Our Money or Your Job

CFOs and other "responsible persons" may need to choose between their money and their jobs as the IRS steps up collections of unpaid withholding taxes.

By Stephen G. Huggard and Timothy Roskelley

John Lubetzky had come to a fork in the road, but he may not have recognized where each path could take him. As CFO of MediaForum, Inc., Lubetzky had received clear instructions from his bosses, the president of MediaForum and the president of MediaForum's British parent corporation, not to pay over to the Internal Revenue Service the Social Security, Medicare and federal income taxes the company had withheld from its employees. The money was needed elsewhere, not an uncommon situation. Of course, everyone knows the certainty of death and taxes, but equally certain is the fact that creditors must be paid to keep a business running. [1]

Lubetzky knew the taxes were due, but had he paid the taxes, he may have lost his job and, in his mind, been guilty of "stealing" from the corporation. He faced a very difficult dilemma, indeed, and one with which we can all sympathize.

Well, not all of us. The IRS decided to collect its taxes, with interest and penalties, from Lubetzky personally, a course of action which might surprise many a CFO.

Arguing that he was a "responsible person" under the tax code, the IRS sought to hold him responsible. Interestingly, although the unrefuted evidence at trial indicated that Lubetzky had just been following orders, the IRS did not pursue his superiors in their individual capacities, choosing instead to train their firepower upon him. Lubetzky fought back, but a jury of his peers sided with the IRS, and the court of appeals affirmed the judgment: he was civilly liable under I.R.C. § 6672 for failing to pay over the Social Security, Medicare and federal income taxes withheld from the employees of MediaForum, Inc. Although he acted on the orders of his superiors, the courts concluded that CFOs and other similar "responsible persons" must choose between losing their livelihood or risking substantial tax liability. Since the code creates joint and several liability, and the IRS chose to pursue Lubetzky rather than his superiors, the court required him to pay MediaForum's entire tax liability of more than $90,000 plus interest.

Employers must withhold from their employees' paychecks certain taxes such as income taxes, Federal Insurance Contributions Act (FICA) taxes, and Railroad Retirement Act (RRA) taxes. These are known as "trust fund taxes" because they are a tax on the employee that the employer must collect and hold in trust for the US. Employers must pay over the trust fund taxes on a quarterly basis.

Sometimes the employer fails in this obligation. Typically, this happens when the company faces a cash shortage and pays its other liabilities before the IRS. Those responsible for paying the tax may hope that by the

time the IRS comes knocking, either the company's fortunes will have reversed or that the company will be in bankruptcy, leaving the IRS to battle the other creditors.

Such tactics present great risk. The statute enables the IRS to collect the "total amount of the tax evaded, or not collected, or not accounted for and paid over" from any person deemed responsible for collecting and paying the tax. This is known as the 100% penalty, and provides the government with two powerful tools. First, it strips away the protections of the corporate veil and makes responsible parties personally liable. In the typical situation where the company is short on cash or bankrupt, this tool significantly increases the chances that the government will collect the money owed. Second, the statute creates joint and several liability. In many situations, several people will be potentially responsible under the statute. Rather than pursue all of them for their equitable share of the liability, the code provides the IRS with a more efficient solution: target one person, even the least responsible one, and hold them responsible for the entire penalty. Though the 100% penalty is harsh, § 6672 does not leave the targeted person entirely without recourse – once the government collects its judgment, that person may, at his or her own expense, sue other responsible parties for contribution.

While the code makes the liability of a responsible person clear, the actual determination of whether a particular person is "responsible" is murkier. Under § 6672(a), the 100% penalty applies to "any person required to collect, truthfully account for, and pay over any [trust fund tax] who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof." This creates a two-prong liability test. First, the government must prove that the person is required to collect and pay the tax—the "responsible person" test. Second, the government must demonstrate that the responsible person willfully failed to collect and pay the tax–the "willfulness" test.

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The statute itself does not explicitly define who is a responsible person, nor does it provide any guidance on how to derive the definition. In the absence of statutory guidance, the courts have developed a few general rules. First, a person is liable if they are required to do any one of three tasks: collect, account for or pay over the tax. Second, more than one person can be liable. Third, courts read the statute broadly to protect the government's interest in collecting its money. Finally, the plaintiff challenging the IRS assessment bears the burden of proof.

Within these boundaries, the IRS and the courts have sought to fill in the remaining gaps with their own definitions, resulting in what one court called a "laundry list of criteria that is well developed but moored only to some vague concept of power and control." The IRS guidance reflects this focus on power and control, stating that "responsibility is a matter of status, duty and authority. Those performing ministerial acts without exercising independent judgment will not be deemed responsible." The IRS also counsels that non-owner employees, acting "solely under the dominion and control of others, and who are not in a position to make independent decisions on behalf of the business entity," will not be held responsible. These definitions, however, create their own issues. Most glaringly, they fail to distinguish between formal decision-making power, what the corporate rules theoretically permit specific employees to do, and with decision-making power, what that person can actually decide in practice. Thus, the IRS definitions shed little light on the common situation where a person with nominal decision-making power either fails to exercise the power or is constrained by higher ranking authorities in the corporation.

The courts have attempted to fill this void by focusing on the taxpayer's level of influence and control over the company's finances. Courts do not require that the taxpayer have exclusive control over financial decisions. This allows a finding of more than one responsible person. Rather, the cases focus on whether the taxpayer exhibited significant control—whether the person had the actual, effective power to pay the taxes. To determine this important question of power, the courts generally rely on a facts and circumstances test that includes several factors:

- Status as an officer, director or shareholder;
- Ownership stake in the business;
- Corporate bylaws;
- Management of day-to-day business operations;
- Authority to hire and fire employees;
- Authority to decide which creditors to pay and in what order;
- Control of bank accounts;
- Authority to sign checks;
- Ability to borrow money; and
- Preparation or signing of employment tax returns.

None of these factors are dispositive. Nor are they equal. They can be divided into three general categories. The taxpayer's position in the corporation is the first and least important category. This includes corporate title and ownership. Without more criteria, mere titular authority and ownership are insufficient to create liability.

The second category contains the criteria that identify the taxpayer's involvement in the daily affairs of the corporation. These criteria require more than incidental involvement. For example, management of day-to-day operations includes hiring and firing employees, ordering supplies, conducting business correspondence, setting wages, negotiating contracts, disbursing checks and depositing receipts.

The third category covers those criteria that identify the taxpayer's involvement in the company's financial affairs. These criteria form the heart of the significant control test because they identify the people who could have paid the taxes, but chose not to do so. Within these criteria, the most crucial is whether the taxpayer possessed and exercised decision-making authority. This requires the fact-finder to look beyond superficial control and focus on who actually makes the decisions. While check-signing authority is a significant factor in determining whether the taxpayer can actually pay the taxes, this authority alone is not always enough to conclude that an individual is a responsible person. Check-signing authority is relevant only to the extent it demonstrates actual financial control.

While the IRS must prove that the responsible person acted willfully, it need not show that he acted with "bad intent." The government must only show that the taxpayer made a voluntary, conscious and intentional decision to prefer other creditors over the government. Under this standard, any payment to any other creditor, including employee wages, with knowledge that trust fund taxes are due and owing to the government, may result in liability.

John Lubetzky will not be the last person to come to his particular fork in the road. Many people will face the choices he faced. To some extent, such dilemmas are difficult to avoid for responsible persons who are not the ultimate decision-makers in a company. What is important is to fully understand the ramifications of the decision. Armed with the knowledge of the potential consequences of his decision, a CFO can follow the instructions of Yogi Berra – "when you get to the fork in the road, take it."

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[1] The facts are taken from the opinion of Lubetzky v. United States, 393 F.3d 76 (1st Cir. 2004).

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