Avoid Payroll Tax Filing Penalties

by: Bob Williams, CPA

For those businesses not using a Payroll Service, it is important that payroll taxes are handled properly.

An employer is required to withhold federal income and payroll taxes from its employees' wages and pay these funds over to the IRS within a prescribed time period. Withheld payroll taxes are considered trust funds because the employer holds the employees' money in trust until a federal tax deposit of these amounts is made.

Sec. 6672(a) of the IRS code provides that "any person required to collect, truthfully account for, and pay over any tax imposed" by the Internal Revenue Code who willfully fails to do so, will, "in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax … not collected … and paid over." The term "any person" is important because Sec. 6672(a) allows the IRS to pierce the corporate veil and proceed against any person who is responsible for the corporation's failure to pay over trust fund taxes, thereby making that person personally liable for the employer's unpaid payroll taxes. Therefore, the penalty can be imposed on any responsible person, regardless of the form of business entity. The IRS is the only Federal entity that can cross these lines from business to individual.

Both the "responsible person" and the "willful failure" tests have to be met for the trust fund recovery penalty to apply. Once the penalty is assessed, the person held responsible has the burden of disproving both of these tests.

RESPONSIBLE PERSON TEST

Both the IRS and the courts broadly define a "responsible person." The key element in determining responsible person status is whether a "person has the statutorily imposed duty to make the tax payments".

Several factors indicate responsibility, including whether the person (1) has power to compel or prohibit the allocation of funds; (2) has the authority to sign checks; (3) has the authority to make decisions as to disbursement of funds and payment of creditors; (4) is an officer or director of the corporation; (5) has control over the company's payroll; (6) prepares and signs payroll tax returns; (7) actively participates in day-to-day management; or (8) hires and fires employees. Although this list is not exhaustive, the <u>status</u>, <u>duty</u>, and <u>authority</u> of an employee principally determine whether the person is responsible for remitting withholding taxes.

Company officers often instruct an employee to assume responsibility for paying payroll taxes. If that employee fails to pay payroll taxes, the officer could be held responsible. Delegation of authority does not relieve a person of responsibility to collect and pay taxes to the IRS. Courts have consistently held that the authority that permits control carries with it a non-delegable duty to ensure that withholding taxes are properly collected and paid to the IRS.

WILLFUL FAILURE TEST

A failure to remit trust fund taxes is willful if it is voluntary, conscious, and intentional, as opposed to an accidental act. Courts have held that willfulness is present if a taxpayer knew of the nonpayment or recklessly disregarded whether the payments were being made. This can be established by showing that the responsible person failed to assess and remedy the payroll tax deficiencies immediately upon learning of their existence, directed the corporation to first pay other creditors, or neglected his or her duty to use all current and future unencumbered funds available to the corporation to pay the taxes.

HOW BAD CAN IT GET?

It is important to understand that the IRS is aggressive in assessing the trust fund penalty. Payroll taxes are the government's money, and when the taxes are not paid, the government believes those who are responsible for non-payment are taking its money. The government does not take this lightly and will not relent in its efforts to collect the amounts it is owed. Unpaid trust fund taxes add up quickly, and the trust fund penalty consequently assessed against a responsible person can be huge.
Furthermore, failing to pay trust fund taxes can lead to criminal charges. Under Sec. 7202, a willful failure to collect or remit payroll taxes is a felony punishable by up to a $10,000 fine or five years in prison, or both. However, the IRS reserves criminal charges for extreme cases, usually where the responsible person who owned the business diverted the money for their own personal use, rather than in situations in which an owner or other responsible person was in a business facing hard times and/or used the money to pay other creditors in a misguided attempt to keep the business afloat.

CRIMINAL PROSECUTIONS

A person who is a responsible person under Sec. 6672 can be criminally liable under Sec. 7202. Thus, Sec. 7202 can apply to corporate officers, partnership members, employees, and others responsible for collecting and remitting payroll taxes. As previously noted the IRS generally targets business owners who have used trust funds for their own benefit that they should have used to pay employment taxes.
Courts have held that Sec. 7202 creates three obligations the person must meet. The person must (1) collect, (2) account for, and (3) pay over the trust fund taxes. If the person does not do all three, he or she has violated Sec. 7202. Under Sec. 7202, willful means a voluntary, intentional violation of a known legal duty. The IRS does not have to prove that the person acted under bad faith or with a bad purpose. In addition, the financial circumstances of the person or the company he or she represents are not taken into account in determining whether the failure to pay the tax was willful.

WHAT IS YOUR STATUS?

You can find out the status of your payroll tax filings by any of the following methods:

1. Complete Form 4506-T (Request for Transcript of Tax Return)
2. Go to: http://www.irs.gov/Individuals/Get-Transcript
3. Call 1-800-908-9946

CONCLUSION

Although there are options to help resolve a trust fund liability, such as an offer in compromise, installment agreement, IRS appeals process, or litigation, these options can be drawn out, complex, and expensive. It is better to avoid the trust fund penalty by filing timely payroll tax returns and properly remitting payroll taxes.