Designation of tax payments can save you a lot of grief

Every year many hundreds of thousands of businesses close because of financial downturns. Many of the owners of these businesses were clued in enough to "limit" their personal liability by choosing a corporate or limited liability company structure.

However, what they were not clued in about was that the payroll tax (or sales tax) liabilities would follow them post the death of their business. An awful specter that can rise from the grave of a dead company (or a dying company) is the IRS' responsible person assessment, or the so-called *Trust Fund Recovery Penalty (TFRP)*.

Many times the shareholders of the company will be caught holding the tax bag for uncollected, unpaid federal withholding and FICA taxes. These are the taxes that are withheld from the employees' paychecks and paid over to the IRS through the federal tax deposit system. The employer is trusted to collect and pay over these taxes; to hold the money in trust for the government; thus, the terminology – Trust Fund.

Normally, the shareholders of a corporation or the members of a Limited Liability Company are not liable for the debts of their companies. Those individuals are protected by the so-called corporate veil, or corporate shield.

Usually, under only very limited circumstances can the corporate veil *be pierced*, and liability for corporate debts "transferred" to the shareholders. Generally, for the corporate shield to be ignored, the shareholder must have engaged in certain conduct, like comingling assets, ignoring corporate formalities and some element of injustice or fraud that would be perpetrated if the corporate structure was respected. This state law remedy is usually difficult to obtain. After all that is what incorporation is all about – to limit the liability of the owners.

However, the IRS – thanks to Congress, has a very powerful and easy to use veil piercing implement. Under Internal Revenue Code § 6672(a), any person that was ***required*** to collect, account for and pay over taxes withheld from the employees of that

company, and ***willfully*** failed to do so, will be liable for 100% of the taxes not paid over.

Most people targeted by the IRS for a TFRP can readily accept that they were "responsible" for collecting and paying over employees' taxes. Such responsible persons are corporate officers, managers, and members of the board of directors.

However, many people get hung up on the willful element. Most will say that they intended no wrong. That they tried all means, to no avail, to get the taxes paid. They did not <u>intend</u> not to pay them.

Unfortunately, neither good intentions nor bad are relevant under the law. Willful under § 6672 simply means that the shareholder was aware that the taxes were due, and either did not pay them, or paid another creditor in favor of the IRS. For example, the corporate President (a responsible person) knew that the corporation was behind in paying payroll taxes to the IRS, and instead of paying the taxes decided to pay the rent with the only available funds. That's all the IRS needs to pierce the corporate veil and assert the TFRP against the President.

Thus, if you run a company, and are not paying the employees withheld taxes to the IRS, most likely you will eventually be personally targeted for a trust fund penalty.

Also, as a side note, although it is uncommon compared to the tens of thousands of individuals that the IRS does assert a trust fund penalty against, failing to pay over withheld taxes is also a felony. Generally, the IRS only prosecutes a very small number of "failure to pay" trust fund cases a year, but it does happen. Internal Revenue Code § 7202 is almost identical in its language to § 6672, except the <u>criminal</u> penalty is a $10,000 fine and not more than 5 years imprisonment.

The best and simplest solution to this situation is, of course, to pay all the taxes. But, when there simply is not enough money to pay all the tax, then, and this is extremely important – pay the trust fund tax first.

I have seen scores of cases where taxpayers damaged themselves by not designating their tax payments. NO voluntary tax payment, in any amount, should be tendered to the IRS without a designation. That means that you write on the check what particular tax is being paid. The IRS will honor the designations of voluntary payments. The IRS will apply undesignated voluntary payments to the government's best interest. Usually that means the money will go to the oldest tax period first. In the case of a business, the money is applied to non-trust fund tax first, then trust fund, then penalties, then interest. If there is any money left after that, then the second oldest tax period will be paid, in the same order.

Taxpayers need to be aware that a significant amount of "business" taxes due the IRS are not trust fund taxes. Because trust fund taxes are the only type that a shareholder needs to personally worry about – any payment that is less than full payment – should be designated to "trust fund taxes only." Non-trust fund taxes, such as unemployment taxes, the non-trust fund portion of FICA taxes, and tax penalties should be paid last.

Thus, if a "responsible person" finds that his or her company is failing, and unpaid trust fund taxes have accumulated – every available dollar should be paid against those trust fund taxes before the company is gone. Leave the non-trust fund taxes, penalties and interest to die with the company and you will live a much happier life.

About the Author:

William Winspear is an experienced tax lawyer based in Buffalo, NY that deals with IRS and New York State tax controversies including IRS audit strategies and defenses, offer in compromise, tax liens, tax levies, tax bankruptcies, tax appeals and more.

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