United States, 988 F.2d 1029, 1033 (10th Cir. 1991); Smith v. United States, 894 F.2d 1549, 1553 (11th Cir. 1990); Thomsen v. United States, 887 F.2d 12, 17 (1st Cir. 1989); Collins v. United States, 848 F.2d 740, 742 (6th Cir. 1988); Wood v. United States, 808 F.2d 411, 415 (5th Cir. 1987); Godfrey v. United States, 748 F.2d 1568, 1576-77 (Fed. Cir. 1984); United States v. Pomponio, 635 F.2d 293, 297-98 n.5 (4th Cir. 1980); Wall v. United States, 592 F.2d 154, 163 (3d Cir. 1979).

c) Any one of three general standards may be used to show that a responsible person has acted willfully for TFRP purposes:

Deliberate choice. Willfulness exists where a responsible person makes a deliberate choice to pay trust fund taxes to other creditors, instead of paying these taxes over to the United States. United States v. Gilbert, 266 F.3d 1180, 1185 (9th Cir. 2001); Davis v. United States, 961 F.2d 867, 870 (9th Cir. 1992); Collins v. United States, 848 F.2d 740, 742 (6th Cir. 1988); Emswiller v. United States, 565 F.2d 1042, 1045 (8th Cir. 1977).

Knowledge of Non-Payment of Trust Fund Taxes. Willfulness exists if a responsible person obtains knowledge of a trust fund tax delinquency and continues to permit the company to make payments to other creditors.

Reckless Disregard of Risk of Non-Payment of Trust Fund Taxes. Willfulness exists where a responsible person acts with a reckless disregard of a known or obvious risk that trust fund taxes will not be paid over to the United States, including failing to investigate or correct mismanagement after being notified that trust fund taxes have not been properly paid over or allowing the business to pay creditors knowing that trust fund taxes have not been paid over to the United States. Phillips v. U.S. IRS, 73 F.3d 939, 942-44 (9th Cir. 1996). Once a responsible person knows that taxes have not been paid, he has an affirmative duty to ensure that trust fund taxes are paid before making payments to any other creditors. Conway v. United States, 647 F.3d 228, 234 (5th Cir. 2011); Finley v. United States, 82 F.3d 966, 973 (10th Cir. 1996); Keller v. United States, 46 F.3d 851, 854-55 (8th Cir. 1995); Domanus v. United States, 961 F.2d 1323, 1326 (7th Cir. 1992); Thomsen v. United States, 887 F.2d 12, 19 (1st Cir. 1989).

d) Lack of knowledge of the non-payment of trust fund taxes to the United States is not a complete defense to the willfulness element of the TFRP. Willfulness may be met if a responsible person recklessly disregards a known or obvious risk that trust fund taxes may not be paid to the United States. Conway v. U.S., 647 F.3d 228, 234 (5th Cir. 2011); Oppliger v. U.S., 637 F.3d 889, 894 (8th Cir. 2011); Erwin v. U.S., 591 F.3d 313, 325 (4th Cir. 2010); Mortenson v. Nat'l Union Fire Ins. Co. of Pitts., PA, 249 F.3d 667, 669 (7th Cir. 2001); Winter v. U.S., 196 F.3d 339, 345 (2d Cir. 1999); Vinick v. U.S., 110 F.3d 168, 173 (1st Cir. 1997); Malloy v. U.S., 17 F.3d 329, 332 (11th Cir. 1994); Denbo v. U.S., 988 F.2d 1029, 1033 (10th Cir. 1993); Brounstein v. U.S., 979 F.2d 952, 956 (3d Cir. 1992); Teel v. U.S., 529 F.2d 903, 905 (9th Cir. 1976).

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2. Common Scenarios Involving “Willfulness” for the TFRP

a) Payment of net wages – The payment of net wages (wages minus trust fund taxes) to employees when funds are not available to pay withholding taxes is a willful failure to collect and pay over under section 6672. If funds are not available to cover both wages and withholding taxes, a responsible person has a duty to prorate the available funds between the United States and the employees so that the taxes are fully paid. For purposes of determining willfulness, an employee owed wages is viewed as another creditor of the business, and preferences to employees over the government constitute willfulness. Hochstein v. United States, 900 F.2d 543, 548 (2d Cir. 1990); Collins v. United States, 848 F.2d 740, 742 (6th Cir. 1988); Emshwiller v. United States, 565 F.2d 1042, 1045 (8th Cir. 1977); Sorenson v. United States, 521 F.2d 325, 328 (9th Cir. 1975).

b) “Hear No Evil, See No Evil” Policy – A responsible person can not absolve himself of TFRP liability by simply closing his eyes to his company’s financial difficulties and paying other creditors. Self-imposed ignorance is not a defense to willfulness, which may be found from the reckless disregard of an obvious risk. United States v. Running, 7 F.3d 1293, 1299 (7th Cir. 1993); Wright v. U.S., 809 F.2d 425, 427 (7th Cir. 1987); Sorenson v. U.S., 521 F.2d 325, 329 (9th Cir. 1975).

c) Mistaken Beliefs or Bad Advice – A mistaken belief by a responsible person that a trust fund tax need not or cannot be paid over to the United States does not render the failure to pay non-willful. Mistaken reliance on advice from an attorney does not negate willfulness, nor does a misunderstanding of bankruptcy law. A hope or intent that funds will be available to pay the United States when the withholding taxes become payable also does not negate willfulness. Jones v. United States, 60 F.3d 584, 589 (9th Cir. 1995); Smith v. United States, 894 F.2d 1549, 1554 (11th Cir. 1990); Thomsen v. United States, 887 F.2d 12, 17 (1st Cir. 1989); Brown v. United States, 591 F.2d 1136, 1141 (5th Cir. 1979); Teel v. United States, 529 F.2d 903, 906 (9th Cir. 1976); Newsome v. United States, 431 F.2d 742, 747-48 (5th Cir. 1970).

Note: If an employer misclassified employees as “independent contractors” and was granted relief under section 530 of the Revenue Act of 1978 or under section 3509, it will be difficult for the Service to establish willfulness for TFRP purposes. See IRM 5.7.3.4. However, when a responsible person’s business intentionally misclassified employees as independent contractors, the TFRP should be sustained. In re Smith, 99-1 U.S.T.C. ¶ 50,278 (Bankr. D. Haw.), aff’d, 243 B.R. 89 (D. Haw. 1999), aff’d, 246 F.3d 676 (9th Cir. 2000).

d) Orders Not to Pay – Orders from a superior not to pay the trust fund taxes to the United States may not negate willfulness in an otherwise responsible person. A responsible person follows such directions of a superior at his own peril; if necessary, the responsible person may need to risk losing his job or quit. Lubetzky v. United States, 393 F.3d 76, 81-82 (1st Cir. 2004); Brounstein v. United States, 979 F.2d 952, 956 (3d Cir. 1992); Hochstein v. United States, 900 F.2d 543, 549 (2d Cir. 1990); Gephart v. United States, 818 F.2d 469, 475 (6th Cir. 1987); Roth v. United States, 779 F.2d 1567, 1571-72 (11th Cir. 1986); Howard v. United States, 711 F.2d 729, 734-36 (5th Cir. 1983).

Note: Some courts have looked at this scenario from the “responsibility” angle and found that persons with the status, duty, and authority within a business to ordinarily make them “responsible” were so dominated by another person in the company as to make them not “responsible persons” for the TFRP. Alsheskie v. United States, 31 F.3d 837, 839 (9th Cir. 1994); McCullough v. United States, 462 F.2d 588, 590 (5th Cir. 1972).

e) Outside Control – The willfulness of a responsible person within a company is not negated simply because a lender or other creditor exerts significant or even exclusive control over the company's finances and forbids payment of the taxes; a responsible insider, who may have acquiesced in giving the outside lender or creditor control, may have to shut down the business operations in these circumstances. McDonald v. United States, 939 F.2d 916, 919 (11th Cir. 1991); Bowen v. United States, 836 F.2d 965, 968 (5th Cir. 1988); Kalb v. United States, 505 F.2d 506, 511 (2d Cir. 1974).

f) Responsible Persons Not Aware of Unpaid Taxes When Accrued – If a responsible person becomes aware that trust fund taxes have gone unpaid during a prior period when he was responsible, but nevertheless still goes ahead and pays other creditors in preference to the United States, his actions at that time represent a willful failure to pay over the trust fund taxes that previously accrued. The responsible person is liable for the TFRP to the extent that he subsequently applies or permits the application of any “unencumbered funds” of the company – not just the funds that are physically available when he becomes aware of the unpaid taxes – to the payment of creditors other than the United States. Erwin v. United States, 591 F.3d 313, 326 (4th Cir. 2010); Thosteson v. United States, 331 F.3d 1294, 1300-01 (11th Cir. 2003); United States v. Kim, 111 F.3d 1351, 1362 (7th Cir. 1997); Barnett v. IRS, 988 F.2d 1449, 1457-58 (5th Cir. 1993); Honey v. United States, 963 F.2d 1083, 1087-89 (8th Cir. 1992); Davis v. United States, 961 F.2d 867, 871 (9th Cir. 1992); United States v. Vespe, 868 F.2d 1328, 1334 (3d Cir. 1989).

g) Changes in Control of a Business – If a person was not a responsible person of a business when the trust fund taxes went unpaid and subsequently became a responsible person of the business, the new person's potential liability for the TFRP is considerably more limited than in the scenario immediately above (where the person was “responsible” at all relevant times, but was not “willful” until he became aware of the failure to pay after the tax went unpaid). In change of control cases, the responsible person's potential TFRP liability for pre-control periods is limited to the amount of the company's unencumbered liquid assets on the change of control date. Slodov v. United States, 436 U.S. 238, 259-60 (1978); Purdy Co. of Ill. v. United States, 814 F.2d 1183, 1191 (7th Cir. 1987).

3. “Reasonable Cause” Challenges to “Willfulness”

a) Many “penalties” in the Internal Revenue Code contain a statutory “reasonable cause” exception that excuses the actions or omissions of an otherwise liable person. For instance, sections 6651(a)(1)-(3), involving the failure to file a return and pay taxes, include “reasonable cause” exceptions, and section 6664(c) includes a “reasonable cause” defense against the accuracy-related penalties described in section 6662 and the fraud penalty in section 6663. Congress did not provide for a “reasonable cause” defense to the TFRP within I.R.C. § 6672.

b) The circuits that have decided the issue have split on whether “reasonable cause” negates a responsible person's willfulness and is a defense to TFRP liability. The Eighth and First Circuits have determined that reasonable cause is not a defense. Olsen v. United States, 952 F.2d 236, 241 (8th Cir. 1991); Harrington v. United States, 504 F.2d 1306, 1316 (1st Cir. 1974). The Ninth Circuit has not stated specifically that the reasonable cause defense does not apply; however, it has determined that “conduct motivated by a reasonable cause may, nonetheless, be willful.” Phillips v. U.S. IRS, 73 F.3d 939, 942 (9th Cir. 1996). The Tenth, Eleventh, Second, and Fifth Circuits have determined that the reasonable cause defense applies, at least conceptually, to willfulness determinations under section 6672. Even, these circuits, however, apply the defense narrowly. Smith v. United States, 555 F.3d 1158, 1170 (10th Cir. 2009) (reasonable cause defense must be narrowly construed with respect to section 6672); Thosteson v. United States, 331 F.3d 1294, 1301 (11th Cir. 2003) (court does not decide whether reasonable cause applies, but notes that this defense is exceedingly limited); United States v. Winter, 196 F.3d 339, 345 (2d Cir. 1999) (reasonable cause defense negated willfulness only if the responsible person reasonably believed that taxes were being paid); Logal v. United States, 195 F.3d 229, 233 (5th Cir. 1999) (reasonable cause defense is exceedingly limited).

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E. Procedural Issues for TFRP Determinations and Challenges

1. Summoning Information Necessary to Assess

In RRA 98, Congress made significant changes regarding when the Service is required to notify taxpayers of third party summons. For a summons served on a third party to ascertain a person's liability for the TFRP, the Service no longer takes the position that a "collection" exception (discussed in Treas. Reg. § 301.7609-4(a)(2)(ii) (2007)) to giving "notice" applies.

2. Statute of Limitations

a) Generally, the assessment limitation period for the TFRP is three years from the later of (i) the date on which the employer's tax return for the period was filed, or (ii) the unextended due date of the employer's tax return for the period. The unextended due date of an employer's tax return for all four quarters of a calendar year is April 15 of the following calendar year. I.R.C. § 6501(b)(2); Morales v. United States, 805 F. Supp. 1062, 1071 (D.P.R. 1992). TFRP assessments are generally governed by the assessment limitation regime described in section 6501. Lauckner v. United States, 68 F.3d 69 (3d Cir. 1995), action on dec., 1996-006, 1996 AOD LEXIS 8, (Jul. 15, 1996), acq., 1996-2 C.B. 1.

b) A potentially responsible person for the TFRP and the Service may extend the ordinary assessment limitation period for the TFRP by timely signing a waiver agreement (Form 2750) pursuant to section 6501(c)(4). The Service commonly obtains extensions of the TFRP assessment limitation period when the underlying taxpayer (the employer) has an approved and adhered to installment agreement or bankruptcy payment plan. See the policy described in ¶ (8) of IRS Policy Statement 5-14, IRM 1.2.14.1.3; IRM 5.7.3.6.1(3).

c) Since June 30, 1996, whenever the Service timely issues a 60-day pre-assessment notice of proposed TFRP liability (a Letter 1153) to a person pursuant to section 6672(b)(1), the TFRP assessment limitation period for the employer quarters covered by the Letter 1153 for that person will not expire before the later of: (i) 90 days after the notice was properly issued (i.e., 30 days after the 60-day period to mail the Service a timely protest expires); or (ii) if the person submits a timely protest, then 30 days after the Service's Appeals office issues its final determination with respect to the protest. I.R.C. § 6672(b)(3).

Note: An “imperfect,” but timely, protest from a Letter 1153 is considered a “timely protest” for purposes of any suspension of the TFRP assessment limitation period. Consistent with this view, if Collection receives a taxpayer’s timely imperfect protest from a Letter 1153, and if Collection is unable to obtain a perfected protest from the taxpayer within the time frame discussed in IRM 8.25.1.2.1, Collection should still forward any such timely imperfect protest to Appeals for consideration as a timely protest.

3. Burden of Proof/Production

a) Historically, as in almost all tax matters, the taxpayer has the burden of proof in a TFRP case. The Service’s determination of a TFRP liability is presumed correct, and the taxpayer has the burden of proving otherwise. In a court proceeding, once the government introduces a TFRP assessment into evidence, the taxpayer has the burden of proof. Erwin v. United States, 591 F.3d 313, 319 (4th Cir. 2010); Jean v. United States, 396 F.3d 449, 454 (1st Cir. 2005); Winter v. United States, 196 F.3d 339, 344-45 (2d Cir. 1999); United States v. Kim, 111 F.3d 1351, 1357 (7th Cir. 1997); Barnett v. IRS, 988 F.2d 1449, 1453 (5th Cir. 1993); Cline v. United States, 997 F.2d 191, 194 (6th Cir. 1993); Brounstein v. United States, 979 F.2d 952, 954 (3d Cir. 1992); Honey v. United States, 963 F.2d 1083, 1087 (8th Cir. 1992); Oliver v. United States, 921 F.2d 916, 919 (9th Cir. 1990); George v. United States, 819 F.2d 1008, 1013 (11th Cir. 1987).

b) In bankruptcy cases, it is clear that the burden of proof for any tax claim, including a TFRP liability, is allocated in accordance with applicable non-bankruptcy law (i.e., the burden of proof for a tax claim is no different in a bankruptcy case). Raleigh v. Ill. Dep’t of Revenue, 530 U.S. 15, 20 (2000).

c) RRA 98 added new general burden of proof/production provisions to the Internal Revenue Code for taxes imposed by subtitle A or B of the Code. I.R.C. § 7491. The underlying federal employment and excise trust fund taxes for which the TFRP is used as a collection device arise under subtitles C and D of the Internal Revenue Code, rather than under subtitles A or B, so the burden-shifting provisions of section 7491(a) do not apply to the TFRP. Section 7491(c) discusses “the burden of production in any court proceeding” for “any penalty.” However, it is the Service’s position that the TFRP is not a “penalty” for purposes of section 7491(c), just as the TFRP is not treated as a “penalty” for Bankruptcy Act or Bankruptcy Code purposes.

d) Sometimes the administrative file that the Service compiled to recommend the assertion of a TFRP liability has either been lost or destroyed before the taxpayer files a suit for refund of a TFRP. In these

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missing file cases, the Service may still be able to reconstruct a sufficient foundation for its TFRP determination through informal or formal discovery; so the court is not faced with a “naked assessment” and the usual burden of proof on the taxpayer in a TFRP case is not affected. Cook v. United States, 46 Fed. Cl. 110, 113-15 (Fed. Cl. 2000); Morales v. United States, 805 F. Supp. 1062, 1068-69 (D.P.R. 1992).

4. New TFRP Computation Methods

a) Application of Employer's Payments within a Tax Module – prior to June 19, 2000, the Service calculated the amount of the **unpaid** “trust fund” taxes owed by the business (the employer) for any quarter by applying any undesignated or involuntary payments received on the business account in the following order: non-trust fund portion of tax (employer's FICA share); lien fees and collection costs; employer penalties and interest; and lastly, trust fund taxes.

Since June 19, 2000, a proposed TFRP liability for any quarter is calculated by applying any undesignated or involuntary payments received on the business account: (1) to the non-trust fund portion of the employer's tax (the same as before); (2) to the trust fund portion of the employer's tax; 3) to lien fees, collection costs, penalties and interest. See ¶¶ (9-10) of IRS Policy Statement P-5-14, IRM 1.2.14.1.3.

The typical result of the Service's current payment application policy is that the TFRP is now often asserted for a lesser amount because payments that formerly would have been applied to lien fees, employer penalties, and employer interest are now applied to the trust fund taxes owed (for TFRP computation purposes), and the TFRP can only be asserted for the employer's unpaid trust fund taxes. The Service's current application of payments policy is not retroactive.

b) Migration from Lump Sum to Quarterly TFRP Assessments – Prior to August 17, 2001, the Service made one lump sum TFRP assessment against a responsible person for all employer quarters that were all part of the same investigation, and recorded the lump sum TFRP assessment as being for the employer's final quarter at issue. This lump sum assessment method complicated the Service's internal accounting systems and sometimes created legal problems. Stallard v. United States, 12 F.3d 489 (5th Cir. 1994).

Since August 17, 2001, the Service began making a separate TFRP assessment for the unpaid trust fund taxes for each employer quarter. (**Note:** Up until the billing notice stage for taxpayers, revenue officers should include multiple TFRP quarters on revised TFRP forms for

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purposes such as extending the assessment limitation period (Form 2750), consenting to proposed TFRP assessments (Form 2751), giving the 60-day preliminary notice of a proposed TFRP assessment (Letter 1153), and transmitting cases internally within the Service for various purposes.)

5. Preliminary Notice

a) The federal employment and excise taxes for which the Service may assert the TFRP are not taxes imposed by subtitles A or B or by chapters 41 through 44 (sections 4911 through 4982) of the Internal Revenue Code; so the notice of deficiency and taxpayer petition to Tax Court procedures described in sections 6212 and 6213 do not apply to the TFRP.

b) Prior to the Taxpayer Bill of Rights 2 (TBOR 2) and the effective date of the changes it made to section 6672 (June 30, 1996), the Service ordinarily sent taxpayers a prior version of the Letter 1153 to notify them of a proposed TFRP assessment and to allow them an opportunity to seek a pre-assessment administrative hearing with the Service's Appeals function. However, if a taxpayer filed a timely protest seeking a hearing with Appeals before TBOR 2, the assessment limitation period for the TFRP was not automatically suspended during the timely protest and administrative hearing periods. Accordingly, before TBOR 2, if a taxpayer protested a proposed TFRP assessment but was unwilling to extend the TFRP assessment limitation period during the appeal period, the Service could assess the TFRP and give the taxpayer an immediate (pre-refund claim) hearing in Appeals after the assessment had been made.

c) TBOR 2 essentially codified the Service's longstanding administrative practice of giving TFRP preliminary notices and administrative appeals. I.R.C. § 6672(b). However, the current provision provides that, if notice is given before the assessment period has expired, the period shall not expire before the date that is 90 days after the date such notice is mailed or delivered in person or, if a timely protest is filed, until 30 days after the date the Service makes a final administrative determination. The current provision also provides that the notice requirement shall not apply when collection of the TFRP is in jeopardy. I.R.C. § 6672(b)(4).

d) Technically, section 6672(b)(2) requires the Service's preliminary notice to "precede any notice and demand" by at least 60 days, rather than requiring the preliminary notice to precede a TFRP "assessment" by 60 days. However, in ordinary circumstances, the Service should give the preliminary notice at least 60 days before assessing the TFRP.

Note: In addition to jeopardy to collection, a further exception to pre-assessment hearing procedures for the TFRP may arise when one responsible person commences a refund suit for the TFRP before another potentially responsible person has exhausted his administrative appeal rights. In such cases, Counsel may request that Appeals assess the TFRP against the second person immediately so that the United States may join the second person to the first person's refund suit via a third party complaint. Rev. Proc. 84-78, 1984-2 C.B. 754. In such cases, the Service could rely upon the "judgment" it obtains against the second person, rather than the "lien" arising after the Service gives notice and demand for the TFRP assessment.

e) Section 6672(b) provides that the preliminary notice shall be sent by mail or delivered in person to an address as determined under section 6212(b), *i.e.*, "the last known address." As with respect to notices of deficiency, proper mailing of a preliminary notice to the last known address is sufficient to comply with section 6672(b)(1). Where the notice has been mailed to the taxpayer's last known address, it is not necessary for the taxpayer to receive the notice before the Commissioner can assess the TFRP. Mason v. Commissioner, 132 T.C. 301, 322 (2009). A bankruptcy court reached the same conclusion in In re Chabrand, 301 B.R. 468, 476-77 (Bankr. S.D. Tex. 2003).

f) As with taxes subject to deficiency procedures, a taxpayer may "waive" the preliminary notice (Letter 1153) requirement and/or the 60-day period before notice and demand may be given by signing a standard form (Form 2751) that consents to the Service making the proposed TFRP assessment and waives the 60-day period.

6. Tax Refund Procedures for the TFRP

a) The TFRP, like the underlying employment and excise taxes for which it may be imposed, is a "divisible" tax. Accordingly, unlike a refund suit for income taxes, a responsible person need not pay the full amount of a TFRP assessment in order to file a proper refund claim with the Service or, thereafter, to commence a proper refund suit in a federal district court or in the Court of Federal Claims. Instead, a person who has been assessed a TFRP need pay only the portion of the TFRP attributable to one employee for each quarter in question, in order to file a proper refund claim and later commence a refund suit for the quarter. See Steele v. United States, 280 F.2d 89, 90 (8th Cir. 1960), wherein the United States confessed error and stipulated that the full payment rule for income tax refund actions discussed in Flora v. United States, 357 U.S. 63 (1958), does not apply to assessments of divisible taxes such as the TFRP.

b) A taxpayer (responsible person) does not file a return that establishes his liability for the TFRP, so any claim for a refund of an overpayment of the TFRP must be filed by the taxpayer with the Service within two years from the time the tax was paid. I.R.C. § 6511(a); Treas. Reg. § 301-6511(a)-1(a)(2); Kuznitsky v. United States, 17 F.3d 1029, 1032-33 (7th Cir. 1994); Clark v. United States, 76 A.F.T.R.2d 95-7831 (N.D. Ga. 1995).

c) Once the taxpayer has paid the required amount of the TFRP and filed a timely administrative claim for refund, the Service may then either reject the claim or not act upon it for a period of six months. If the claim has been rejected or the Service has not timely acted upon it, then the taxpayer may institute a refund suit in federal district court or the Court of Federal Claims for the paid portion of the TFRP liability and may request abatement of the unpaid portion of the TFRP liability. I.R.C. §§ 6532(a)(1) and 7422(a). These procedural requirements are jurisdictional in nature and cannot be waived. Ranzini v. Commissioner, No. 92-4351, 1994 U.S. Dist. LEXIS 3307, at *4 (D.N.J. 1994); Mo. Pac. R.R. v. United States, 558 F.2d 596, 599 (Ct. Cl. 1977).

d) In a TFRP refund suit, if the taxpayer has not fully paid the assessed amount, the United States will file a counterclaim for the unpaid TFRP balance with its answer. If a responsible person brings a refund suit in a federal district court, the United States may file third-party complaints joining any other persons believed to be responsible persons for the same employer quarters at issue in the refund suit.

F. Collection Issues Surrounding the TFRP

1. Collectability Determinations before TFRP Asserted

a) As a matter of policy, the IRM now directs revenue officers to make an upfront determination of the “collectability” of a potential TFRP liability from any potentially responsible persons before the TFRP is even asserted. IRM 5.7.5.1.

b) If the potentially responsible person can be located within the United States or its territories, the “collectability” determination that precedes assertion of the TFRP should consider both the responsible person's current assets and the responsible person's likely future financial prospects over the ten year collection period that would follow a TFRP assessment.

c) The uncollectability of a TFRP liability is not a legal defense to the Service's assertion of the liability, though a lack of collectability may serve as the basis for a taxpayer's offer-in-compromise concerning an unpaid TFRP liability.

2. Collection Actions against the Employer

a) There is no legal requirement that the Service first attempt to collect from the employer before asserting a TFRP liability against a responsible person. Cash v. United States, 961 F.2d 562, 565 (5th Cir. 1992); Hochstein v. United States, 900 F.2d 543, 549 (2d Cir. 1990), In re Ribs-R-Us, Inc., 828 F.2d 199, 201 (3d Cir. 1987); United States v. Huckabee Auto Co., 783 F.2d 1546, 1549 (11th Cir. 1986).

b) Nevertheless, absent assessment limitation period concerns, the Service normally withholds assessing the TFRP in the case of an approved and adhered to business installment agreement (IA) between the Service and the employer under I.R.C. § 6159 or a court-approved and adhered to Chapter 11 bankruptcy plan of reorganization for the employer. See ¶ (8) of IRS Policy Statement 5-14, IRM 1.2.14.1.3. However, if a potentially responsible person files a Chapter 13 bankruptcy case while the employer is under an IA or a Chapter 11 plan, the Service should not fail to file a proof of claim for the TFRP in the individual's Chapter 13 case.

c) Trust fund taxes plus costs of collection, interest, and penalties will be collected by the Service only once, as a matter of policy. "Collection" of the trust fund taxes occurs only when the Service's right to retain the collected funds is established by expiration of the two year period for filing a claim for refund. See ¶¶ (2-3) of IRS Policy Statement 5-14, IRM 1.2.14.1.3.

d) If an employer's payments are applied to trust fund taxes for a quarter after the TFRP has been asserted against responsible persons for the same quarter, a payment credit should be tentatively cross-referenced against the TFRP liabilities of the responsible persons who have been assessed. Conversely, if a responsible person makes payments toward his assessed TFRP liability, the payments should be tentatively cross-referenced against the TFRP liabilities of other persons assessed the TFRP for the same period and against the employer's liability for the taxes. Final cross-referencing of payments does not occur, however, until the Service's right to retain the payments is established.

3. Single Entity Limited Liability Companies (LLCs)

According to Treas. Reg. 301.7701-3(a), an eligible single owner business entity may elect for tax purposes to be classified as an association, *i.e.*, corporation, or disregarded as an entity separate from its owner. McNamee v. Dep't of the Treasury, IRS, 488 F.3d 100, 103 (2d Cir. 2007); Littriello v. United States, 484 F.3d 372, 376 (6th Cir. 2007). A single owner LLC is generally disregarded under Treas Reg. 301.7701-2(c)(2)(i). Effective January 1, 2009, however, the LLC is recognized as a corporation separate from its owner with respect to the underlying employment tax imposed under Subtitle C—Employment Taxes and Collection of Income Tax. Treas. Reg. § 301.7701-2(c)(2)(iv)(A). Therefore, the Service may assess the underlying employment tax against the LLC. To the extent the LLC does not pay the employment tax assessment, the TFRP may be considered as to any responsible person. Treasury Regulation 301.7701-2(c)(2)(i), which disregards a single owner LLC, also does not apply to excise taxes effective January 1, 2008 pursuant to section 301.7701-2(c)(2)(v)(A)(1).

4. Bankruptcy Principles and the TFRP

a) Assessed and potentially assessable TFRP liabilities are frequently highlighted in bankruptcy cases involving the employer who originally failed to pay the trust fund taxes or the responsible persons who failed their fiduciary duties regarding these trust fund taxes. It is generally beyond the scope of this lesson to discuss these bankruptcy controversies in any detail; however, a few of the applicable statutory provisions and Supreme Court cases are mentioned below.

b) The trust fund tax liabilities of an employer and the TFRP liabilities of responsible persons are uniquely entitled to “priority” claim treatment in a bankruptcy case regardless of the age of these trust fund tax liabilities. 11 U.S.C. § 507(a)(8)(C).

c) If the Service files a timely bankruptcy claim for these priority taxes, an employer or a responsible person debtor in a Chapter 11, 12, or 13 bankruptcy case must agree in its plan to pay the allowed amount of the Service's priority claim in full. 11 U.S.C. §§ 1129(a)(9)(C)-(D), 1222(a)(2), and 1322(a)(2).

d) Even if the Service fails to file a timely bankruptcy claim for a TFRP liability, an individual responsible person in a Chapter 7, 11, 12, or 13 bankruptcy case will remain liable for paying the TFRP debt outside of bankruptcy because these tax debts are non-dischargeable in these types of bankruptcy cases. 11 U.S.C. § 523(a)(1)(A).

e) In considering a Chapter 11 plan of reorganization, a bankruptcy court may order the Service to apply the employer's tax payments to pay its trust fund taxes first, provided such action is necessary to the success of the reorganization plan. United States v. Energy Res. Co., 495 U.S. 545, 551 (1990).

f) Trust fund taxes which are voluntarily paid by an employer within 90 days of the employer's bankruptcy filing require no element of tracing to show they were held in trust for the United States when paid; voluntary prepetition payments of trust fund taxes may not be set aside and recaptured as "preferences" under bankruptcy law. Begier v. IRS, 496 U.S. 53, 66-67 (1990).

IV. LIABILITY OF LENDERS AND SURETIES

A. Overview

In addition to the TFRP, in certain instances, the government may impose liability on lenders or sureties for unpaid withholding and FICA taxes pursuant to I.R.C. § 3505. If a lender, surety, or other third party pays wages directly to the employees of an employer or to the employees' agent, he may be liable for any required withholding on those wages. Similarly, if a lender, surety, or other person supplies funds to the employer for the specific purpose of paying wages of the employees with knowledge that the employer does not intend to make timely payments or deposits of amounts required to be withheld from such wages, such lender, surety or other person may be liable for the amounts not paid over.

The purpose of section 3505 is to prevent the practice of "net payroll financing." Net payroll financing is a device used by lenders to minimize their costs and their risks when advancing money to employers in poor financial condition by advancing funds sufficient to cover the employers' net payroll. The lender pays neither the employees nor the government the withholding taxes due to the government.

B. Statutory Provisions

1. Direct Payment of Wages

a) Section 3505(a) provides that, for purposes of the employment trust fund taxes described in sections 3102, 3202, and 3402, if a lender, surety, or other person, who is not an employer with respect to an employee(s), pays wages directly to such an employee(s) or their agent, then such lender, surety, or other person shall be personally liable to the United States in a sum equal to the taxes (plus interest) required to be deducted and withheld from such wages by such employer. Section 3505(a)

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imposes a liability of 100% of the unpaid tax on a third party who directly pays net wages.

b) **Supplying Funds to Employer for Paying Net Wages** – Section 3505(b) provides that, if a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required to be deducted and withheld by such employer from such wages, then such lender, surety, or other person shall be personally liable to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied by such person to or for the account of such employer for such purpose.

2. Some Differences between Sections 6672 and 3505

a) **Types of Taxes Covered** – Sections 6672 and 3505 both cover an employer's unpaid employment trust fund taxes, but the TFRP may also be asserted for certain unpaid federal excise taxes of a business.

b) **Manner of Assertion** – The TFRP may be summarily assessed and collected without any pre-assessment opportunity for judicial review of the proposed liability. However, section 3505 liability is not an “assessable tax;” the United States must first commence a suit to establish section 3505 liability, unless the liable person signs a Form 4219, *Statement of Liability of Lender, Surety, or Other Person for Withholding Taxes*, consenting to the liability.

c) **Burden of Proof** – For the TFRP, it is the Service's position even after the enactment of section 7491, that the burden of proof and of production is on the responsible person. For section 3505 liability, the Service and the courts have always taken the position that the burden of establishing the elements of section 3505 by a preponderance of the evidence is on the United States. See LGM GL-14, “Section 3505 Liability of Lenders and Sureties” at *2 (1994), 1994 IRS LGM LEXIS 12.

d) **Limitation Period on Assertion** – The TFRP generally must be assessed within the ordinary 3-year framework in section 6501. Since August 1, 1995, the Service has been able to commence a timely section 3505 suit within ten years after assessment of the unpaid tax against the employer. See Treas. Reg. § 31.3505-1(d)(1), (g).

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e) Liability for Pre-Assertion Interest – A responsible person’s liability for interest does not begin to run, pursuant to section 6601(e)(2)(A), until after the TFRP has been assessed and notice and demand have been given to the responsible person. A lender, surety, or other person liable under section 3505, however, is responsible for paying the United States pre-judgment interest on its ultimate section 3505 liability, starting from the due date of the employer’s return relating to the unpaid taxes at issue. See Treas. Reg. § 31.3505-1(a)(1), (b)(1).

C. Elements of I.R.C. § 3505(a)

1. Wages Paid by Person Other than Employer

For purposes of section 3505(a), a “person” may be a lender, surety, or any other person similar to a lender or surety who directly pays wages. It does not include a person acting only as an agent of the employer or as an agent of the employees, such as a union agent. See Treas. Reg. § 31.3505-1(c).

The most common situation where a person other than a lender or surety (“other person”) may be found liable under section 3505(a) is if a prime or general contractor, out of necessity (to keep the employees of the subcontractor on the job) or by contract, pays net wages directly to employees of a subcontractor that is having financial problems. See United States v. Kennedy Constr. Co. of NSB, 572 F.2d 492, 496 (5th Cir. 1978) (section 3505(a) liability imposed on a general contractor who co-signed payroll checks for a subcontractor’s employees); United States v. Towne Realty, Inc., 575 F. Supp. 77, 79-80 (E.D. Wis. 1983).

2. Wages Paid Directly

a) Section 3505(a) applies only to a lender, surety, or other person who directly pays wages to the employee(s) of another or to an agent on behalf of such employee(s).

b) In evaluating whether wages are being paid directly, the Service and the courts look to the “substance” of the transaction and may find the direct payment of net wages present even though a “subterfuge” is used to attempt to disguise the substance of the arrangement. See United States v. Kennedy Constr. Co. of NSB, 572 F.2d 492 (5th Cir. 1978); Houston v. United States, 492 F. Supp. 574, 575 (C.D. Cal. 1980); United States v. Clayton-Kent Builders, Inc., 378 F. Supp. 1109, 1113-14 (M.D. La. 1974).

D. Elements of I.R.C. § 3505(b)

1. Funds Supplied by Person Other than Employer

a) For purposes of section 3505(b), a “person” who supplies funds may be a lender, surety, or any other person similar to a lender or surety who supplies funds for the specific purpose of paying net wages, but it does not include a person acting only as an agent of the employer or as an agent of the employees.

b) Persons found liable for section 3505(b) may include:

(1) A prime or general contractor who supplies funds directly to a subcontractor to meet its net payroll, with knowledge of the subcontractor's inability to pay its withholding taxes. See United States v. Algernon Blair, Inc., 441 F.2d 1379, 1381 (5th Cir. 1971).

(2) A shareholder, including a parent company of a subsidiary, which makes a capital contribution or a direct loan or puts up collateral for a loan from a third party to a corporation if the loan is used by the corporation to pay net wages. See United States v. Intercontinental Indus., Inc., 635 F.2d 1215, 1218-19 (6th Cir. 1980).

(3) A bank which honors a customer/employer's overdrafts for payroll checks. See Fid. Bank, N.A. v. United States, 616 F.2d 1181, 1184 (10th Cir. 1980); United States v. Park Cities Bank & Trust Co., 481 F.2d 738, 739 (5th Cir. 1973).

2. Funds Supplied for Wages

a) To be liable under § 3505(b), the supplier of funds must advance the funds to or for the account of an employer for the specific purpose of paying wages of the employer's employees. See Treas. Reg. § 31.3505-1(b)(1)(i).

b) Section 3505(b) liability will not be imposed if the person makes an “ordinary working capital loan” to the employer, even though the person supplying the funds knows that part of the funds advanced may be used to make wage payments in the ordinary course of business. Generally, an ordinary working capital loan is one which is made to enable the borrower to meet current obligations as they arise. The person supplying such funds is not obligated to determine either the specific use of the ordinary

working capital proceeds or the ability of the employer to pay the amounts of tax required to be deducted and withheld. See Treas. Reg. § 31.3505-1(b)(3).

c) However, section 3505(b) will be applicable to the maker of an “ordinary working capital loan” if the person has actual notice or knowledge at the time of the advance that the funds, or a portion thereof, are to be used specifically to pay net wages, whether or not the written agreement under which the funds were advanced states a different purpose. Whether or not a lender has actual notice or knowledge that the funds are to be used to pay net wages depends upon the facts and circumstances of each case. See Treas. Reg. § 31.3505-1(b)(3).

3. Actual Notice or Knowledge of Intent Not to Pay Taxes

a) At the time that such funds are advanced, the supplier of funds must have actual notice or knowledge within the meaning of section 6323(i)(1) that the employer to whom the funds are advanced either does not intend to, or will not be able to, make timely payment or deposit of the employment trust fund taxes required to be withheld. See Treas. Reg. § 31.3505-1(b)(1)(ii).

b) Section 6323(i)(1) provides that notice or knowledge of any fact is deemed from the time that such fact is brought to the attention of the individual conducting such transaction or from the time such fact would have been brought to such individual's attention if the organization had exercised due diligence.

c) Notice to, or knowledge by, any agent of a third-party supplier-of-funds is imputed to the third party. This is true even if the agent is acting adversely to the principal's interest and in fact conceals the facts from the principal. United States v. Park Cities Bank & Trust Co., 481 F.2d 738, 740-41 (5th Cir. 1973).

d) A third-party supplier-of-funds, however, is under no affirmative duty to investigate outside of its own organization the borrower's ability to pay withholding taxes absent suspicious circumstances. United States v. Coconut Grove Bank, 545 F.2d 502, 508 (5th Cir. 1977).

E. Extent of Liability of Supplier of Funds

1. The liability of the lender, surety, or other person for unpaid withholding taxes under section 3505(b) is limited to 25% of the amount supplied for the payment of wages.

2. The 25% limitation includes any interest accrued on the unpaid taxes. See LGM GL-14, “Section 3505 Liability of Lenders and Sureties” at *5 n.2 (1994) IRS LGM LEXIS 12.

3. The liability of a lender, surety, or other person does not include penalties imposed on the taxpayer.

F. Procedure to Collect Liability under I.R.C. § 3505

1. Government Must File Suit to Collect

a) In order to collect from a third party under section 3505, the United States must bring suit against the third party within ten years of the assessment against the employer. Treas. Reg. § 31.3505-1(d)(1).

b) A lender, surety, or other person may consent to personal liability for the payment of taxes under section 3505, and thereby avoid a lawsuit by the United States, by signing and filing with the Service a Form 4219, *Statement of Liability of Lender, Surety, or Other Person for Withholding Taxes*, along with payment of the taxes acknowledged to be due.

c) There is a split of authority on whether the collection limitation period for commencing a section 3505 suit against a lender, surety, or other person is automatically tolled by the automatic stay in the employer’s bankruptcy case. Compare United States v. Harvis Constr. Co., 857 F.2d 1360, 1363-65 (9th Cir. 1988) (limitations period not tolled); with United States v. Assocs. Commercial Corp., 721 F.2d 1094, 1097 (7th Cir. 1983) (limitations period suspended during taxpayer’s bankruptcy), followed in United States v. Wright, 57 F.3d 561, 564 (7th Cir. 1995).

2. Notice of Assessment Not Required

a) Generally, the Service must give notice of an assessment to persons liable for unpaid taxes pursuant to section 6303 before attempting to collect the unpaid taxes.

b) However, the Service is not required to provide a notice and demand for payment to a third party lender who finances the employer’s payroll before bringing suit against such lender under section 3505 for liability arising from the unpaid taxes. Jersey Shore State Bank v. United States, 479 U.S. 442, 447 (1987).