TAXES - The Tax Magazine, The 100 Percent Penalty: Avoidance and Mitigation, (Jan. 1, 1989)

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After discussing how a small to medium-sized employer may become liable for the 100 percent penalty for failing to remit withholding payments and the likely ramifications of this liability on an employer's business, the author suggests approaches the practitioner can take to deal with the problem before it arises and a course of action to mitigate ultimate liability when a trust fund delinquency occurs.

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Individual federal income tax rates surged in the early 1940's in order to finance America's war effort. The federal income tax affected a wider segment of the population and assumed an increasingly prominent role as a revenue raiser amid growing concern that many wage earners would be unable and/or unwilling to satisfy their annual tax liabilities with a year-end, lump-sum payment. These considerations led Congress in 1943 to enact the first wage withholding legislation. Under this newly implemented "pay as you go" legislation, employers were initially required to withhold and periodically remit to the Government an amount equal to 20 percent of each employee's wages.[1]

Employers are currently required to withhold from their employees' wages,[2] and periodically remit, income[3] and employee FICA[4] taxes. Employer FICA[5] and FUTA[6] tax liabilities based on the amount of wages paid are imposed directly on the employer. Quarterly and annual returns and reports must be filed with the IRS and/or sent to employees.[7]

Payroll taxes[8] represent a substantial claim against gross receipts in many labor-intensive businesses. Unsophisticated and unsuspecting owners of financially troubled small to mediumsized businesses view these payroll funds as a convenient and "inexpensive"[9] source of working capital when cash flow diminishes. With the best of intentions, these business owners use unremitted payroll taxes to satisfy operating expenses arising in the ordinary course of business, while planning to replace the "borrowed"[10] funds as soon as additional cash becomes available.

Unfortunately, many employers who engage in this form of "creative financing" fail to anticipate the severity of the penalties imposed. The individual decision makers of noncompliant corporate employers incorrectly believe that the corporate entity will shield them from personal liability for unpaid payroll taxes. Their false sense of security is bolstered by the fact that the IRS often takes many months, and sometimes years, to respond to payroll tax delinquencies.

The IRS recognizes noncompliance in the payroll tax area as a top priority and has mobilized its forces on all fronts to combat this problem aggressively.[11] The most potent weapon in the IRS's arsenal is Section 6672, which imposes personal liability for the full amount of the tax upon "any person[12] required to collect,[13] truthfully account for and[14] pay over any [payroll tax]…who willfully fails [to do so]…."

Practitioners who represent small to mediumsized businesses will confront payroll tax delinquency issues with increasing frequency. In order to effectively represent a client with a payroll tax delinquency problem, today's tax practitioner must have a thorough understanding of the issues and a firm grasp of the myriad solutions.

Overview

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Payroll tax problems generally arise when cash flow diminishes. Assume, for example, that a firm of professional engineers employs 25 professional and 30 nonprofessional employees. Respectively, the firm's average professional and nonprofessional salaries are $45,000 and $20,000.[15] As set out in Table 1, the firm's total biweekly payroll tax expense, not including FUTA tax, is $17,025. Regulation §31.6302(c)-1(a)(1)(i)(b) provides that if the employer's tax liability at the end of any eighth monthly deposit period exceeds $3,000, at least 95 percent of the liability must be deposited within three banking days.

Table 1

Computation of Payroll Tax Liability of Hypothetical Engineering Firm

Category	Total Annual Payroll*	Total Bi-weekly Payroll*	Withheld Income Tax**	Withheld Employee FICA**	Employer FICA**
Professional	$1,125,000	$43,270	$5,475	$3,250	$3,250
Staff	600,000	23,077	1,584	1,733	1,733
Total	$1,725,000	$66,347	$7,059	$4,983	$4,983

Total Biweekly Payroll Expense:	
Withheld Income Tax**	$7,059
Withheld Employee FICA**	4,983
Employer FICA**	4,983
Total	$17,025

* Does not include FUTA or employer FICA.

** Derived from 1988 tax tables. Assumes married filing joint status, four dependents. See CCH STANDARD FEDERAL TAX REPORTER, 1988 Index Volume, ¶ 113.

Table 2

Computation of Trust Fund Deficit

Tax Liability:	First Qtr.	Second Qtr.	Total
Income Tax	$45,884	$45,884	$91,768
Employee FICA	32,390	32,390	64,780
Employer FICA	32,390	32,390	64,780
Total	$110,664	$110,664	$221,328
Penalties and Interest:	First Qtr.	Second Qtr.	Total
Failure to Deposit	$11,066	$11,066	$22,133
Failure to File	24,899	14,940	39,839
Failure to Pay	3,320	1,660	4,980
Interest at 10%	6,156	2,953	9,109
Total	$45,441	$30,619	$76,061
Application of Payment:			
Employer FICA	$64,780		
Penalty	66,952		

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Interest	9,109
Trust Fund Taxes	80,487
Total Applied	$221,328
Remaining Trust Fund Deficit:	
Income Tax	$91,768
Employee FICA	64,780
Total Trust Before Fund Application of Payment	$156,548
Applied to Trust Fund	(80,487)
Trust Fund Deficit	$76,061

This hypothetical firm experiences temporary collection problems with several of its larger clients and discovers that its available cash is insufficient to meet operating expenses arising in the ordinary course of business. Faced with some difficult choices, the president of the corporation, over the vehement objections of several prominent firm members, decides to temporarily suspend tax deposit payments. The deposit delinquency persists through the due dates of two quarterly payroll tax returns, so the president, in an effort to avoid detection by the IRS, does not file payroll tax returns for two quarters. During the third quarter the firm remits current deposits timely and manages to accumulate enough cash to cover the delinquent liabilities that accrued during the two previous quarters. The delinquent returns are filed with the return for the third quarter and the delinquent taxes are remitted without instructions. As illustrated in Table 2, the firm still owes $76,061 of trust fund tax, on which interest and penalty continue to accrue at the corporate level and for which various officers, directors and employees of the firm face potential personal liability.[16]

The IRS begins to send notices demanding payment of the delinquent taxes.[17] The firm, believing the notices are erroneous,[18] does not respond. Ultimately, perhaps as much as a year or more later, the IRS levies against the firm's operating bank account and files a Notice of Federal Tax Lien in the county record office. By now, the delinquent tax is nearly $90,000.

Most conventional lenders hesitate to lend funds to borrowers with significant tax problems, particularly where liens and levies are involved, and the firm discovers that it is unable to secure a loan sufficient to discharge its tax obligations.

Recognizing the inevitability of their plight, various members of the firm depart and the firm is dissolved. After satisfaction of all secured creditors and administrative expenses of the bankruptcy one year later, nothing is left to pay the tax delinquency, which by now is nearly $100,000.

The IRS now proposes the assessment of the 100 percent penalty against all former officers and directors of the firm. Former friends and business associates are suddenly embroiled in an internecine conflict, with each accusing the other of responsibility for the delinquent payroll taxes.

Ultimately, the IRS succeeds in collecting the entire liability from one or two former firm members. Much to their chargin, they learn that they have no legal right to recover from any of their former business associates, nor are they entitled to deduct the amount paid to the IRS.

Planning

Status Considerations. Several status questions should be addressed and resolved upon the commencement of any business in order to avoid future payroll tax problems. A most significant issue is whether persons performing services for the business will be classified as employees or as independent contractors for federal income tax purposes.[19] Remuneration paid to an independent contractor is not subject to withholding. Since the enactment of uncodified Section 530 of the Revenue Act of 1978, the IRS has not been raising this issue on audit as frequently as in the past. Nevertheless, an employer's latitude in this area is not as wide as many believe.

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Perhaps the hypothetical engineering firm discussed above should have been organized as a partnership instead of a corporation. A partner's distributive share of income attributable to the rendition of personal services is subject to self-employment tax,[20] but is not subject to withholding, FICA or FUTA.

Another overlooked issue concerns the form in which remuneration is paid. Some employment benefits are excluded from gross income and some remuneration is not subject to withholding and/or FICA tax. As explained earlier, the applicability of withholding or FICA tax provisions hinges on whether the compensation is classified as a wage payment for purposes of that particular provision. To the extent that benefits can be paid in a nontaxable form, future payroll tax problems are avoided.[21]

The issue of responsibility[22] is rarely addressed until an IRS revenue officer begins conducting an investigation. All potentially "responsible persons"[23] should be apprised of their potential liability at the time the business commences. Responsibility and a procedure for ensuring that payroll taxes are timely collected, accounted for and paid over should be documented, implemented and faithfully observed.

The Cost of Noncompliance. The Code requires employers to "collect, account for and pay over" employee FICA and income taxes.[24] Additionally, an employer is required to deposit withheld taxes periodically. The frequency with which withheld taxes must be deposited depends on the amount withheld.[25] For failure to deposit withheld taxes on a timely basis, the Code imposes a penalty equal to 10 percent of the deposit delinquency.[26]

Form 941, Employer's Quarterly Federal Tax Return, must be filed within 30 days after the last day of each calendar quarter.[27] For each month or part thereof for which a return is delinquent, the Code imposes a penalty equal to 5 percent of the amount due on the return. The maximum penalty for delinquent filing is 25 percent.[28]

Quarterly payroll tax liabilities reflected on a return and not previously paid or deposited must be remitted with the return on which reported, on or before the due date of the return. For each month, or part thereof, for which payment is delinquent, the Code imposes a penalty equal to 0.5 percent of the amount due but unpaid, up to a maximum of 25 percent.[29]

Finally, the Code imposes interest on the tax delinquency and the failure to file penalty at a rate equal to the federal short term rate plus 3 percentage points.[30] Interest runs from the due date of the return to the date of payment.[31] Interest is not imposed on the failure-to-deposit penalty or the failure-to-pay penalty until 10 days after notice and demand.[32]

To illustrate the high cost of noncompliance, assume a corporation in the 15 percent tax bracket incurs a payroll tax liability of $10,000, but fails to deposit the tax, to file its return or to pay the tax for six months. Additionally, assume the interest rate on delinquent taxes for the period of the delinquency is 10 percent. At the end of the six-month period, the corporation would owe approximately $14,163 in tax, penalty and interest, as illustrated in Table 3. Since penalties are not deductible for federal income tax purposes, only the additional amount attributable to interest, $613, would be deductible. The total addition to tax, net of income tax effect, would be $4,071. After-tax costs of funds on an annual basis would be 80.42 percent. It is difficult to imagine a more expensive source of funds; however, even with no available cash, this cost can be reduced substantially.

Filing the payroll tax return on or before its due date will reduce the after tax cost to 34.5 percent.[33] Additionally, making partial deposits on a timely basis will save 18 cents for each dollar remitted.[34] In the event partial deposits are made, care should be exercised to ensure that the payment is applied first to trust fund taxes, in order to reduce potential personal liability.[35]

Table 3

Computation of Tax, Penalty and Interest After Six-Month Delinquency

	Applicable

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		Code Section
Delinquent Payroll Tax	$10,000	
Failure to Deposit Penalty	1,0006656(a)	
Delinquent Filing Penalty	2,2506651(a)(1)	
Delinquent Payment Penalty	3006651(a)(2)	
Interest* *	613	
Total	$14,163	

* A 10 percent assumed rate.

Table 4

Comparison of After-Tax Costs for Timely Filed Payroll Tax Return and Partial Deposits

Timely Filed Return:

		Applicable Code Section
Delinquent Payroll Tax	$10,000	
Failure to Deposit Penalty	1,000	6656(a)
Delinquent Payment Penalty	300	6651(a)(2)
Interest* *	500	
Total	$11,800	
Cost of Funds	$1,800	
(15 percent of $500)	(75)	
After-Tax Costs	$1,725	
Partial Deposit:		
Failure to Deposit Penalty	10.00%	
Delinquent Payment Penalty	3.00%	
Interest	4.25%	
Penalty and Interest Saved Expressed as a Percentage of Partial Deposit	17.25%	

* A 10 percent assumed rate.

This example illustrates the need to address payroll tax problems even before a deposit delinquency occurs. Lenders respect the business acumen of management which recognizes and addresses a cash flow problem before severe financial damage is sustained, and financial statements will inspire greater confidence if they do not contain payroll tax delinquencies. Even though a lender may require a personal guarantee from various individuals, it is important to remember that trust fund tax liabilities are not dischargeable in bankruptcy.[36] Finally, if a willing lender cannot be located, perhaps the time is ripe to reassess the true value of the business and the degree of risk acceptable to the individual participants.

Designation of Payment. As discussed above, if an employer is unable to completely satisfy payroll tax liabilities with available or borrowed funds, it should nevertheless remit partial payments. The after-tax costs of remitting partial deposits, compared to timely filing returns, are set out in Table 4. In order to receive maximum protection against personal liability for potentially responsible persons, the employer, when remitting payment, should instruct the IRS to apply the payment to trust fund taxes first. Issues which arise

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with respect to the ability of an employer to designate application of payments include the identity of the person attempting to designate and the "voluntariness" of the payment.

The IRS takes the position that only a taxpayer, and not a third party, has the authority to designate payments.[37] A client who is a potentially responsible person may be well advised to time a contemplated resignation so as to avoid this limitation.[38]

Only "voluntary"[39] payments may be designated. The issue of what constitutes a "voluntary" payment has been litigated on numerous occasions.[40] The IRS has taken the position that a payment made after the delinquent filing of a tax return[41] or after a tax lien arises[42] is not voluntary; however, these positions have not received wide support.[43] The weight of authority supports the proposition that a payment is not "voluntary" if it is made after the taxpayer files a petition in bankruptcy[44] or after the IRS employs enforced collection action.[45]

An employer wishing to designate payments is well advised to do so as early as possible. Trust funds taxes for each period and for each component[46] of trust fund tax should be paid by separate check. Each check should bear a memorandum disclosing the employer's TIN and instructing the IRS to apply the payment only to trust fund taxes for the period to which the payment relates. The payment should be remitted with a cover letter which clearly states the authority of the person remitting payment on behalf of the employer, confirms the amount of trust fund tax and reinforces and references the instructions set forth on the checks. Datestamped copies of the letter and checks should be obtained from the IRS.[47]

In the event the employer fails to make a timely and proper designation, the policy of the IRS is to apply the payment to nontrust-fund liability first, including penalty and interest.[48]

Affirmative and Restrictive Covenants. All participants in the business, whether active or passive,[49] should consider an agreement which affords them certain protections and assurances in the event of a payroll tax delinquency. This agreement should address status considerations, contribution, indemnification, salaries, dividends, loan repayments and payment priorities.

With respect to status, the parties should identify those persons who will be passive participants. The employer and the active participants should agree to indemnify passive participants against any trust fund liability which they may incur in connection with the operation of the business of the employer. Indemnification should be contingent on adherence to the terms of the agreement.[50]

Active participants can decide, in advance, to create a contractual right of contribution among themselves in the event all or any of them incur any trust fund liability in connection with the operation of the business of the employer. As in the case of passive participants, the active participant's right to contribution should be contingent on adherence to the terms of the agreement.

Drafting a contribution/indemnification agreement is much easier in theory than in practice, and care must be exercised to avoid conflicts of interest. In the absence of such an agreement, a responsible person's right to contribution from other responsible persons is nonexistent.[51]

The parties to this agreement should also agree in advance that in the event of a cash deficit[52] for any given accounting period, employer's counsel is to be consulted immediately in an effort to determine payment priority.[53] Of course, the safest course is to require that trust fund taxes always be paid first, despite the fact that some creditors, by virtue of their secured status, will be entitled to payment priority. Salaries, dividends, loan repayments and other amounts payable to any party to the agreement should be subordinate to the payment of trust fund taxes under the terms of the agreement. The agreement should provide that any party who attempts to circumvent the terms of the agreement forfeits his or her right to indemnification or contribution.

Enhanced Prospects of Deductibility. As previously stated, the payment of a 100 percent penalty assessment is not deductible for federal income tax purposes.[54] Nevertheless, in certain situations, a

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responsible person may be able to structure his payment in a manner which enhances his prospects of deducting, albeit indirectly, the amount of the liability.

For example, assume that the only potentially responsible person of a corporate employer is the sole shareholder of an inactive, insolvent, cash-basis S corporation[55] and that prior to the assessment of the penalty, the shareholder contributes the amount of the potential liability to the S corporation. If the corporation is able to designate payment to trust fund taxes,[56] not only will the shareholder eliminate his potential liability, he will also be entitled to deduct the amount of the payment.[57]

If the shareholder/responsible person is not the sole shareholder, the deduction attributable to the payment will be allocated among the other shareholders in accordance with their percentage interest in the corporate stock.[58] In order to avoid this result, the corporation and all shareholders could enter into a redemption agreement pursuant to which the corporation agrees to apply the proceeds of the contributing shareholders' monetary contribution to outstanding trust fund taxes in exchange for all of the stock of the noncontributing shareholders.[59] Of course, this course of action is fraught with numerous legal and economic consequences, some of which are completely unrelated to the tax considerations.

If the corporate employer is a C corporation, the possibility of a timely S election[60] should be explored. If an S election is not a viable alternative,[61] the shareholder could lend the amount of the trust fund liability to the corporation and claim a bad debt deduction.[62] If the payment is structured as a capital contribution as opposed to a loan, the shareholder could claim a capital loss; however, if the shareholder receives Section 1244 stock, his loss may be ordinary.[63]

Procedure and Strategy for Contesting 100 Percent Penalty Liability

Trust fund cases generally originate in the IRS Collection Division. Initially, a revenue officer identifies and interviews prospective responsible persons in order to evaluate their responsibility for the 100 percent penalty.[64] After completion of the interview, the revenue officer notifies[65] those persons against whom he proposes to assess the penalty.

After receipt of the notice of proposed assessment, a prospective responsible person has 30 days within which to file a protest with the IRS Appeals Division. If the noticee fails to file a protest within 30 days, the tax is assessed. If a protest is filed, the noticee is entitled to a conference with an officer of the Appeals Division, who reviews the evidence adduced by the IRS and the noticee and makes an independent determination of culpability.[66]

The IRS has three years to assess a 100 percent penalty.[67] After assessment, the IRS has six years to collect the assessment administratively.[68] In order to contest the assessment in court, a responsible person must pay the full amount of the tax[69] and file a claim for refund within two years of the date of payment. Upon disallowance of the claim for refund, the taxpayer must institute suit in the District Court or the Court of Claims not earlier than six months from the date of filing the claim and not later than two years after the date on which the claim is disallowed.

The IRS's unwritten policy is to propose assessment of the 100 percent penalty against as many potentially responsible persons as is possible. As a result, many "innocent" persons face the dilemma of incurring substantial legal expenses and enduring the financial uncertainties associated with contesting an assessment, proposed or actual, or contributing to the satisfaction of a liability for which they are not objectively responsible.

By involving as many people as possible, the IRS increases the probability that all of the potentially responsible persons will agree to contribute their pro-rata share of the total liability in order to avoid the possibility that the total amount will be assessed against one of them individually. Nevertheless, as suggested below, it may be possible for taxpayers to use the IRS's policy to their advantage.

With proper planning and cooperation, all prospective responsible persons can mitigate their individual risk and enhance the prospects of complete avoidance of liability. One possible approach is for the prospective

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responsible persons to identify, prior to assessment, the least culpable party against whom assessment is proposed.

Once identified, this least culpable party (hereinafter, the taxpayer) consents to the assessment of the penalty and pays the full amount of the tax to the revenue officer. After the expiration of the statute of limitations on assessment, the taxpayer files a claim for refund and, after disallowance of the claim, litigates the case.

Obviously, no one, particularly a party with minimal exposure, is likely to volunteer to pay a substantial trust fund liability in order to protect other, more culpable persons; therefore, the more culpable persons will, under this suggested approach, lend the amount of the penalty and costs of litigation to the taxpayer. Repayment of the loan would be contingent on the taxpayer's prevailing in litigation. Care must be exercised not to run afoul of the anti-assignment statute.[70]

Conclusion

The 100 percent penalty is a formidable weapon which the IRS will use with increasing frequency. In order to effectively represent a client who pays wages, a practitioner must recognize the problem before it arises and recommend a course of action designed to mitigate ultimate liability when a trust fund delinquency occurs.

Footnotes

* The author wishes to express his gratitude for the support provided by his secretary, Mary Kurylo, in the typing of this article.

1 Allman, 392 T. M., "Withholding, Social Security and Unemployment Taxes on Compensation," A-1 and A-54.

2 The definitions of "wages" are set forth in Sections 3121(a), (employee/employer FICA), 3306(b), (FUTA) and 3401(a), (income tax withholding).

3 IRC Secs. 3401 to 3406.

4 IRC Secs. 3101 to 3126.

5 See note 3, supra.

6 IRC Secs. 3301 to 3311.

7 Form 941, Employer's Quarterly Federal Tax Return, is filed with the IRS quarterly and is used to report the amount of withheld employee FICA and income taxes and employer FICA taxes. See Reg. § 31.6011(a)-1(a). Form 940, Employer's Annual Federal Unemployment Tax Return, is filed with the IRS annually and is used to report the employer's unemployment tax liability. See Reg. § 31.6011(a)-3(a). Form W-2, Wage and Tax Statement, is furnished to each employee annually. See Reg. § 31.6051-1(a)(1)(i).

8 The term "payroll taxes," as used in this article, includes employer and employee FICA, FUTA and income tax.

9 Actually, the cost of these funds is extremely high. See "Cost of Noncompliance," at 65-66, infra.

10 The term "borrowed" implies the existence of a consensual lender/borrower relationship between the IRS and the employer. In fact, willful failure to collect and pay over tax is a crime and may result in the employer's prosecution. See Saltzman, *I. R. S. Practice and Procedure* (1988 Cum. Supp.), 17-30, note 9.

11 See id., 17-30, note 11.1.

12 Section 6671(b) defines the term "person" to include "an officer or employee of a corporation, or a member or employee of a partnership who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." These persons are commonly referred to as "responsible persons."

13 Use of the term "collect" delimits the scope of the liability to employee FICA taxes and income taxes. These taxes are referred to as trust fund taxes because of the trust imposed by Section 7501.

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Employer's FICA, FUTA, penalties and interest are classified as nontrust fund or direct taxes for which no personal liability is imposed.

14 Prior to the Supreme Court's decision in *In Re: Slodov,*78-1 USTC ¶ 9447, 436 U. S. 238 (1978), some practitioners hypothesized that liability would not attach unless the person against whom the IRS proposed to assess the tax was required to perform all three duties. *Slodov* addressed the liability of a successor in interest who was not a responsible person at the time the duty to collect arose, but who subsequently became a responsible person when the duty to pay over arose. The Court held that a successor in interest was a responsible person despite the fact that the statute is phrased in the conjunctive; nevertheless, no liability attached in *Slodov,* since no funds were available at the time the successor assumed control and Section 7501 does not impose a trust on after acquired funds. See 436 U. S. at 259-60.

15 See Table 1.

16 IRC Secs. 6601 and 6651(a)(2).

17 The IRS is required to send the initial notice of assessment and demand for payment within 60 days after the date of assessment. IRC Sec. 6303. After this initial letter, which is generated by the appropriate Internal Revenue Service Center, the Service Center sends three additional notices over the next three months. See Saltzman, *IRS Practice and Procedure,* (1988 Cum. Supp.) ¶ 14.03.

18 Many clients are astonished by the amount demanded in the initial notice. Usually they assume that the IRS has not given them credit for the full amount remitted.

19 Distinguishing between an employee and an independent contractor is a critical and difficult process. A thorough discussion of the issues is beyond the scope of this article. See Section 530, Revenue Act of 1978, 1978-3 (Vol. 1) CB xi, 119; Sec. 269(c) TEFRA, 1982-2 CB 462, 536; Rev. Proc. 85-18, 1985-1 CB 518; Marmoll, 391 T. M., "Employee Defined."

20 Section 1402(a) provides, in relevant part, that net earnings from self-employment include "an individual's … distributive share … of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member…." Of course, many other tax and nontax factors must be addressed before selecting the form of entity in which the business will be conducted.

21 For a thorough discussion of the various forms of remuneration exempt from FICA, FUTA and withholding, see Allman, 392 T. M., "Withholding, Social Security and Unemployment Taxes on Compensation."

22 See note 12, supra. A person held liable for a trust fund tax is labelled a responsible person. For the IRS to prevail in a trust fund controversy, it must establish the existence of the deficiency and that the person against whom it seeks to assess the 100 percent penalty is a responsible person and acted will fully.

23 The IRS proposes assessment against as many potentially responsible persons as possible. “Thus, while officers of the corporation are routinely asserted to be responsible persons for purposes of the 100 percent penalty, persons who are neither corporation officers nor employees may be responsible for collecting and paying over trust fund taxes. These may be directors, a prospective purchaser, a surety, a creditor, a trustee or other fiduciary, or an attorney…. The most frequently applied standard in making the determination is whether the person in question had "the final word as to what bills should or should not be paid, and when." Saltzman, *IRS Practice and Procedure,* (1988 Cum. Supp.) ¶ 17.08[1].

24 IRC Secs. 3402(a) and 3403 (income tax); Sec. 3102(a) (employee FICA); Reg. §31.6011(a) (reporting requirement); Reg. § 31.6302 (deposit requirements).

25 Social Security and income taxes must be deposited with an authorized financial institution or federal reserve bank. In determining deposit frequency, each calendar month is divided into eight deposit periods ending on the 3rd, 7th, 11th, 15th, 19th, 22nd, 25th and the last day of the month.

Generally, if the liability for any eighth monthly deposit period is $3,000 or more, the employer must deposit at least 95 percent of the liability within three banking days. If at the end of any month, the

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liability is $500 or more, but less than $3,000, the employer must deposit the liability within 15 days after the end of the month.

If at the end of any month, the liability is less than $500, it may be carried over to the next month.

If the liability at the end of any quarterly reporting period is less than $500, it may be paid with the return. See Allman, 392 T. M., "Withholding, Social Security and Unemployment Taxes on Compensation," A-86.

26 IRC Sec. 6656(a). The penalty is increased to 25 percent if the deposit reported on a quarterly return exceeds the actual deposit. IRC Sec. 6656(b).

27 Reg. § 31.6071(a)-1(a)(1). See note 7, supra.

28 IRC Sec. 6651(a)(1). The amount of the penalty for delinquent filing is reduced by the amount of the penalty for delinquent payment, infra, note 29. Accordingly, the delinquent filing penalty is 4.5 percent per month, to a maximum of 22.5 percent.

29 IRC Secs. 6651(a)(2) and (a)(3). After the IRS demands payment, the penalty is increased to 1 percent per month. IRC Sec. 6651(d).

30 IRC Secs. 6601 and 6621(a)(2).

31 IRC Sec. 6601(a).

32 IRC Sec. 6601(e)(2).

33 See Table 4.

34 Id.

35 See discussion of Designation of Payments, pages 9 through 11.

36 *U. S. v. Sotelo,*78-1 USTC ¶ 9446, 436 U. S. 268 (1978); 11 U.S.C.A. Secs. 507(a)(7)(C) and 523(a)(1).

37 *Hewitt v. U. S.,*67-2 USTC ¶ 9486, 337 F. 2d 921 (CA-5). Hewitt, the former president of a corporation with a payroll tax delinquency, attempted to instruct the IRS to apply the proceeds from the forced sale of corporate assets to trust fund taxes after he had resigned. The court, affirming the IRS's refusal to honor the instruction, held that "a third party [has] no right to direct the application of [payments made by the corporation]." See 377 F. 2d at 925.

38 For example, if, prior to a contemplated resignation, a corporate officer remits payment to the IRS on behalf of the corporation, with instructions to apply the payment to trust fund delinquencies, the instruction should bind the IRS, assuming the payment is voluntary, as discussed below.

39 Rev. Rul. 79-284, 1979-2 CB 83, permits taxpayers to designate the application of voluntary payments to withheld employment taxes. In the event the taxpayer fails to make a written designation, the IRS will apply the payment to the tax, penalty and interest, in that order, of the oldest period first. Any excess will be applied, in the same order, to the next succeeding period. The term "voluntary" is not defined in the revenue ruling.

40 See Falk and Dougherty, "Designating Payments to Avoid or Mitigate the Section 6672 Penalty," 66 TAXES —*The Tax Magazine* 529 (1988).

41 *In re: Hannan Trucking, Inc. v. U. S.,*81-2 USTC ¶ 9793, 17 Br. 475 (Ba. Ct.) and *Hirsch v. U. S.,*75-1 USTC ¶ 9348, 396 F. Supp. 170 (S. D. Ohio).

42 The general tax lien arises automatically upon the occurrence of three events: (1) assessment of the tax; (2) notice of assessment and demand for payment is made upon the taxpayer within 60 days after assessment; and (3) the taxpayer fails to pay the tax within 10 days after notice and demand. IRC Secs. 6303 and 6321.

43 The cases cited in note 41 are the only cases in which the IRS has prevailed in this argument.

44 *O'Dell v. U.S.,* 326 F. 2d 451 (CA-10, 1964).

45 *Amos v. Comm.,*CCH Dec. 28,149, 47 TC 65 (1966).

46 The two trust fund tax components are employee FICA and income tax.

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47 This documentation will prove invaluable if the case ultimately reaches the Appeals Division or is litigated.

48 See Rev. Rul. 79-284, note 39, supra.

49 The term "passive" implies that the participant is an investor who does not actively participate in the management of the business.

50 For example, if a passive participant attempts to circumvent the agreement by coercing management to prefer a business creditor not otherwise entitled to priority over the IRS, he would automatically forfeit his right to indemnification from the corporation.

51 Section 7501 of the Internal Revenue Code imposes a trust on funds withheld from the wages of employees. A responsible person is a trustee with a fiduciary duty to remit withheld taxes on a timely basis. A trustee's intentional breach of fiduciary duty is an intentional tort. The liability which arises under Section 6672 when a responsible person fails to discharge his fiduciary duty is predicated on willful misconduct.

As often as not, the IRS Collection and/or Appeals Divisions determine that two or more individuals are responsible persons. Trust fund liability is joint and several, and the IRS generally attempts to collect first from persons with the greatest financial resources.

Courts addressing the issue have consistently denied the right of a responsible person to contribution from other responsible persons. Contribution is not available to joint tortfeasors if the tortious conduct is intentional. Nevertheless, contribution agreements should be enforceable. See Saltzman, IRS Practice & Procedure, (1988 Cum. Supp.), Paragraph 17.11[5], note 27.

52 As used in this article, the term "cash deficit" means current peruniary obligations in excess of available cash.

53 Determining priority is an extremely complicated matter. See Vasek, "The Hidden Tax Trap of IRC Section 6672," 67 *Kentucky Law Journal* 27, 45-54 for a discussion of some of the complex issues associated with this determination.

54 See *Medeiros v. Comm.,*CCH Dec. 38,485, 77 TC 1255 (1981), *Arrigoni v. Comm.,*CCH Dec. 36,758, 73 TC 792 (1980) and *Patton v. Comm.,*CCH Dec. 35,589, 71 TC 389 (1978), interpreting Section 162(f) to preclude deduction of amounts assessed pursuant to Section 6672.

55 A taxpayer is permitted to report its income and deductions under the cash receipts and disbursements method of accounting. IRC Sec. 446(e)(1). A corporation may not use the cash method unless its gross receipts are $5,000,000 or less, it is a qualified personal service corporation or it is engaged in the business of farming. IRC Sec. 448(c).

56 See the discussion at 66-67, supra.

57 A shareholder of an S corporation is entitled to deduct his or her pro rata share of corporate loss. IRC Sec. 1366(a)(1)(B). Since the corporation is inactive, it will have no income by which the payment will be reduced; therefore, the shareholder will have succeeded in deducting the payment indirectly.

58 IRC Sec. 1366(a)(1) and 1377(a)(1).

59 The general rule applicable to the deductibility of S corporation losses is that the loss is divided equally among the days of the corporation's taxable year and allocated among all shareholders who are shareholders for each such day in accordance with his/her interest in the corporation on that day. IRC Sec. 1377(a)(1). Nevertheless, if all shareholders file an election under Section 1377(a)(2), the taxable year for the corporation, for purposes of determining entitlement to loss deduction, shall be divided into two taxable years: a pretermination year and a post-termination year. Shareholders whose interest in the corporation continue after the date of termination shall be entitled to their pro rata share of post-termination losses determined by reference to their post-termination interest in the corporation.

60 An S election may be made by filing a Form 2553 with the IRS any time before or within 75 days after the beginning of the tax year for which the election is made. IRC Sec. 1362 and Temp. Reg. § 13.1362-1.

61 If there is not sufficient time or if the corporation does not qualify as an S corporation. IRC Sec. 1361.

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62 Deductibility of bad debts is governed by Section 166. A loan from an individual to a corporation of which he is a shareholder will generally be classified as a nonbusiness debt. See *Omaha Nat. Bank, Special Admr. v. Comm.,*50-2 USTC ¶ 9429, 183 F. 2d 899 (CA-8). A nonbusiness bad debt is treated as a short-term capital loss for federal income tax purposes. IRC Sec. 166(d). Accordingly, deductibility may be deferred over several years due to the limitations on deductibility of capital losses. IRC Sec. 1211.

63 IRC Sec. 1244. Taxpayers are entitled to ordinary loss treatment on realized losses up to $50,000 ($100,000 on a joint return). IRC Sec. 1244(b).

64 During the identification process, the revenue officer reviews cancelled checks, signature cards, bank resolutions, payroll tax returns, by-laws, minutes of meetings of directors and shareholders, stock ledgers and other corporate documents which tend to establish the identity of those persons who exercise corporate fiscal control.

65 A form titled Notice of Proposed Assessment of 100 Percent Penalty is sent to each person prior to assessment.

66 See Saltzman, *IRS Practice and Procedure* (Cum. Supp., 1988), ¶ 17-10.

67 IRC Sec. 6501(a). For purposes of the statute of limitations, an employment tax return is deemed to be filed on April 15 of the calendar year following the calendar year to which the return relites. IRC Sec. 6501(b)(2).

68 IRC Sec. 6502(a).

69 *Flora v. U. S.,*60-1 USTC ¶ 9347, 362 U. S. 145 (1960) sets forth the "full payment" rule; however, since employment taxes are divisible taxes, the taxpayer need only pay the tax attributable to one employee for each period. After suit is commenced, the Government will counterclaim for the balance.

70 31 U. S. C. A. § 3727.

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