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Employment Taxes and the Trust Fund Recovery Penalty

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In light of the troubled economy, rising unemployment, the sub-prime lending fallout, and recent business failures, we thought that it was an opportune time to remind employers of what could happen if one fails to pay to the IRS employment taxes withheld from employees.

To persuade employers to pay withheld income and employment taxes, Congress enacted legislation that authorizes the Employment Taxes and the Trust Fund Recovery Penalty. The taxes are called trust fund taxes because the employer actually holds the employee's money in trust until the federal tax deposit is made.

The unusual thing about the penalty is that it may apply to you personally if unpaid trust fund taxes cannot be immediately collected from the employer. Regardless of whether the employer is a corporation, a limited liability company, or a limited partnership, you are not covered by the liability protection usually provided by these forms of ownership and therefore, you can be held personally responsible.

The penalty may be assessed against any person who:

- Is responsible for collecting or paying withheld income and employment taxes, and
- Willfully fails to collect or pay the taxes.

A responsible person is a person or group of people who has the duty to perform and the power to direct the collecting, accounting, and paying of trust fund taxes. This person may be:

- An officer or an employee of a corporation,
- A member or employee of a partnership,
- A corporate director or shareholder,
- A member of a board of trustees of a nonprofit organization,
- Another person with authority and control over funds to direct their disbursement, or
- Another corporation.

For willfulness to exist, the responsible person must have been, or should have been, aware of the outstanding taxes, and either intentionally disregarded the law or was plainly indifferent to its requirements (no evil intent or bad motive is required). According to the IRS, using available funds to pay other creditors when the business is unable to pay the employment taxes is an indication of willfulness.

We should also point out that the penalty can be assessed even if the employer out-sources its payroll. The employer is still ultimately responsible for payment of trust fund taxes. In other words, if the third-party fails to make the payments, the IRS may assess the employer's account. And if the employer does not make the payment, the responsible person may be held personally liable.

The amount of the penalty is equal to the unpaid balance of the trust fund tax. In other words, the penalty is equal to 100 percent of the unpaid tax.

Once the IRS asserts the penalty, it can take collection action against your personal assets. For instance, the IRS can file a federal tax lien or take levy or seizure action.

Based upon our observations, the penalty is usually assessed against individual business owners and nonprofit officers where the origin of the problem was traceable to a serious business downturn. Under such circumstances, the responsible person was either unable to manage or more often, unwilling to recognize the decline. In the first case, the person responsible was unable to pay business expenses, including the employment taxes. In the second and more frequent case, he or she believed the business was simply experiencing a temporary cash flow difficulty. Finding it hard to admit failure, the individual, hoping for a turnaround, refused to cut costs and then, as the last resort, decided to use trust fund taxes to fund business deficits.

We almost never see a malicious intent to evade the payment of trust fund obligations. Instead, we have found hardworking, honest people make poor business decisions in the face of unfortunate and difficult circumstances. Their decisions were made with the heart – not the brain.

We hope that you never have to make such difficult choices, but if you do, this article might help you make the right decision and avoid risking your personal assets.

If you have any questions, or if you require any additional information please feel free to contact Vincent Ruocco, LLC CPA at 203.932.2931.

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