Business Owners and Managers May Have Personal Liability for Unpaid Payroll Taxes and Not Know It

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A recent 9th Circuit Court of Appeals decision *emphasizes again* the potential exposure "responsible persons" have to personal liability for payroll taxes under the Trust Fund Recovery Penalty (TFRP) provisions of Section 6672 of the Internal Revenue Code (IRC § 6672). **You may be a responsible person and not know it.** Moreover, the failure of other personnel in a company to pay over to the IRS withheld employment taxes, even if you are unaware of such failure, can result in personal liability for you.

Employers are required to withhold from an employee's wages income taxes (Federal and State) and the employee's share of FICA (Federal Insurance Contributions Act) taxes. The Internal Revenue Code makes the employer a fiduciary of the United States with respect to these payroll taxes. When an employee's income taxes and share of FICA taxes are withheld from the employee's wages by the employer, the employee is treated as having paid those amounts to the IRS, whether the employer actually pays over such amounts to the IRS. This protects employees if the employer never pays over such amounts. (The employee's withheld income taxes and withheld share of FICA taxes are referred to herein as "payroll taxes.")

Employers experiencing cash flow problems sometimes fail to pay the payroll taxes, choosing instead to use the cash attributable to those taxes to fund operations. **This always is a bad idea**. If an employer's business ultimately fails and cannot pay the IRS the payroll taxes, the IRS, under the authority of IRC § 6672, will seek to collect the withheld taxes from any "responsible person" of the employer (*e.g.*, an officer, director, shareholder [or another owner,] or bookkeeper with signature authority over a bank account.) This personal liability for "responsible persons" can be substantial. Moreover, in some cases, the IRS and the Department of Justice may seek criminal prosecution. *See* Department of Justice, Tax Division, Employment Tax Enforcement.

For the TFRP to be imposed against an individual, three conditions must be met.

1. The individual qualifies as a "responsible person;"
2. The individual fails to collect or account and pay over the payroll taxes; and
3. The individual acts willfully in doing so.

It is much easier to meet these conditions than one might think.

In *In re Richard York v. United States of America*, No. 20-56047 (9th Cir. 2023), Richard York appealed a decision of the U.S. District Court for the Central District of California denying his motion for summary judgment that he was not a “responsible person” for unpaid payroll taxes for purposes of the TFRP. (The appellate argument can be viewed at 20-56047 Richard York v. USA.) The 9th Circuit denied his motion for summary judgment. To prevail on the motion for summary judgment, the 9th Circuit held that York would have to show that, viewing the summary judgment record in the light most favorable to the IRS, a rational trier of fact could not reasonably find in the IRS’s favor. The 9th Circuit held that York failed to make such a showing.

Facts

The case arose in the context of a Chapter 13 bankruptcy filing by York and involves several procedural issues that are not relevant to the tax issues addressed in this Alert.

The tax-related facts in the case were:

- York was an employee of both Convergence Ethanol, Inc. (Convergence), an oil-and-gas technology company, and its subsidiary California MEMS USA, Inc. (CA MEMS, and, collectively with Convergence, the Company).
- York “was hired primarily to effect compliance with SEC filing requirements” for Convergence and its subsidiaries, and in order to allow him to sign the necessary certifications, he was given the title of Chief Financial Officer (CFO) of Convergence.
- Convergence’s President and Chief Executive Officer specifically told York that York would “not be involved in the day-to-day financial operations” or the accounting of Convergence and its subsidiaries, which instead would be handled by an “experienced CPA.”
- The experienced CPA, who had check-signing authority, was responsible for ensuring that the Company paid its payroll taxes.
- York had check-signing authority for the Company and kept the Company’s checks in this office locked in a cabinet, to which only he had a key.
- Even though York had check-signing authority and maintained the Company’s checks, it “was not York’s function to, nor did he, originate any payments.”
- Instead, the CPA was in charge of keeping track of bills and making sure they were paid.
- In 2004, shortly after York began his employment, he learned that CA MEMS owed unpaid payroll taxes.
- York worked out the unpaid taxes with the IRS.
- York asked the CPA not to make payroll payments unless the corresponding payroll tax deposits could also be made.
- Convergence encountered substantial financial trouble, and by December 21, 2007, it and its three main subsidiaries had ceased operations and were all in Chapter 7 bankruptcy proceedings.
- York resigned from Convergence and CA MEMS, effective December 31, 2007.
- The IRS subsequently contended that CA MEMS had failed to pay the payroll taxes due for three quarters of 2007 and two quarters of 2008.
- In 2010, the IRS assessed a penalty against York personally for the unpaid taxes, pursuant to IRC § 6672(a).
- York was not aware that payroll taxes were not being paid when due in 2007.

Analysis

Again, for an individual to be liable for the TFRP, three conditions must be met, according to the 9th Circuit.

1. The individual qualifies as a “responsible person;”
2. The individual fails to collect or account and pay over the tax; and
3. The individual acts willfully in doing so.

***Responsible Person*.** The court identified the following standards for determining whether an individual is a responsible person:

- Did the individual have the effective power to pay taxes, such that the person could have made a decision that the taxes be paid?
- Did the scope and nature of an individual’s power to determine how the corporation conducts its financial affairs give that individual authority to pay or to order the payment of delinquent taxes?
- Did the individual have the authority required to exercise significant control over the corporation’s financial affairs, regardless of whether he or she exercised such control in fact? If this standard is met, it is irrelevant that an individual’s day-to-day function in a given enterprise is unconnected to financial decision-making or tax matters.

It was not York’s responsibility to ensure that the payroll taxes were paid. In fact, he specifically was told that he was not to be involved in the day-to-day operations of the Company. Nevertheless, the 9th Circuit concluded that he could be found to be a responsible person under the standards identified by the court.

The TFRP can be imposed on any responsible person. It is not a defense to show that someone else was more responsible. Thus, York could not avoid the TFRP by showing that the CPA or President and CEO were more responsible.

***Willfulness*.** There was no dispute that the payroll taxes had not been paid, so the court turned to the issue of willfulness. The court said it has defined “willfulness” for purposes of the TFRP as a voluntary, conscious, and intentional act to prefer other creditors over the United States. An intent to defraud the Government or other bad motive need not be proven. In fact, mere conduct motivated by reasonable cause, such as meeting the payroll, may be willful.

For nonpayment to be willful, there must be either knowledge of nonpayment or reckless disregard of whether the payments were being made. A reckless disregard of whether the payments were being made can be established even if the responsible person has no knowledge that the payroll taxes were not being paid.

It is important to remember that the court was deciding whether to grant York’s motion for summary judgment that he was not liable for the TFRP. By declining to grant York’s summary judgment, the court was not making a finding that York was liable for the TFRP. Rather, the court was holding that there were enough facts that he could be found liable if the case went to trial.

A fact that seemed important to the court was York’s knowledge that the Company had previously failed to pay over to the IRS payroll taxes in 2014. He worked with the IRS to resolve that matter and knew that the Company always had financial difficulties, the implication being that he was on notice that the Company might not be paying the payroll taxes. York contended that when he became aware in August 2007 that payroll taxes were not being paid, the President and CEO was controlling all payment decisions. With respect to this contention, the court stated that once York acquired actual knowledge that the payroll taxes were not being paid, he willfully failed to take steps to pay them or to see that they were paid.

What Should York Have Done To Protect Himself?

The court offered no advice as to what York could have done to protect himself, other than pay the payroll taxes. He did have control over the Company's checks, and he had check-signing authority. Notwithstanding the instructions of the President and CEO, York could have written checks to pay the payroll taxes. To do so, however, he would have needed the cooperation of the CPA to get the information necessary to pay the payroll taxes, and she may not have cooperated. If the CPA would not have cooperated, what could York have done then?

As unreasonable as it may seem, a responsible person, such as York, may have no option but to quit once he or she learns that payroll taxes are not being paid and cannot ensure payment. In some cases, even quitting may be too late to avoid the TFRP.

A Lesson Not to Forget

Every (i) officer, director, and controlling shareholder of a corporation, (ii) officer, managing member, and controlling member of a limited liability, and (iii) officer and general partner of a partnership should understand the exposure to personal liability presented by the TFRP provisions. Regardless of your assigned responsibilities or job description, the position you hold in a business by itself may make you a responsible person. Moreover, you cannot assume the payroll taxes are being paid. As the 9th Circuit noted, you cannot "prefer ignorance." Willfulness is not just an affirmative act. It can be a reckless disregard of whether the payroll taxes are being paid. More alarming is that recklessness can be found if you know that payroll taxes *should* be paid even if you have no knowledge that they are not being paid by the person assigned to pay them. Your exposure is increased if you know that payroll taxes were not paid in the past.

You must be vigilant when it comes to the payment of payroll taxes.

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