By Howard Levy, Esq.

IRS Trust Fund Investigations:

The Best Defense Is a Good Offense

In today's difficult economic environment, expect more businesses to resort to using payroll tax money to stay afloat and a corresponding increase in IRS enforcement measures. With bank lending tight, employee tax withholding is a ready—but dangerous—source of immediate operating capital.

But the IRS does not like being made an unwilling partner to a loan. The IRS trusted the owners and operators of the business to protect the employee payroll tax withholdings and timely pay them to the government. This violation of trust is the basis for the trust fund recovery penalty.

The trust fund recovery penalty allows the IRS to collect the unpaid withholding taxes from the assets of the owners and operators of the business. It penalizes those who had control over the decision to divert the payroll money from the IRS to other creditors of the business.

The trust fund recovery penalty is equal to the income taxes, social security taxes, and Medicare taxes withheld from employee paychecks. The trust fund recovery penalty is authorized by Sec. 6672 of the Internal Revenue Code (IRC).

There is also a non-trust fund component to employee payroll withholdings. Non-trust fund taxes equal the employer's required matching to the employees' social security and medicare fund. These contributions are made from the employer's own pocket rather than deducted from employee paychecks. There is no personal liability for non-trust fund withholdings; they can only be collected from the business.

THE IRS TRUST FUND INVESTIGATION

The IRS tends to use a large net to sweep in as many people as possible in trust fund investigations. This large net often catches the innocent who may appear to be responsible on the surface. The investigation is conducted by an IRS revenue officer.

The IRS determines responsibility for the trust fund recovery penalty primarily by (1) reviewing bank signature cards and signatures on cancelled checks and (2) conducting interviews with those believed to have responsibility for the unpaid taxes.

These methods can be fraught with error and often fail to reveal the defenses. Trust fund penalty cases require the representative to do background homework, fill in the blanks, and show the IRS what is real.

Bank Signature Cards and Cancelled Checks

As part of the investigation, the IRS will seek bank statements, bank signature cards, and cancelled checks from the business. In most cases, the IRS revenue officer obtains the banking information by issuing a summons for it directly to the bank.

The purpose of obtaining the bank information is to determine who had the authority to direct the tax withholdings to creditors other than the IRS. In the mind of the IRS, signature authority on checking accounts is control over financial decision-making, whether exercised or not. If the IRS finds a signature on a check or a name authorized on a bank card, it will put that person under potential investigation.

However, bank information can be misleading. The real question is not who had mere signature authority, but who had true effective power and control over the decisionmaking. The checks are not always the end of the story.

Here is an example: A project manager on a construction site who cut checks to vendors on site could be implicated by the numerous checks bearing his signature. But the reality is that the project manager had signature authority for the convenience of the employer at the job site only. He had no say in determining who was paid and when—in other words, no real power. The checks the IRS receives from the bank do not point out these very important and legitimate defenses.

Bank signature cards can also cause minority owners with no involvement in the business to come under IRS scrutiny. For example, take the minority owner in a trucking company who took on minority ownership after getting to know the company from his job selling trucks to the company. He never worked for the trucking company; he had no office there and rarely visited. He signed a few checks for the company—those to pay his employer for the trucks he sold. In cases like this, background work needs to be done to develop facts to explain away the checks. The IRS will not do homework for the taxpayer.

Also wrongfully caught in the IRS crosshairs from bank checks are office managers, secretaries, and payroll administrators. In these situations, it must be established the signatures resulted from paying bills as directed by a superior. Facts must be presented showing the employee did not have the power to determine which creditors would or would not be paid.

Writing checks is often a delegated task that lacks any true authority or power over a company's financials. The person delegating the task may be responsible, but the IRS must be made aware that the person to whom it was delegated had no authority.

Interviews with Those Suspected of Being Responsible

The IRS will want to question the individuals it suspects of being responsible, starting with those who have signatures on bank checks and owners, investors, and officers of the business.

The questions to be asked are standardized. The revenue officer conducting the interview will use IRS Form 4180 (Report of Interview with Individual Relative to Trust Fund Recovery Penalty or Personal Liability for Excise Taxes). This form is available ahead of time to be reviewed with your client. There is no excuse for not being prepared for the interview.

Here are the questions the revenue officer will focus on:

- Did you determine the financial policy for the business?
- Did you direct or authorize payment of bills?
- Did you open or close bank accounts for the business?
- Did you guarantee or co-sign loans?
- Did you sign or countersign checks?
- Did you authorize or sign payroll checks?
- Did you authorize or make federal tax deposits?
- Did you prepare, review, sign, or transmit payroll tax returns?

Each of these questions on the Form 4180 requires a "yes" or "no" answer. The more "yes" responses, the more the pendulum swings toward responsibility for the trust fund penalty. The potential for liability becomes even greater when "yes" answers are coupled with ownership or holding a corporate office.

Beware. This "yes or no" form of response is extremely dangerous to the target of a trust fund investigation. This is where innocent taxpayers get themselves in trouble. This short response format is inconsistent with the practitioner's need to make the IRS aware of exculpatory facts. It is not always as simple as yes or no.

Form 4180 can also cause false positive answers to be given. For example, the question "Did you sign or countersign checks?" could cause someone signing three checks over a two-year period as a convenience to give a correct but misleading answer of "yes."

Consider the question, "Did you authorize or sign payroll checks?" It is really a two-part question: (1) Did you authorize payroll checks? and (2) Did you sign payroll checks? There is a big difference between authorizing and signing. Authorizing the checks could show responsibility and control; signing checks can be okay if at the direction of others. But the format permits only one yes or no answer.

A vice president who signed payroll checks only when the treasurer was on vacation might answer "yes" to "Did you authorize or sign payroll checks?" But what if the bills were reviewed in advance by the treasurer and merely handed to the vice president for a ministerial signature? There was no authority, and the checks were signed only sparingly as a convenience. The question does not lend itself to the taxpayer's defense.

The Form 4180 interview also requests the interviewee to turn in others—colleagues, investors, family members—who may have been involved in the business. The question asked is: "Who else performed this duty?"

"Performing the duty" is not always the same as the control and authority over financial matters. Other individuals can be wrongly implicated if the interviewee lacks a proper understanding of the question.

A "yes" to colleagues, investors, and family members when there should be a "no" creates a difficult game of "he said/she said." If your client is the one wrongfully (but honestly) implicated by another, this creates confusion as to the facts, often requiring your client's denial and explanation and cooperation from the third party to better explain his or her answers.

Do not expect the IRS to conduct a complete investigation that will absolve your client.

The revenue officer will likely stick pretty close to the Form 4180. Your job is to go past that.

DEFENDING AGAINST IRS' METHODS

The following sections are some strategies for defending against the IRS trust fund investigation process.

Conduct an Interview with Your Client Ahead of Time

No taxpayer with representation should go into a trust fund investigation without knowing what will be asked ahead of time. Get the Form 4180 and review all the IRS questions with your client. To see an online version of Form 4180, go to www.howardlevyirslawyer.com/blog.

How many checks did the office manager sign and under what circumstances? Was there a process where a third party approved the checks first? Did a vice president have the title in name only without real authority? Did a minority owner have any real influence over company financial decisions?

Your interview process should be focused on drawing out facts that prove a lack of control and authority over the company's financial affairs. Third parties with exculpatory knowledge should also be interviewed to supplement your client's statements.

Complete the Form 4180 and Return it to the Revenue Officer without an Interview

Although IRS guidelines require the revenue officer to conduct an in-person interview, many revenue officers will waive the interview and accept the Form 4180 by mail. This means that you and your client complete the Form 4180 in advance and return it to the revenue officer.

Ask the revenue officer if it is okay to complete the form in advance and provide a date when the revenue officer will receive it. In only the rarest cases is it beneficial to have your client submit to an open interview rather than a controlled recital of the facts.

Completing the Form 4180 ahead of time is an important part of the defense. You control the answers.

Provide Written Statements of Explanation

As the Form 4180 interview process can leave important facts out, it is essential to provide the IRS with supplemental written statements. This clarifies the issues the form does not take into account.

The statement should be from your client and others in the business. Third-party statements provide additional credibility to your client and another point of view.

The statements should be direct and to the point and no more than two typewritten pages, if possible. They should focus on the distinguishing facts, such as the process of how an officer manager had to submit invoices to a chief financial officer (CFO) for review before payment. In that situation, a supporting statement from the CFO should also be obtained.

Obtain the Bank Checks in Advance and Review Them

As the bank checks are a primary source in directing the IRS to those with liability, it is important to know how many checks your client signed and to whom they were paid.

If the checks were only signed during one quarter but the business had a payroll tax problem for six quarters, there may be limits to your client's liability to just that one quarter. Knowing when the checks were signed can be important.

Knowing how many checks your client wrote can also be beneficial. Authority to write a few checks a month for deliveries to the office is not the same as control over company financials. The checks can prove the vendors paid were consistent with the nature of C.O.D. payments.

Remember that most trust fund cases are won or lost based on whether your client had the authority to exercise significant control over the company's financial affairs, regardless of whether the control is in fact exercised. Developing the facts is the key to a good defense.

ADDITIONAL ISSUES TO CONSIDER

Other important items to keep an eye on in trust fund recovery penalty cases include:

- Using IRS appeals to resolve trust fund disputes,
- Understanding when assessment of the penalty is barred,
- Knowing when to use collectibility as an alternative method of resolution, and
- Eliminating confusion over single-member LLCs.

Using IRS Appeals for Case Resolution

If the IRS is unwilling to concede the trust fund penalty, the revenue officer will issue a letter of notification to your client that he or she is considered to be personally responsible for the payroll tax delinquency. The notification is IRS Letter 1153 and Form 2751 (Proposed Assessment of Trust Fund Recovery Penalty).

If there is a disagreement over responsibility, the IRS Letter 1153 allows for sixty days for the filing of an appeal. If no appeal is filed in the sixty days, the IRS will place the liability on its books and proceed with collection remedies against the responsible party, including the filing of federal tax liens against his or her house.

A protest letter should be drafted and sent to the revenue officer detailing the reasons why the trust fund penalty should not be assessed. All the background homework now comes in handy—the bank checks and written statements should be resubmitted as proof of why the revenue officer's conclusions are incorrect.

The revenue officer can rescind the Letter 1153 after receipt of the appeal, but it is more likely the case will be forwarded to an IRS appeals officer for review. If the case cannot be resolved in appeals, the next step would be litigation in U.S. District Court. The appeals officer will review the case based on the perceived "hazards of litigation" in the event the case were to go to court. The appeals settlement should be based on the strengths of each party's potential court case, a deliberation a revenue officer rarely takes into consideration.

Statute of Limitations on Assessment

Pursuant to IRC 6501(b)(2), employment tax returns filed for any period ending within a calendar year are considered filed on April 15 of the succeeding year. For example, employment tax returns for all four quarters of 2007 are considered filed on April 15, 2008. The IRS has three years (beginning April 15, 2008 and ending on April 15, 2011) to complete its trust fund investigation for the 2007 returns.

As the trust fund recovery penalty is only investigated by an IRS revenue officer, if all is quiet, then the liability of the individuals can lapse by expiration of the statute of limitations on assessment.

An ongoing business that can demon-strate a substantial ability to repay the tax may defer a trust fund assessment if waivers of the statute of limitations on assessment are provided.

Collectibility of the Trust Fund Recovery Penalty

Many IRS revenue officers will request a 433-A financial statement from the individuals being investigated for the trust fund recovery penalty while the investigation is still pending and before liability has been finalized. There is no obligation to disclose financials pre-assessment during a trust fund investigation. This should be respectfully pointed out to the revenue officer.

In some situations it could be an advantage to disclose a personal financial statement during the investigation. Internal Revenue Manual 5.7.5 (Collectibility Determination) permits the IRS to withhold assertion of the trust fund recovery penalty if the collection potential from the individual is minimal.

It is important to review Internal Revenue Manual 5.7.5 for the specific situations when collectibility can be a factor in defeating a trust fund assessment. For example, repeat offenders can expect assessment regardless of collectibility.

Bear in mind the IRS has been weak in collecting the trust fund recovery penalty after assessment. The IRS taxpayer advocate reports that an average of eighty-six percent of trust fund recovery penalty assessments end up being uncollectible.

Single-Member LLCs

The owner of a single member limited liability company who is taxed as a disregarded entity and files a Schedule C (Profit or Loss from Business) will be held responsible for both trust and non-trust fund payroll taxes. For any payroll tax liability resulting from wages paid before January 1, 2009, the owner of the LLC (rather than the LLC itself) is considered the taxpayer for payroll tax purposes. This has caught many LLC owners off guard.

The IRS collection of all unpaid employment taxes from the owner of a single member LLC was recently litigated and upheld by the U.S. Tax Court in *Medical Practice Solutions, LLC v. Commissioner*, 132 T.C. 7 (2009). There is no trust fund recovery penalty process for a single-member LLC.

For wages paid after January 1, 2009, Treasury Regulation 301.7701-2(c)(iv) makes the disregarded LLC the taxpayer, not the owner. For post-January 2009 employment taxes, the owner of the single-member LLC will no longer be immediately responsible for all taxes (trust and non-trust), but should expect the trust fund recovery investigation.

SUMMARY

The failure to remit payroll taxes is a cardinal sin in the eyes of the IRS. It results in the IRS investigating those who were responsible for violating the trust of managing employee withholdings. The trust fund recovery penalty brings owners and operators into a financial hole that is very hard to dig out of.

The key to a successful defense is proving there was no ability to exercise independent judgment or control. This is best accomplished by reviewing bank checks in advance, controlling the IRS interview process, and submitting written statements of explanation. This requires work the IRS will not do for you. The best defense to a trust fund investigation is a good offense. EA

About the Author:

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