

TRUST FUND RECOVERY PENALTY: THE SIXTH CIRCUIT CONCLUDES THAT RESPONSIBLE PARTIES WERE NOT WILLFUL DUE TO REMEDIAL MEASURES THAT FOLLOWED LATE DEPOSITS

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When an employer fails to withhold and pay over FICA and income taxes from employees' wages, individuals associated with the business may be subject to liability for the employer's tax obligations under section 6672(a) of the Internal Revenue Code, which imposes the trust fund recovery penalty. Specifically, "the officers or employees of the employer responsible for effectuating the collection and payment of trust-fund taxes who willfully fail to do so are made personally liable to a 'penalty' equal to the amount of the delinquent taxes." *Slodov v. United States*, 436 U.S. 238, 244-45 (1978). Liability is therefore tied to two distinct requirements: First, the individual must be "responsible," and second, he must act willfully.

On May 15th, the Sixth Circuit held that two senior officers of a delinquent employer were not willful and therefore not liable for the trust fund recovery penalty. *Byrne v. United States*, No. 15-2396, 2017 U.S. App. LEXIS 8510 (May 15, 2017). The case is noteworthy because defense victories on the issue of willfulness are relatively rare.

Byrne involved the employment tax liabilities of Eagle Trim, Inc. a corporation that was formed to take over the auto trim business of Eagle Picher Corporation. Eric Kus and Roger Byrne were part of a group that invested funds in Eagle Trim so that it could acquire the auto trim business. *Byrne*, 2017 U.S. App. LEXIS 8510 at *2-*3. After the transaction closed in late 1998, Kus became the chairman and chief executive officer; Byrne became the president, and Bernard Fuller, another investor, became controller. *Id.* at *3. Financing was provided by GMAC, which granted Eagle Trim a line of credit secured by a lien on its receivables and inventory; the amount of credit available was tied to the amount of collateral securing the loan. *Id.* GMAC used accounting firms to review Eagle Trim's business records under the loan

agreement, but it generally did not share their reports with Eagle Trim. *Id.* at *3-*4. The loan agreement also required Eagle Trim to provide GMAC with annual financial statements that were audited by an independent accounting firm, and Eagle Trim retained Weber, Curtin & Drake (“WCD”) to conduct the annual audit and prepare its tax returns. *Id.* at *4.

While Kus and Byrne were responsible for Eagle Trim’s tax returns, Fuller, as controller, was the individual directly responsible for keeping Eagle Trim current on its tax obligations. *Id.* at *4-*5. The accounting firm provided Fuller with the relevant forms and furnished guidance on the deposit of trust-fund taxes. Fuller, however, failed to make timely deposits, which triggered a significant penalty in early 1999. As a result, Kus and Byrne gave Fuller a task list of items to be completed on a timely basis. *Id.* at *5.

In early 2000, GMAC’s auditor expressed dissatisfaction with the documentation that Eagle Trim had provided to it as part of its review under the loan agreement, and suggested to GMAC that Eagle Trim should implement a variety of changes, which included the use of procedures that would ensure that all tax payments were made in a timely fashion. *Id.* GMAC forwarded this letter to Eagle Trim, where Kus, the CEO, reviewed it. Two weeks later, Fuller, the controller, wrote to GMAC’s auditor, acknowledging that he had missed two deposits when Eagle Trim switched banks; he also wrote that Eagle Trim was current on all tax deposits. *Id.* at *5-*6. Both Kus and Byrne were copied on Fuller’s letter.

Meanwhile, WCD, Eagle Trim’s auditor, sent a management letter to Kus, Byrne and Fuller, indicating that some deficiencies in Eagle Trim’s accounting procedures were identified in the course of its audit of the 1999 financial statements. The letter recommended that Eagle Trim hire an assistant controller with an accounting degree, but it also indicated that the accounting firm had not identified any “material weaknesses” in the company’s internal control structures. *Id.* Subsequently, Eagle Trim hired an assistant controller to work with Fuller in April 2000 and a chief financial officer to supervise him in July 2000. *Id.* at *6-*7.

In October 2000, the IRS assessed Eagle Trim with a penalty of over \$98,000 for unpaid trust-fund taxes for the first quarter of 2000. A partner from the company’s accounting firm met with Fuller to discuss the notice; Fuller told him that two deposits had been late because Eagle Trim switched banks. *Id.* at *7. Fuller also advised the representative of WCD that he had discussed the penalty with the IRS several times and that Eagle Trim was current on its tax obligations. In response, WCD sent a letter to the IRS requesting that the penalty be abated; then on November 10, 2000, Fuller sent a letter to Kus, Byrne, and the company’s CFO describing the penalty, his conversation with WCD, and the request for abatement. *Id.* at *7-*8.

On December 11, 2000, WCD issued a clean audit opinion on Eagle Trim’s financial statements; the audit report indicated that Eagle Trim was current on its employment taxes. *Id.* at *8. In January, the firm sent Eagle Trim its management letter; this letter recounted the issue with timely payment of trust fund taxes and the prior IRS penalty. It also indicated that WCD had been informed by “management” that deposits in the second quarter had also been late. *Id.* While indicating that additional measures should be taken to assure that trust fund taxes were deposited on time, the management letter indicated that no material weaknesses were observed in Eagle Trim’s control system. *Id.* at *8-*9.

That same month, however, GMAC’s auditor reached a radically different conclusion, as it determined that Eagle Trim’s financial statements “were fraudulently overstated” because Fuller had been falsifying its receivables. *Id.* at *9. GMAC and Eagle Trim entered into a series of agreements to resolve the situation on January 31, 2001. Under these agreements, GMAC hired BBK, Ltd., a crisis management firm, and GMAC and BBK were authorized to review and approve all funding for Eagle Trim; they also

controlled its accounts. *Id.* At this time, both Kus and Byrne were unaware that Eagle Trim was delinquent on its trust fund taxes for the second, third, and fourth quarters of 2000. In February 2001, Kus and Byrne were advised by BBK that Eagle Trim was behind on its trust fund taxes for those periods; Fuller and Byrne requested permission to pay the taxes, but that request was denied. *Id.* at *9-*10. Eagle Trim then fired Fuller. *Id.* at *10.

In March 2001, WCD, Eagle Trim's accounting firm, withdrew its prior audit opinion as a result of Fuller's fraudulent activities. *Id.* The following month, Eagle Trim filed a petition for relief under Chapter 11 of the Bankruptcy Code; the company liquidated, yielding some payments to the IRS on account of its second quarter 2000 employment tax obligations. *Id.* at *10-*11.

With the taxes unpaid, the IRS assessed Byrne and Kus with the trust fund recovery penalty, and litigation ensued. Byrne and Kus lost in the trial court and appealed. The Sixth Circuit rejected their argument that they were not "responsible" within the meaning of section 6672, but remanded the case for further proceedings on the question whether they acted willfully. On remand, following a bench trial, the district court ruled against them again, setting the state for the Sixth Circuit's opinion on willfulness.

After summarizing the record, the court commenced its analysis by addressing the standard of review, which the parties disputed. While the government argued that willfulness was an issue of fact, the Sixth Circuit concluded that plenary review was appropriate. *Id.* at *13.

The court then focused on the required elements of proof, noting first that Byrne and Kus had the burden to establish that their failure to pay trust fund taxes was not willful by a preponderance of the evidence. *Id.* at *15-*16. The Sixth Circuit explained that willful behavior could be shown if a responsible party "had actual knowledge that the trust-fund taxes were not paid and the ability to pay the taxes"; or if the risk that the taxes were not paid was "recklessly disregarded." *Id.* at *16.

Noting that it had never determined what constituted "reckless disregard," the Sixth Circuit reviewed case law from other circuits. In that context, the court noted that the Second Circuit had defined reckless disregard in such a fashion that a responsible person would not be held liable if he "believed that the taxes were in fact being paid, so long as that belief was, in the circumstances, a reasonable one." *Id.* at *18 (quoting *Winter v. United States*, 196 F.3d 339, 345 (2d Cir. 1999)). The court elected to apply this standard because it struck an appropriate balance between the government's power to recover taxes due and "limiting liability for that recovery to those who are personally at fault." *Id.* at *19.

The Sixth Circuit then applied this standard to the record before it. At the outset, the court indicated that the district court had correctly concluded that Byrne and Kus were not liable under the actual knowledge standard. *Id.* at *20. While acknowledging that the case was "a close call," however, the Court of Appeals concluded that the two were not reckless as they did not act unreasonably. *Id.* at *21.

Initially, the Court of Appeals indicated that the record demonstrated that Byrne and Kus were on notice that there was a substantial risk that Eagle Trim's taxes were not being paid. The court cautioned that knowledge of management concerns alone was not enough, but the fact that Byrne and Kus were continuing to receive notifications about late deposits was sufficient to put them on notice that there was a significant risk that the taxes were not being paid. *Id.* at *23-*24. The court also agreed with the district court that Byrne and Kus were in a position to investigate whether Eagle Trim was current on its trust fund taxes given their positions at the company, their education, and their experience in business and accounting matters. *Id.* at *24-*25.

The Court of Appeals determined, however, that Byrne and Kus had acted reasonably. While the district court had ruled that the two could not rely upon WCD's audit determination that the trust fund taxes were paid because they did not review the steps that the auditors had taken to verify that fact, the Sixth Circuit held that their failure to verify the audit determination independently was not enough to impose liability for a variety of reasons.

First, the court viewed the fact that Eagle Trim hired an assistant controller in April 2000 and a CFO in July 2000 favorably, although it cautioned that merely hiring support staff would not insulate responsible persons from liability. *Id.* at *27-*28. Second, the Court of Appeals indicated that the hiring of an accounting firm that was given authority to audit Eagle Trim's financial statements "further demonstrates that they took reasonable steps to comply with all of Eagle Trim's legal tax obligations, including the timely payment of trust-fund taxes." *Id.* at *28. While it acknowledged that the company was responsible for its financial statements, the Court of Appeals nonetheless stressed that there was no evidence "that would cause us to question the reasonableness of Byrne and Kus's continued reliance on WCD's competency." *Id.* The court specifically rejected the district court's conclusion that Byrne and Kus could not rely upon a statement made by a WCD partner in a letter to the IRS indicating the company was current in its deposits because the letter did not indicate that the accounting firm had investigated that fact. *Id.* at *29. In the Sixth Circuit's view, the fact that Fuller had previously failed to make timely deposits did not make it inappropriate for Byrne and Kus to rely on the statement made by a member of the company's accounting firm because they had no reason to question its competence. *Id.*

Third, the Court of Appeals put significant weight on the accounting firm's opinion that its financial statements fairly presented its financial condition and accurately disclosed any pending tax assessments. *Id.* at *29-*30. In view of the fact that WCD did not detect Fuller's fraud until after its audit report was finalized, as well as the fact that it took several months for the crisis management firm to determine that taxes were still due, the Court of Appeals concluded that Byrne and Kus acted reasonably: "Short of Byrne and Kus's personally contacting the IRS to verify the status of Eagle Trim's trust-fund tax liability or their firing Fuller upon the first or second notice of an irresponsible action by Fuller, we are hard-pressed to articulate what additional measures they could have taken." *Id.* at *31. Given the various corrective measures that Byrne and Kus had taken in response to the late deposits by adding staff, and their reliance on the accounting firm's audit opinion, the Sixth Circuit held that they had a reasonable basis for their belief that the taxes were being paid. *Id.* at *33. In the court's view they were negligent, but not reckless.

Opinions in this area tend to be fact-sensitive, but there are several aspects of the Sixth Circuit's opinion in *Byrne* that could have an impact on future cases:

- *First*, by treating willfulness as a mixed question of law and fact, subject to plenary review, the court dramatically improved the odds on appeal for anyone who has been assessed with the trust fund recovery penalty in the Sixth Circuit. Practitioners should also invoke the case in other circuits where the standard of review is either unclear or in a state of flux. The plenary standard is frankly the correct one to apply, as the ultimate issue in these cases is not what the responsible party did, but whether it was enough to satisfy their legal duties.
- *Second*, the Sixth Circuit's holding that a reasonable belief that the taxes are being paid can support a determination that a responsible party is not reckless is a taxpayer-friendly standard; the Sixth Circuit's approach implicitly recognizes that business operations are complex and that reasonable corporate officers frequently must rely upon others in a variety of contexts. The fact that the court stressed the remedial measures taken by the employer provides a meaningful basis to differentiate this case from others involving unremediated failures which suggest that compliance with tax obligations was aspirational rather than actual.
- *Third*, in light of the court's view of the accounting firm's role, practitioners should focus more on the role of the employer's accountants in defending future cases, particularly when the employer's financial statements are audited.



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