

Corporate Officers and Directors Beware: Do Not “Borrow” Employee Payroll Taxes to Pay Business Expenses

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The Issue: Whether officers and directors of a corporation can be held personally liable for a corporation’s payroll taxes not properly remitted to the Internal Revenue Service (“IRS”)?

The Answer: Yes, officers and directors of a corporation can be held personally liable (both civilly and criminally) for failing to properly withhold and remit payroll taxes to the IRS.

Summary of the Potential Problem:

During these economically troubled times (i.e., the current “Great Recession of 2008 – 2010”), there exists great economic pressure on businesses of all types and sizes. Cash flow short falls are increasingly common. One of the temptations, and indeed common business practices for businesses, is to reduce and defer the payments to some creditors in a desperate attempt to keep the business operational. Officers, directors, and other employees of a corporation are generally not liable for the legal obligations, including tax obligations, of their corporation. This is known as the “corporate shield” defense for such individual. Nevertheless, there is an exception to this general rule or defense where an employer fails to properly withhold and remit the employee’s share of income taxes and employment taxes (i.e., FICA) (together, “**Payroll Taxes**”) to the IRS and the officer or director, as the case may be, was in a position to prevent this from occurring. The failure to remit such Payroll Taxes to the IRS most often occurs when the corporation decides to use the Payroll Taxes as, in effect, a short-term loan to pay off other creditors before the IRS.

The following provides a brief summary of the potential civil and



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criminal consequences to a “responsible” officer, director, or employee for “willingly” failing to properly withhold and remit Payroll Taxes to the IRS.

I. Trust Fund Recovery Penalty

A. Background. Employers are required by law to withhold from their employees’ paychecks the employee’s share of Payroll Taxes. When this occurs, the employer is deemed to hold the withheld Payroll Taxes “in trust” for the IRS until such Payroll Taxes are remitted to the IRS. Section 6672 of the Internal Revenue Code (“IRC”), also known as the “**Trust Fund Recovery Penalty,**” subjects those persons considered responsible for the collection and payment of Payroll Taxes to personal liability when their employer fails to pay over the Payroll Taxes to the IRS. (Note: the State of California has a similar provision.)¹ Although technically a penalty provision, the Trust Fund Recovery Penalty is used solely as a device to collect the amount of unpaid Payroll Taxes, not as a means of imposing an additional penalty over and above the outstanding corporate tax liability.

The IRS frequently chooses to pursue collection of unpaid “trust fund” taxes

from officers and directors of a business. These individuals are the most likely to meet the two-part culpability test that is required by the Trust Fund Recovery Penalty, including “responsibility” and “willfulness.” Accordingly, liability for the Trust Fund Recovery Penalty can occur only when an individual is determined to be a “responsible person” and his or her actions as it relates to the Payroll Taxes are considered “willful.”

B. Responsible Person. The term “responsible person” is very broadly defined and includes employees, board of directors, shareholders, and others outside the formal corporate organization. The responsible person is, in general, any person who can effectively control the finances of the corporation or determine which bills should or should not be paid and when. The responsible person usually has the ability to sign checks on behalf of the corporation. Factors such as knowledge, delegation of authority, and the relative responsibility of others have little or no bearing on the finding of “responsibility.” As such, the “least” responsible person is no less liable for the unpaid trust fund taxes than the “most” responsible person. Consequently, the IRS can attempt to collect from any deemed responsible person it chooses.

C. Willfulness. The Trust Fund Recovery Penalty is civil rather than criminal. Accordingly, it is not necessary for the IRS to prove that the failure to remit the Payroll Taxes resulted from an individual’s bad purpose or evil motive. Generally, the willfulness requirement is met if a responsible person: (1) knowingly pays other creditors (or allows creditors to be paid) instead of the IRS; or (2) recklessly disregards the obligation to pay the trust fund Payroll Taxes to the IRS. As

discussed above, actual knowledge of the nonpayment of taxes is not absolutely necessary to find one liable for the Trust Fund Recovery Penalty. Willfulness is deemed to exist if the responsible person ought to have known about a grave risk of nonpayment and was in a position to find out.

II. Criminal Penalty: Willfully Failing to Withhold and Remit Payroll Taxes

IRC Section 7202 is the criminal counterpart to the Trust Fund Recovery Penalty. Section 7202, entitled, "Willful failure to collect or pay over tax," provides that "[a]ny person required under this title [26 of IRC] to collect, account for, any pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall . . . be guilty of a felony" (emphasis added).²

In a significant recent case, *United States v. Easterday*, 564 F.3d 1004 (9th Cir. 2009), the defendant, Jack E. Easterday, operated a chain of nursing homes in Northern California through a corporation and subsidiaries. Although the corporation's payroll tax returns filed with the IRS accurately stated its tax liabilities, the defendant, through the corporation, repeatedly failed to pay over to the IRS the full amount of Payroll Taxes due. When the corporation did not pay the outstanding payroll tax liability to the IRS, the IRS filed liens against the corporate accounts and eventually filed criminal charges.

The defendant, Mr. Easterly, did not dispute that he failed to pay the

Payroll Taxes when due. Instead, Mr. Easterly's defense was simply that under long established Ninth Circuit law in *United States v. Poll*, 521 F.2d 329 (9th Cir. 1975), the criminal element of "willfulness" did not exist (and, therefore, could not be proven by the government) because the corporation lacked the financial ability to comply with the corporation's Payroll Tax obligations as a result of the trust fund taxes being used to pay other corporate bills in order to keep the nursing homes operational.

The Ninth Circuit in *Easterly* held, however, that the government is not required to prove the taxpayer defendant had sufficient funds to pay the taxes due in order to establish the "willfulness" element of an offense of willfully failing to pay employee Payroll Taxes in violation of IRC Section 7202. In so holding, the Ninth Circuit overruled its prior decision in *Poll* (and relied upon by the defendant), which held that willfulness requires a showing that, at the time payment was due, the taxpayer had sufficient funds to enable him to meet his obligations or that the lack of sufficient funds on the date was created by, or was the result of, a voluntary and intentional act without justification in view of all the taxpayer's financial circumstances. As a result, the defendant in *Easterly* was convicted of a felony for failing to remit Payroll Taxes to the IRS.

III. Conclusion

There is a great temptation to use corporate Payroll Taxes as a short-term loan to pay other creditors instead of the IRS. Responsible persons of a corporation, including

officers and directors, should be aware, however, that the "corporate shield" does not always protect them against all of the corporation's unpaid Payroll Taxes. Consequently, such individuals can be held personally liable both civilly and, in more egregious cases, criminally, for allowing other creditors and bills to be paid before the IRS with funds withheld (or which should have been withheld) from their employees' wages.

Mr. Swenson's practice encompasses both tax controversy/audit and tax planning. Mr. Swenson has represented corporations, partnerships and individuals in federal, state and local tax disputes including audits, appeals and litigation before and against the IRS, Franchise Tax Board (income taxes), Employment Development Department (payroll taxes), Board of Equalization (sales taxes), and San Diego County Assessor (property taxes). Mr. Swenson also advises on complex business transactions, including structuring and planning corporate mergers and acquisitions, debt and equity restructuring, litigation settlements, and the formation and operation of corporations, limited liability companies, and nonprofit organizations. Mr. Swenson was previously employed as an attorney for the IRS District Counsel Office in San Diego for 6 years prior to going into private practice. Reach him at 619.515.3235 or eds@procopio.com.

¹ See *Cal. Unemp. Ins. Code* § 1735.

² On conviction, the punishment for failure to collect and pay over taxes is a fine of not more than \$10,000 or imprisonment for not more than five years (or both), together with costs of prosecution.