



1978

The Hidden Tax Trap of I.R.C. Section 6672

Stephen J. Vasek
University of Kentucky

Follow this and additional works at: <https://uknowledge.uky.edu/klj>

 Part of the [Tax Law Commons](#)

Right click to open a feedback form in a new tab to let us know how this document benefits you.

Recommended Citation

Vasek, Stephen J. (1978) "The Hidden Tax Trap of I.R.C. Section 6672," *Kentucky Law Journal*: Vol. 67 : Iss. 1 , Article 4.
Available at: <https://uknowledge.uky.edu/klj/vol67/iss1/4>

This Article is brought to you for free and open access by the Law Journals at UKnowledge. It has been accepted for inclusion in Kentucky Law Journal by an authorized editor of UKnowledge. For more information, please contact UKnowledge@lsv.uky.edu.

The Hidden Tax Trap of I.R.C. Section 6672

BY STEPHEN J. VASEK*

INTRODUCTION

Two recent decisions of the United States Supreme Court examined section 6672 of the Internal Revenue Code. In *Slodov v. United States*,¹ the Court expressed its views on the personal liability of business managers for unpaid taxes on employee wages. Discharging such liability because of the personal bankruptcy of the business manager was considered in *United States v. Sotelo*.² The focal point of these cases — section 6672 of the Internal Revenue Code— provides for the potential liability of business managers for the employees' share of taxes on wages (hereinafter trust fund taxes):

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or willfully attempts in any manner to evade or truthfully account for and pay over¹⁸ such tax, or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable.³

Although *Slodov* and *Sotelo* are helpful in understanding the scope and effect of section 6672, they do not lessen its hidden-trap character. The following scenario is used to illus-

* Associate Professor of Law, University of Kentucky. B.S., B.A. 1961, J.D. 1966, Northwestern University; LL.M. 1969, Harvard University.

The author expresses his appreciation for the research assistance of Penny Warren, third-year law student at the University of Kentucky.

¹ 98 S. Ct. 1778 (1978).

² 98 S. Ct. 1795 (1978).

³ I.R.C. § 6672. A proposed amendment to § 6672 passed Congress on October 14, 1978. H.R. 7320, 95th Cong., 2d Sess. (1978); CONGRESSIONAL INDEX CCH ¶ 34,512 (Nov. 1, 1978). The proposed amendment would add a subsection providing procedures for contesting personal liability for the trust fund taxes and for obtaining a stay of collection.

trate the nature of that trap and the consequences of falling into it.

Mylo Unwary, President of Aba Corporation, has been working fourteen hours per day for the last two years in an attempt to save Aba from financial collapse. Investors, creditors, employees of Aba, and many others have been depending on him. However, four months ago Mylo recognized that Aba Corporation could not be saved, and he attempted to wind down Aba in such a manner so as to cause the fewest number of hardships. Employees were given notice of the status of the corporation so that they would have time to search for new jobs. Existing raw materials were converted into finished goods and sold in an effort to minimize the corporation's losses. Mylo relinquished the Aba Corporation to the trustee in bankruptcy in better condition than it had been in two years. The corporation had sufficient funds to pay all tax liabilities although not all taxes had been paid: all tax returns had been filed and the trustee in bankruptcy was aware of those that had not been paid. Mylo had discussed the problem of the unpaid taxes with an IRS agent a year earlier, and the agent told Mylo that it was a good idea to try to save the business.⁴ Mylo suggested that the IRS seize some corporate assets before bankruptcy, but the IRS did not act.

The trustee in bankruptcy paid the secured claims and the first, second, and third priority claims. The size of these claims resulted in a shortage of cash to pay all of the taxes, a fourth priority claim.⁵ The remaining funds were used to pay a propor-

⁴ See, e.g., *Tozier v. United States*, 16 A.F.T.R.2d 5626, 5630 (W.D. Wash. 1965), in which — with IRS approval — business operations were continued in an effort to reduce hardships on employees in an economically depressed area.

⁵ Bankruptcy Act, 11 U.S.C. § 104 (1976). The order of payment of claims is as follows: secured claims are paid first, followed by costs and expenses of administration (first priority), wages and commissions (second priority), costs of setting aside a wage earner plan, a bankruptcy discharge, or an arrangement with creditors (third priority), and taxes which became legally due and owing by the bankrupt to the United States or any state or subdivision thereof (fourth priority). Perfected tax liens are ranked above the first priority as secured claims, but tax liens on personal property must be perfected by possession or they are postponed until after payment of the first and second priorities. J. MOORE & L. KING, *COLLIER ON BANKRUPTCY* ¶ 64.403 at 2160 (14th ed. 1975). Taxes on wages earned prior to bankruptcy but unpaid at the time of the filing of bankruptcy are given second priority, the same as the unpaid wages to which they relate. *Otte v. United States*, 419 U.S. 43 (1974); *In re Armadillo Corp.*, 410 F. Supp. 407 (D. Colo. 1976).

tionate part of state taxes and a proportionate part of federal taxes.⁶ The money paid for federal taxes was applied to the non-trust fund portion of the corporation's tax liability.⁷ The corporation could not designate the application of tax payments; they were neither voluntary nor timely.⁸ Because few, if any, of the payments to the IRS were allocated toward the trust fund tax liability, Mylo Unwary was left personally liable for the unpaid trust fund taxes under I.R.C. section 6672.⁹

What course is open to Mylo? Assuming there is some question as to Mylo's liability, he may be able to negotiate his liability with the IRS.¹⁰ If he does not settle, he may pay his

Only taxes that are not dischargeable in bankruptcy are given fourth priority status, according to 11 U.S.C. § 104 (1976). 11 U.S.C. § 35 (1976) specifically makes "taxes which became legally due and owing by the bankrupt . . . within three years preceding bankruptcy" non-dischargeable in bankruptcy. Also, 11 U.S.C. § 35 (a)(1)(e) (1976) makes taxes that the bankrupt has collected and withheld from others nondischargeable. Dischargeable taxes are given parity with general unsecured claims after all priorities. COLLIER, *supra*, ¶ 64.404 at 2176.

⁶ Bankruptcy Act, 11 U.S.C. § 104(a)(4) (1976); COLLIER, *supra* note 5, ¶ 64.401 at 2151.

⁷ In determining the amount of the 100 percent penalty to be assessed in connection with employment taxes, any payment made on the corporate account involved is deemed to represent payment of the employer's portion of the liability (including assessed penalty and interest) unless there was some specific designation to the contrary by the taxpayer.

IRS Policy Statement P-5-60 (MT 1218-56, approved Nov. 5, 1965), reprinted in 1 (C.C.H.) I.R.M. 1305-25-26; *see also* 4 (C.C.H.) I.R.M. 21,410 at 5544.32. The court in *United States v. DeBeradinis*, 305 F. Supp. 944, 952 (D. Conn. 1975), *aff'd*, 538 F.2d 315 (2d Cir. 1976), stated that for the Commissioner of Internal Revenue to have applied payments to the trust fund tax liability "would have been to shirk his responsibility to insure that the maximum amount of assessed tax be collected." This reasoning would support allocation of receipts to all non-trust fund taxes, including corporate income taxes, before any receipts are allocated to the liability for trust fund taxes.

⁸ The power of designation, "while absolute if timely, evaporates upon the expiration of the relevant period for filing a timely return." *Hirsch v. United States*, 306 F. Supp. 170, 173 (S.D. Ohio 1975). *See also Monday v. United States*, 421 F.2d 1210, 1218 (7th Cir.), *cert. denied*, 400 U.S. 821 (1970), in which the court allowed the IRS to disregard directions from the bankruptcy referee regarding the application of payments to trust fund liabilities.

⁹ Recent substantial raises in F.I.C.A. taxes, *see* I.R.C. § 3101, are likely to increase the number of cases where the employer is faced with the dilemma of closing the plant and terminating his employees or keeping the plant open and risking personal liability for unpaid trust fund taxes.

¹⁰ Hearings at the district and appellate levels were possible in most cases prior to October 2, 1978. *See, e.g.*, Rev. Rul. 69-26, 1969-2 C.B. 308; Rev. Rul. 61-27, 1961-2 C.B. 563; Rev. Rul. 57-26, 1957-2 C.B. 1093. *See generally* 4 (C.C.H.) I.R.M. 21,401-21-487 MT 5500-25. Effective October 2, 1978, the district conference level of appeal

liability for the payroll taxes of a particular employee and sue for a refund.¹¹ The IRS will counterclaim for the remainder of the outstanding tax and thus allow the court to determine the extent of Mylo's liability. The court would probably find Mylo personally liable for the entire amount. Driven into personal bankruptcy, the final blow is dealt to Mylo when he learns that his indebtedness for the 100% penalty is not dischargeable in bankruptcy.¹² Mylo, now bankrupt, but still in debt, can consider himself lucky if no criminal charges are brought against him under I.R.C. sections 7202 and 7215. Unfortunately, this hope offers Mylo no succor. He purchased 5,000 pounds of dynamite and was last seen en route to Washington, reading a copy of "Pick Up Where Guy Fawkes Left Off" and muttering something about "those _____ feds."

Variations on this scenario are many. Mylo Unwary might be the treasurer of a corporation, the manager of a partnership's financial affairs, an employee responsible for collecting and paying over taxes, or a lender or surety of a loan which is used for the payment of wages.¹³ It is possible that a lawyer or accountant for the business could be liable for malpractice in not advising his client of the tax liability of persons responsible for collecting and paying over taxes withheld from employees. To the IRS, Mylo Unwary is Sly Highroller, a slick financier who has refused to pay the trust fund taxes in order to obtain an interest-free loan from the federal government or to give preference to creditors over the federal government. The assessment of the 100% penalty under section 6672 generally does not depend on whether the responsible person is Mylo Unwary or Sly Highroller.

The problem of tax deficiencies for unpaid taxes on em-

was eliminated. See News Release, IR-2038 ¶ 55,489 (P-H) notifying of the amendment of the Statement of Procedure Rules, 26 C.F.R. part 601.

¹¹ See 4 (C.C.H.) I.R.M. 21,416 at 5547.6. H.R. 7320, 95th Cong., 2d Sess. (1978), which passed Congress on October 14, 1978, would amend § 6672 to provide for a stay of collection of the penalty if the taxpayer pays the minimum amount required to commence a court proceeding, files a claim for refund, and furnishes a bond equal to one and one-half times the amount of any unpaid penalty.

¹² *United States v. Sotelo*, 98 S. Ct. 1795 (1978). See also *Lackey v. United States*, 538 F.2d 592 (4th Cir. 1976); *In re Murphy*, 533 F.2d 941 (5th Cir. 1976).

¹³ See text accompanying notes 16-64 for a discussion of who qualifies as a responsible person.

ployee wages is of enormous magnitude. In fiscal year 1976, there were 28,599 businesses delinquent in such taxes in the Chicago district of the IRS. This statistic translated into \$88.9 million of unpaid trust fund taxes which resulted in section 6672 penalty assessments against individuals connected with 535 of those businesses.¹⁴ Whether the exceptional remedy given the government under section 6672 to pursue individuals for the unpaid trust fund taxes is necessary to protect federal revenues cannot be answered without an examination of the applications of section 6672 and possible defenses to such penalty assessments. This article will examine these issues and comment on what should be done to reconcile the need to protect federal revenues with the need to be fair to individuals responsible for collecting and paying over trust fund taxes. Part I examines the question of who can be liable under section 6672, Part II examines the concept of "willfulness" which is a prerequisite for liability, and Part III examines possible reforms.

I. THE RESPONSIBLE PERSON

The person liable for the 100% penalty under section 6672 is "[a]ny person required to collect, truthfully account for, and pay over" the trust fund taxes.¹⁵ The term "person" is further defined in section 6671(b) 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."

A. *The Scope of the Responsible Person Concept*

When the IRS is in doubt as to the identity of the person responsible in a corporate setting, the service's policy is to "look to the President, Secretary and the Treasurer of the Corporation as responsible officers."¹⁶ However, the court decisions

¹⁴ UNITED STATES COMPTROLLER GENERAL OPINION B-137762, CCH Standard Federal Tax Reports ¶ 6614 at 71,438 (May 11, 1977) [hereinafter cited as COMPTROLLER OPINION].

¹⁵ I.R.C. § 6672.

¹⁶ IRS Policy Statement P-5-60 (MT 1218-56 approved Nov. 5, 1965), reprinted in 1 (C.C.H.) I.R.M. 1305-25,26. See also *McCarthy v. United States*, 437 F.2d 961,

reject the proposition that mere corporate officeholding is a *per se* basis for liability under section 6672.¹⁷ Other factors are considered in determining liability. Thus, in *Fried v. United States*¹⁸ the court held that the corporation's president was not the responsible person when he only owned sixteen percent of the stock and the treasurer owned fifty-one percent. In the *Fried* case the president had tried to pay the taxes but the treasurer, whose signature was also required on all checks, refused to counter-sign the check.

Although corporate officeholding is some indication of a person's responsibility, nonofficeholders and nonemployees have also been held liable for the penalty under section 6672.¹⁹ The proviso in section 6671(b) that "person" includes "an officer or employee . . . under a duty" has been held to be exemplary rather than inclusive.²⁰ For example, in *United States v. Graham*²¹ the Ninth Circuit held that a corporate director who was neither an officer nor an employee could be held liable for the 100% penalty since the board of directors had not delegated responsibility to some corporate officer. Further, the board of directors had acted to give preference to corporate obligations other than the tax obligations, and the particular board member held liable for the tax penalty knew of the unpaid tax liability. In *Mulcahy v. United States*²² the court concluded

967-68 (Ct. Cl. 1971), stating that a "founder, chief stockholder, president and member of the board of directors of a corporation . . . is rebuttably presumed to be the person responsible under § 2707 [former § 6672]."

¹⁷ "[M]ere office holding of and by itself does not render one responsible for the collection and paying over of employee withholding taxes." *Bauer v. United States*, 543 F.2d 142, 149 (Ct. Cl. 1976) (citing *Monday v. United States*, 421 F.2d 1210, 1214 (7th Cir.), *cert. denied*, 400 U.S. 821 (1970)).

¹⁸ 68-1 U.S. Tax Cas. ¶ 9372 (S.D. Fla. 1968).

¹⁹ *See, e.g.*, *Mueller v. Nixon*, 470 F.2d 1348 (6th Cir. 1972), *cert. denied*, 412 U.S. 949 (1973); *McCarthy v. United States*, 437 F.2d 961 (Ct. Cl. 1971); *White v. United States*, 372 F.2d 513 (Ct. Cl. 1971); *Pacific Nat'l Ins. Co. v. United States*, 422 F.2d 26 (9th Cir.), *cert. denied*, 398 U.S. 937 (1970); *United States v. Graham*, 309 F.2d 210 (9th Cir. 1962); *Regan & Co. v. United States*, 290 F. Supp. 470 (E.D.N.Y. 1968); *Melillo v. United States*, 244 F. Supp. 323 (E.D.N.Y. 1965); *Tiffany v. United States*, 228 F. Supp. 700 (D.N.J. 1963); *National Bank of Commerce v. Phinney*, 65-2 U.S. Tax Cas. ¶ 9512 (S.D. Tex. 1965).

²⁰ *Meuller v. Nixon*, 470 F.2d 1348, 1350 (6th Cir. 1972), *cert. denied*, 412 U.S. 949 (1973).

²¹ 309 F.2d 210 (9th Cir. 1962).

²² 237 F. Supp. 656 (S.D. Tex. 1964).

that a person could be subject to the 100% penalty even if he was merely counsel for the corporation and not an officer or employee. In *Howard v. United States*²³ the court found that a husband (president) and his wife (secretary-treasurer) were not responsible persons despite the fact that they owned 100% of the corporation's outstanding stock. The wife's father, who had organized the corporation but was apparently not an officer, had completely dominated the wife and her husband and in fact controlled the financial affairs of the corporation. Presumably, the father was the responsible person.²⁴

Responsibility has also been extended to a lender or surety of a loan. Lenders and their employees may be held liable for the 100% penalty under either section 3505 or section 6672. Section 6672 has been applied to lenders and their employees as well as sureties when those persons have effective control over the borrower.²⁵ Thus in *Mueller v. Nixon*,²⁶ lender's employee who was put in charge of borrower's operations was found to be the person responsible for the nonpayment of taxes withheld from borrower's employees. Section 3505 makes lenders and sureties liable for the borrower's trust fund taxes in one of two situations. Liability will result if they pay the borrower's employees' wages directly or through an agent and neither they nor the agent pays the trust fund taxes or if they lend directly to the borrower for the specific purpose of paying wages and they have actual knowledge that the borrower will not pay the trust fund tax.²⁷

In general, the IRS does not attempt to assess the penalty against partners or sole proprietors since they usually are personally liable for the unpaid taxes.²⁸ However, such assess-

²³ 38 A.F.T.R.2d 76-6228 (N.D. Ohio 1976).

²⁴ No penalty was assessed against wife's father, presumably because he died shortly after the corporation's withholding tax liability accrued.

²⁵ See, e.g., *Adams v. United States*, 504 F.2d 73 (7th Cir. 1974) (sole issue was whether lender can be a responsible person); *Mueller v. Nixon*, 470 F.2d 1348 (6th Cir. 1972), cert. denied, 412 U.S. 949 (1973); *Pacific Nat'l Ins. Co. v. United States*, 422 F.2d 26 (9th Cir.), cert. denied, U.S. 937 (1970). See also *Goebert v. United States*, 412 F. Supp. 356, 360 (E.D. Pa. 1976) (citing *Werner v. United States*, 374 F. Supp. 558, 563 (D.Conn. 1974)), for distinction between creditors who apply pressure and those who take effective control.

²⁶ 470 F.2d 1348 (6th Cir. 1972), cert. denied, 412 U.S. 949 (1973).

²⁷ See *Treas. Reg. § 31.3505* (1978) for examples of the application of these rules.

²⁸ *COMPTROLLER OPINION*, *supra* note 14, at 71,438.

ments have been made, presumably to prevent discharge in bankruptcy of the debt for the delinquent taxes.²⁹

B. *Defenses to Imposition of Responsible Person Status*

1. *Lack of Control Over Fiscal Affairs*

Determination of who is a responsible person involves "a search for a person with ultimate authority over expenditures of funds."³⁰ The responsible person is the one with fiscal control or, more explicitly, the authority to direct payment of creditors. Ministerial employees and nominal corporate officers are normally not responsible persons because they are powerless to control the preference of one creditor over another. Such personnel usually have authority to select a particular creditor over another only by exerting influence on some other person in the corporate structure.³¹

Application of these principles of control to specific situations is difficult because of the nebulous nature of power and control in corporate structures. To aid in identification of the "responsible persons," the district court in *Datlof v. United States*³² set out seven factors: 1) what the individual's duties were as outlined by the corporate by-laws, 2) whether the individual had the authority to sign company checks, 3) whether the individual signed the tax returns of the firm, 4) whether the individual paid creditors other than the United States, 5) whether the individual was a corporate officer, director and/or principal stockholder, 6) whether the individual hired and dis-

²⁹ *United States v. Sweetser*, 77-2 U.S. Tax Cas. ¶ 9470 (M.D. Pa. 1977). See also *Kaufman v. Scanlon*, 245 F. Supp. 352 (E.D.N.Y. 1965), in which the taxpayer was held to be a responsible person in a business which held itself out as a corporation but was apparently never incorporated. In *Isaac v. United States*, 26 A.F.T.R.2d 70-5396 (C.D. Cal. 1970), the IRS attempted to assess the penalty against an individual when a partnership of two corporations had failed to collect withholding taxes.

³⁰ *Bauer v. United States*, 543 F.2d 142, 148 (Ct. Cl. 1976) (citing *White v. United States*, 372 F.2d 513, 517 (Ct. Cl. 1967)). In determining who has ultimate authority over the expenditure of funds, courts seek to ascertain "who has the final word as to what bills should or should not be paid, and when." *Adams v. United States*, 504 F.2d 73, 75 (7th Cir. 1974) (citing *Turner v. United States*, 423 F.2d 448, 449 (9th Cir. 1970)). Also, "'final' means significant rather than exclusive control." *Id.* at 75 (citing *Dudley v. United States*, 428 F.2d 1196, 1201 (9th Cir. 1970)).

³¹ *United States v. Abrahams*, 312 F. Supp. 1035, 1038 (S.D.N.Y. 1970).

³² 252 F. Supp. 11, 32-33 (E.D. Pa.), *aff'd*, 370 F.2d 655 (3d Cir. 1966), *cert. denied*, 387 U.S. 906 (1967).

charged employees, and 7) whether the individual controlled the financial affairs of the firm in general. Similar lists have been used by other courts in identifying the responsible persons.³³

Some individuals have successfully contended that their authority and responsibility were only in the technical or sales areas and not in the fiscal area. For example, in reaching the conclusion that taxpayer was not a responsible person and was "at best only a nominal figure of authority in the fiscal area,"³⁴ the court in *Bauer v. United States* considered the following:

1. Taxpayer's training and work experience of over thirty years was entirely technical and not of a fiscal nature.

2. As manager of operations, taxpayer was in charge of production, quality control, and scheduling. All accounting and financial affairs were in the hands of the treasurer who reported directly to the president.

3. Taxpayer was appointed rather than elected to the board of directors which had no formal meetings in the tax year in question other than the annual board meeting at the beginning of the year. The business affairs of the corporation were conducted in a lax, informal manner, without the customary corporate formalities.

4. No formal financial reports were prepared for directors on a regular or current basis during 1970, nor were they issued information concerning delinquent employee withholding taxes.

5. The executive committee formed in January, 1970, was not properly formed since it contained only two director-members and the by-laws required three.

6. The treasurer was in charge of financial records and disbursements and reported directly to the president. The treasurer and the president (but not taxpayer) met with personnel from the IRS to discuss the corporation's tax delinquencies. Taxpayer knew of the meetings with the IRS but was not aware of the specific nature of the tax problem, nor of the

³³ See, e.g., *Goibert v. United States*, 412 F. Supp. 356 (E.D. Pa. 1976); *Hoeniger v. United States*, 76-1 U.S. Tax Cas. ¶ 9296 (S.D.N.Y. 1976); *Braden v. United States*, 319 F. Supp. 1189 (S.D. Ohio 1970), *aff'd*, 442 F.2d 342 (6th Cir.), *cert. denied*, 404 U.S. 912 (1971).

³⁴ *Bauer v. United States*, 543 F.2d 142, 148-49 (Ct. Cl. 1976).

specific results of the meetings. Taxpayer did not learn of the tax problem with regard to the employee withholding tax delinquencies until December 1970 (the end of the period in question).

7. Taxpayer never prepared, signed, or filed any tax returns, nor did he participate in the preparation of financial statements.

8. Taxpayer was generally aware of the deterioration of the corporation's financial condition, but was not consulted in making arrangements with creditors other than for his technical expertise regarding supplies. Supply orders were routed to the treasurer or president for approval because of the corporation's poor financial condition.

9. Taxpayer never signed a corporate check or had control, custody or possession of the corporate books, records or check-books, nor did he ever get involved in any corporate banking transactions. The court stated that in every case in which it had found the individual was a responsible person, the individual had actually signed or cosigned corporate checks.³⁵

10. Taxpayer had nothing to do with payroll: he was not authorized to act in that area either by the by-laws or in actual practice.³⁶ That the taxpayer in *Bauer* was the corporation's vice-president, a substantial shareholder, a member of the board of directors, the manager of operations, a member of the executive committee and a signatory on signature cards on two of the corporation's bank accounts was not, in light of his limited technical responsibilities, sufficient to make him a responsible person.

Taxpayers have prevailed in other cases when the taxpayer was a "field man" for a construction corporation with no responsibility for financial decisions³⁷ and when taxpayer was in charge of sales and personnel but not financial management.³⁸

Another aspect of the lack of control over fiscal affairs defense is the contention that taxpayer's fiscal authority did

³⁵ *Id.* at 145-48. *But see* *Brown v. United States*, 464 F.2d 590, 591 (5th Cir. 1972), *cert. denied*, 410 U.S. 933 (1973), in which the court held that the lack of authority to sign corporate checks will not insulate the taxpayer from liability.

³⁶ 543 F.2d at 149.

³⁷ *Stanton v. United States*, 37 A.F.T.R.2d 76-1427 (S.D. Fla. 1976).

³⁸ *Bellah v. Patterson*, 197 F. Supp. 522 (N.D. Ala. 1961).

not encompass fiscal authority over payroll taxes. In *Bernardi v. United States*³⁹ a man named Lutz, who was vice-president, board member, shareholder, and director of operations, was authorized to sign corporate checks and did so. He had actually signed the employer's quarterly tax returns for the quarters at issue, he had intimate knowledge of the corporation's financial problems, and he had met with the accounts receivable factor to discuss credit arrangements. Even though the court found that Lutz and two other officers had often acted jointly in running the corporation, the court concluded that Lutz had no responsibility for paying the payroll or determining creditor priorities and had nothing to do with keeping tax records or preparing tax returns. In finding that Lutz was not a responsible person the court noted that "[i]f Lutz had decided that withheld taxes should be segregated or paid over to the government immediately, he could have implemented that decision only by persuading [the treasurer or the chairman of the board] or both, to segregate funds or to pay the taxes."⁴⁰

The willingness of a court to examine closely the individual's actual authority was also shown in *Builder's Finance v. United States*.⁴¹ The controller of the corporation knew of the trust fund tax delinquency and had authority to cosign checks, but he was held not to be a responsible person since his authority and duties related only to non-payroll accounts payable.

2. Delegation of Fiscal Authority Defense

The situations in which an individual never had fiscal authority over payroll taxes must be distinguished from the cases in which a person has such authority and it is delegated. No cases were found in which a shareholder or member of the board of directors was held liable for the section 6672 penalty solely on the basis of such status.

A director could be a responsible person only if "the board of directors had the final word as to what bills should or should

³⁹ 74-1 U.S. Tax Cas. ¶ 9170 (N.D. Ill. 1973), *aff'd*, 507 F.2d 682 (7th Cir. 1974), *cert. denied*, 422 U.S. 1042 (1975).

⁴⁰ *Id.* ¶ 9170 at 83,215. See also *Campbell v. Nixon*, 207 F. Supp. 826 (E.D. Mich. 1962).

⁴¹ 352 F. Supp. 491 (E.D. Mich. 1970).

not be paid and when."⁴² The test to determine a director's liability is similar to that discussed in the preceding section of this paper:⁴³ whether the director actually exercised control in determining which creditors should be paid, regardless of whether the director could have exercised such control. Delegation of fiscal management authority by the board of directors appears to insulate them effectively from liability as responsible persons.

Non-directors have not been very successful in escaping responsible person status by having delegated responsibility to someone else. For example, in *Bedford v. United States*⁴⁴ the court stated, "Nor may such a responsible person avoid his responsibility by delegating it to a subordinate employee."⁴⁵ The First Circuit, in *Harrington v. United States*, reasoned that delegation would not relieve a corporate president who had the responsibility and authority to avoid the default.⁴⁶ In *United States v. Sweetser* the court concluded that delegation of duty to withhold and pay over the taxes to the president was not a sufficient defense to liability under section 6672 since the "right" to exercise control remained with the secretary-treasurer.⁴⁷ In *Lawrence v. United States*, the court held that a delegation of responsibility was irrelevant as long as the power to revoke the delegation remained in the grantor.⁴⁸

In a few cases the delegation of the duty to withhold and pay the taxes has insulated the person delegating the authority from liability because the failure to pay the taxes was not willful on the delegator's part. In *Wiggins v. United States*⁴⁹ a president/treasurer, who had delegated to his bookkeeper the duty to withhold and pay over the taxes, was held not liable.

⁴² *United States v. Graham*, 309 F.2d 210, 212 (9th Cir. 1962) (citing *Wilson v. United States*, 250 F.2d 312, 316 (9th Cir. 1957)).

⁴³ See notes 30-41 and accompanying text *supra*.

⁴⁴ 39 A.F.T.R.2d 77-1246 (E.D. Wis. 1976).

⁴⁵ *Id.* at 77-1249. The jury in situations discussed by the court inferred that Bedford was a corporate officer. *Id.* at 77-1249, 77-1251.

⁴⁶ 504 F.2d 1306 (1st Cir. 1974).

⁴⁷ 396 F. Supp. 170 (S.D. Ohio 1975).

⁴⁸ 299 F. Supp. 187, 190 (N.D. Tex. 1969). In *Lawrence*, taxpayer's widow — executrix of his estate — was held liable because her husband had loaned money to an employer and assumed financial control and his control had passed to his estate.

⁴⁹ 188 F. Supp. 374 (E.D. Tenn. 1960).

In *Daniels v. United States*⁵⁰ the corporation's founder who had assigned the duties of return preparation to the secretary/treasurer was not liable. In these two cases the respective courts found that the corporate officers' failure to pay the taxes had been not willful, even if they were responsible persons. Similarly, in *Adams v. United States*,⁵¹ the court explicitly recognized that a person with legal and actual authority to control disbursements is a "responsible person" even if he does not take an active interest in and defers to others financial control but that an indifferent, careless, and casual manner resulting in his ignorance of the tax liability makes his nonpayment of the tax liability not willful. The willfulness aspect of the delegation of authority defense will be analyzed further in section II of this article, dealing with willfulness.

C. *Liability Involving Multiple Responsible Persons*

It is clear that more than one person may be responsible for an unpaid trust fund tax.⁵² The IRS may seek to recover the entire penalty from one person; it is not under any duty to charge all responsible persons or all who are alleged to be responsible persons.⁵³ One responsible person cannot implead others to get a court determination of his liability,⁵⁴ nor can the person ultimately held liable sue other responsible persons directly for contributions toward his liability.⁵⁵

Although the IRS will assess the section 6672 penalty only against those persons from whom the tax is collectible — taking into account such factors as the age and health of the taxpayer⁵⁶ — a fairer approach would be to enact legislation allowing impleader. Impleader would permit a fairer allocation of liabil-

⁵⁰ 20 A.F.T.R.2d 5490, 5491 (W.D. Tenn. 1967).

⁵¹ 35 A.F.T.R.2d 75-1174, 75-1177 (W.D. Wis. 1974).

⁵² See, e.g., *Builder's Finance v. United States*, 352 F. Supp. 491 (E.D. Mich. 1970).

⁵³ *DiBenedetto v. United States*, 75-1 U.S. Tax Cas. ¶ 9503 (D.R.I. 1974).

⁵⁴ *Id.* ¶ 9503 at 87,332. Rule 14 impleader is inappropriate since the liability of responsible persons is to the government and not to other responsible persons. *Geiger v. United States*, 41 A.F.T.R.2d 78-1230 (D. Md. 1978).

⁵⁵ *Cohen v. United States*, 241 F. Supp. 740 (E.D. Mich. 1975). See also *DiBenedetto v. United States*, 75-1 U.S. Tax Cas. ¶ 9503 (D.R.I. 1974), for the proposition that there is no right of contribution among willful tortfeasors.

⁵⁶ COMPTROLLER OPINION, *supra* note 14, at 71,438.

ity among all responsible persons. Liability could be joint and several so that the government would not lose revenues if one or more of the responsible persons were unable to pay his entire share. The apportionment of liability would be a difficult but not insurmountable task. Liability could be based on the degree of willfulness of each responsible person. The benefits from such impleader and contribution rules would be: 1) all responsible persons will be encouraged to take their responsibilities seriously and would not rely on the wealth of any particular responsible person, 2) the possibility of biased selection of responsible persons to pursue will be eliminated, and 3) the financial burdens of liability will be more fairly allocated.

D. *When Does Responsibility Begin and End?*

A distinct aspect of the responsible person question is whether an individual is liable for the section 6672 penalty even though he was not responsible for the employee's withholding tax throughout the entire period during which the taxes were to be collected, accounted for, and paid over. This problem arises due to the time lags inherent in the collection process. The employer has the duty to withhold the employees' share of taxes at the time the wages are paid.⁵⁷ The withheld taxes are paid quarterly and reported on form 941, returns being due on April 30, July 31, October 31, and January 31.⁵⁸ Monthly or weekly deposits of withheld taxes may be required depending on their amount.⁵⁹

Section 6672 states that "Any person required to collect, truthfully account for, and pay over any tax imposed by this title 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," shall

⁵⁷ I.R.C. §§ 3102(a) and 3402(a).

⁵⁸ Treas. Reg. §§ 31.6011(a)-1(a)(1) and 31.6011(1)-4 (1978); Treas. Reg. § 31.6151-1(a) (1978).

⁵⁹ Treas. Reg. § 31.6302(c)-1(a)(1)(i)(a) (1978). In general, deposits of withheld taxes in bank qualified as a depository for federal taxes are required within three banking days if the cumulative undeposited taxes for the quarter are \$2000 or more on the 7th, 15th, 22nd or last day of any month. If at the end of any month the cumulative undeposited taxes are more than \$200 but less than \$2000, such taxes must be deposited by the 15th of the following month. *Id.* § 31.6302(c)-1(a)(1)(i)(b) (1978).

be liable for the 100% penalty.⁶⁰ The Supreme Court, in *Slodov v. United States*,⁶¹ held that the phrase "required to collect, truthfully account for, and pay over" did not define responsible person but merely clarified the type of duty to which the penalty was applicable.⁶² Thus, a person who had any one of the three enumerated duties (collection, accounting, or payment) would be a responsible person. For example, a corporate officer who resigns after net wages are paid but before any withholding returns are filed and before any taxes are to be paid or deposited would be a responsible person with respect to the withheld taxes on the net wages.⁶³ Similarly a corporate officer who assumes his office after net wages are paid could also be a responsible person.⁶⁴ Although a person who has less than all three of the enumerated duties is a responsible person, the failure to pay taxes may or may not have been "willful" on his part. The effect of the timing of the responsible person's tenure on willfulness is discussed in section II of this article, following a more general discussion of willfulness.

II. WILLFULNESS

A. Definitions of "Willfulness"

In *Slodov v. United States* the Supreme Court interpreted

⁶⁰ I.R.C. § 6672.

⁶¹ 98 S. Ct. 1778 (1978).

⁶² *Id.* at 1787.

⁶³ See, e.g., *Korman v. United States*, 35 A.F.T.R.2d 75-424 (E.D.N.Y. 1974); *Bernardi v. United States*, 74-1 U.S. Tax Cas. ¶ 9170 (N.D. Ill. 1973), *aff'd*, 507 F.2d 682 (7th Cir. 1974), *cert. denied*, 422 U.S. 1042 (1975); *Long v. Bacon*, 239 F. Supp. 911 (S.D. Iowa 1965). See also *Slodov v. United States*, 98 S. Ct. 1778 (1978).

⁶⁴ *Slodov v. United States*, 98 S. Ct. 1778 (1978). See also *Mueller v. Nixon*, 470 F.2d 1348 (6th Cir. 1972), *cert. denied*, 412 U.S. 949 (1973); *Astleford v. United States*, 35 A.F.T.R.2d 75-1522 (D. Minn. 1975); *Rubin v. United States*, 380 F. Supp. 1176 (W.D. Pa. 1974), *aff'd per curiam*, 515 F.2d 507 (3d Cir. 1975); *Stake v. United States*, 347 F. Supp. 823 (D. Minn. 1972); *Louisville Credit Men's Ass'n v. United States*, 32 A.F.T.R.2d 73-6114 (E.D. Ky. 1970); *Kaufman v. Scanlon*, 245 F. Supp. 352 (E.D.N.Y. 1965).

Prior to the Supreme Court's decision in *Slodov*, a few courts had held that taxpayer was not a responsible person with respect to taxes on wages paid before he became a corporate officer. *McCullough v. United States*, 462 F.2d 588 (5th Cir. 1972); *Howard v. United States*, 38 A.F.T.R.2d 76-6228 (N.D. Ohio 1976); *In re Slodov*, 419 F. Supp. 64 (N.D. Ohio 1975), *rev'd*, 552 F.2d 159 (6th Cir. 1977), *rev'd*, 98 S. Ct. 1778 (1978).

the willfulness proviso in section 6672 as requiring some sort of personal fault on the part of the responsible person:

Section 6672 cannot be read as imposing upon the responsible person an absolute duty to "pay over" amounts which should have been collected and withheld. The fact that the provision imposes a "penalty" and is violated only by a "willful failure" is itself strong evidence that it was not intended to impose liability without personal fault The Government's concession — that § 6672 does not impose a duty on the responsible officer to use personal funds or even to liquidate corporate assets to satisfy the tax obligations — recognizes that the "pay over" requirement does not impose an absolute duty on the responsible person to pay back taxes.⁶⁵

In contrast, the dissent defined "willful" as "a conscious act or omission which violates a known legal duty."⁶⁶ According to the dissent, the "willfulness" requirement is met if the responsible person consciously chose to pay creditors other than the United States with full knowledge of the outstanding tax obligations.⁶⁷

It can be assumed that the *Slodov* majority would not require a finding of "bad" motive, such as an intent to defraud, on the part of the responsible person in order to find his actions willful.⁶⁸ Although the Court's interpretation of "willfulness" in terms of personal fault resembles the "reasonable cause" defense that some courts have used in interpreting "willfulness" under section 6672, the similarity is probably not important. The essence of the reasonable cause defense is that the person charged to withhold, collect, and pay over taxes is excused because he has reasonable cause to avoid performance of his duties.⁶⁹ The reasonable cause defense has been rejected by most courts and its applicability has been severely restricted by the Fifth Circuit Court of Appeals, the only circuit which

⁶⁵ 98 S. Ct. at 1788-89.

⁶⁶ *Id.* at 1794.

⁶⁷ *Id.*

⁶⁸ For cases which reject the need for a finding of bad motive, see *Hartman v. United States*, 538 F.2d 1336, 1341 (8th Cir. 1976) (acknowledging the wide acceptance of the conscious act definition applied in *Monday*); *Kalb v. United States*, 505 F.2d 506, 511 (2d Cir.), *cert. denied*, 421 U.S. 979 (1974); *Monday v. United States*, 421 F.2d 1210, 1216 (7th Cir.), *cert. denied*, 400 U.S. 821 (1970). See also Rev. Rul. 54-158, 1954-1 C.B. 247; Annot., 22 A.L.R.3d 83 (1968).

⁶⁹ *Newsome v. United States*, 431 F.2d 742 (5th Cir. 1970).

still expressly recognizes the reasonable cause defense.⁷⁰ The Fifth Circuit has so restricted application of the defense that its decisions would probably not differ if it expressly rejected the reasonable cause defense.⁷¹

Prior to *Slodov* most courts determined the willfulness issue according to a standard comparable to that stated by the dissent in *Slodov*. Willfulness was viewed as a voluntary, conscious, and intentional failure to collect, truthfully account for or pay over the taxes withheld from employees, or a payment of creditors other than the government with knowledge that the trust fund taxes were unpaid.⁷²

The dissent in *Slodov* interpreted the majority opinion as rejecting the "conscious act or omission" test and suggested that the majority was adopting some vague test of immoral conduct in determining willfulness.⁷³ Although the majority did emphasize *Slodov's* lack of "personal fault,"⁷⁴ the crucial difference between the majority and dissenting opinions was in defining *Slodov's* legal duties.⁷⁵ While emphasis on personal fault as opposed to "conscious acts" arguably should produce different results in certain fact situations,⁷⁶ the following dis-

⁷⁰ *Newsome, id.* at 746-48, limited the applicability of the reasonable cause defense. For cases that have rejected the reasonable cause defense, see *Harrington v. United States*, 540 F.2d 1306, 1315-16 (1st Cir. 1974); *Monday v. United States*, 421 F.2d 1210 (7th Cir. 1970); and *Bloom v. United States*, 272 F.2d 215, 225 (9th Cir. 1959). In *Newsome*, reasonable cause did not exist when financial statements prepared by an accounting firm overstated accounts receivable and the responsible person believed sufficient accounts receivable would be collected by the end of the quarter to pay the taxes.

⁷¹ No Fifth Circuit cases were found in which the reasonable cause defense was successful in shielding the responsible person from liability. In *Cash v. Campbell*, 346 F.2d 670 (5th Cir. 1965), the court suggested that the reasonable cause defense would have been applicable had taxpayer's accountant and attorneys advised taxpayer not to pay taxes as they became due. Such advice might shield taxpayer from liability even under the stricter test of "conscious knowledge" of taxes owing.

For a discussion of the confusing history of the reasonable cause defense outside the Fifth Circuit, see *Frazier v. United States*, 304 F.2d 528 (5th Cir. 1962).

⁷² See note 68 *supra* for supporting cases.

⁷³ 98 S. Ct. at 1794.

⁷⁴ *Id.* at 1788.

⁷⁵ The dissenting opinion would have based *Slodov's* liability on his conscious failure to pay the outstanding tax liability out of business receipts collected after he assumed control. The majority held there was no duty to pay over after-acquired receipts.

⁷⁶ See text accompanying notes 135-46 *infra* for an examination of situations in which different results might arise.

cussion will demonstrate that the results of the two tests will be similar in most cases.⁷⁷

B. *Willfulness Distinguished from Negligence*

Although willfulness requires an awareness of the unpaid tax liability, a responsible person cannot put on blinders and escape tax liability. Negligence in not learning of the tax liability is not willfulness,⁷⁸ but willfulness does exist if there has been a "reckless disregard for obvious or known risks" or a "failure to investigate or to correct mismanagement."⁷⁹

An example of the distinction can be seen in *United States v. Leuschner*.⁸⁰ Nonpayment of the trust fund taxes was held to be not willful when the responsible person (director and general manager of a corporation) relied upon his controller to keep the books, file the tax returns, and pay all creditors. The individual charged with responsibility did not learn of the unpaid tax liability until creditors forced the closing of the business by attachment of assets. This occurred after the due date for paying the taxes. Nonpayment was found to be not willful even though the individual knew about the company's pressing needs for cash and had cosigned company checks and tax returns. The court believed his statements that he signed blank checks and tax returns for the controller to fill out. The lack of knowledge of the liability precluded his actions from being willful.

However, when he continued to conduct the same business through a new corporation in the same manner as he had operated the old corporation, the court did not allow a second bite

⁷⁷ See text accompanying notes 85-134 *infra* in which it is demonstrated that the results will most often be similar.

⁷⁸ See, e.g., *Kalb v. United States*, 505 F.2d 506, 511 (2d Cir. 1974); *Dudley v. United States*, 428 F.2d 1196, 1200 (9th Cir. 1970); *United States v. Leuschner*, 336 F.2d 246, 248 (9th Cir. 1964); *Mazo v. United States*, 77-1 U.S. Tax Cas. ¶ 9325 (S.D. Ga. 1977); *Goebert v. United States*, 412 F. Supp. 356, 361 (E.D. Pa. 1976); and *Hoenger v. United States*, 37 A.F.T.R.2d 76-1011, 76-1104 (S.D.N.Y. 1976).

⁷⁹ *Kalb v. United States*, 505 F.2d 506, 511 (2d Cir. 1974). See also cases cited in note 78 *supra*. But see *Adams v. United States*, 35 A.F.T.R.2d 75-1174, 75-1177 (D. Ore. 1975), in which the court concluded that the responsible person had not acted willfully "however indifferent and careless and casual" he was about his responsibilities.

⁸⁰ 336 F.2d 246 (9th Cir. 1964).

from the apple. Even though he made no inquiries as to whether taxes were paid by the new corporation and allegedly did not learn of the unpaid taxes until the IRS levied on his personal bank account, the court held that the nonpayment of taxes by the new corporation was willful. From his experience with the prior corporation, the responsible person was held to be under a duty to see that the taxes were paid by the new corporation.⁸¹ His actions with respect to the unpaid taxes of the first corporation were characterized as negligence and therefore not willful; his actions with respect to the unpaid taxes of the new corporation qualified as a reckless disregard for obvious and known risks and thus constituted a voluntary, conscious, and intentional failure to pay.⁸²

The distinction between negligent failure to learn of tax liabilities and reckless disregard for obvious or known tax liabilities has been articulated under the "conscious act" standard of willfulness.⁸³ The Supreme Court's "personal fault" concept of willfulness⁸⁴ should continue the recognition of this distinction, since both negligence and reckless disregard are different degrees of personal fault.

C. *The Duty to Withhold*

1. *The Willfulness Implicit in the Payment of Wages When There Are Insufficient Funds to Pay Taxes on Those Wages*

In *Sorenson v. United States*⁸⁵ the Ninth Circuit Court of Appeals held that the payment of net wages at a time when there were insufficient funds to pay the taxes on those wages constituted a willful failure to withhold, collect, and pay over

⁸¹ *Id.* at 248. See also *Fitzgerald v. United States*, 407 F. Supp. 1132, 1136 (E.D. Ky. 1976), in which the court held that the responsible person had an affirmative duty to investigate or correct mismanagement of the withholding taxes after learning that the taxes had not been paid.

⁸² 336 F.2d at 248. The issue of whether a taxpayer's conduct is mere negligence or is recklessness is a question of fact on which the taxpayer (plaintiff in refund suits) has the burden of proof. See, e.g., *Lawrence v. United States*, 299 F. Supp. 187, 191 (N.D. Tex. 1969).

⁸³ See cases cited in notes 78-82 *supra*.

⁸⁴ See text accompanying notes 65-77 *supra* for a discussion of the personal fault concept.

⁸⁵ 521 F.2d 325 (9th Cir. 1975).

the taxes under section 6672.⁸⁶ The use of all available funds to pay net wages was seen as a preference of wage claims over tax claims. The court concluded that the responsible person should have prorated the available funds between wages and the accompanying tax.⁸⁷

In *Slodov v. United States*⁸⁸ the Supreme Court found that the reasoning in *Sorenson* had been unnecessary to impose liability on Sorenson. Sorenson had used his personal funds rather than corporate funds to pay the net wages,⁸⁹ thus giving rise to liability for his failure as third party payor to withhold and collect taxes as they were paid.⁹⁰ The third party payor of net wages is personally liable under section 3505 (as is an employer under sections 3102(b) and 3404) for taxes which should have been withheld from wages. The liability of responsible persons under section 6672 only arises when the failure to collect, withhold, or pay over results from "willful" conduct of the responsible person. The personal liability of the employer or third party payor is absolute, unlike the liability under section 6672. Thus, it is arguable that Sorenson was not liable under section 6672.

Slodov thus leaves unclear whether payment of net wages when there are insufficient funds to pay the corresponding taxes constitutes "willfulness" under section 6672. Willfulness would not be present in this situation if there were no duty to retain funds equal to the employee's share of taxes on the wages paid. To hold otherwise would be to hold a person liable for his failure to do something that he was not required to do.

2. *The Duty to Retain Funds*

The argument that there is an obligation to fund the liability for withheld taxes at the time wages are paid has support. Several I.R.C. sections indicate a Congressional desire to have funds available and on hand to pay the tax liability. Sections 3102(a) and 3402(a) do not expressly require that funds equal

⁸⁶ *Id.* at 328. *Accord*, *Bloom v. United States*, 272 F.2d 215 (9th Cir. 1959); *United States v. Sweetser*, 77-2 U.S. Tax Cas. ¶ 9470 (M.D. Pa. 1977).

⁸⁷ 521 F.2d at 328 n.3.

⁸⁸ 98 S. Ct. 1778 (1978).

⁸⁹ *Id.* at 1787 n.14.

⁹⁰ *Id.*

to the withheld amounts be retained in any particular form.⁹¹ However, use of the terms "collect and withhold" in section 6672 suggests that the employer's duty is actually to retain something as opposed merely to avoid paying to the employee money that represents the withheld taxes.⁹² Parts of the legislative history of these provisions also can be construed to require a withholding or collection of funds.⁹³ Artfully ambiguous regulations require that the F.I.C.A. and income taxes withheld be paid over in money and arguably require that the withholding liability be funded with money.⁹⁴ The legislative history of sec-

⁹¹ I.R.C. § 3102(a) refers to the collection of F.I.C.A. taxes by deducting the amount of such taxes from wages. I.R.C. § 3402(a) refers to deducting and withholding income taxes on employee wages. Although the duty to "collect by deducting" and to "withhold" are consistent with the mere duty not to pay over to the employee, common usage would dictate the interpretation that some physical thing must be collected or withheld, *i.e.*, the property which would otherwise have been paid over to the employee.

See In re Haynes, 88 F. Supp. 379, 385 (D. Kan. 1949), in which the court concluded that "since the officer is directed by the statute to deduct the withholding tax from the employee's wages on a *percentage basis*, the payment of wages to employees charges him with having in his hands the withholding tax." (Emphasis added.)

⁹² *See* the discussion in the preceding footnote.

⁹³ In general, the committee reports paraphrase the language in the statutes. *But see* S. REP. NO. 221, 78th Cong., 1st Sess. 31-32 (to accompany H.R. 2570) (May 19, 1943) and H.R. REP. No. 510, 78th Cong., 1st Sess. 44 (to accompany H.R. 2570) (May 28, 1943). Both reports state:

Withholding under the new system will involve very considerable amounts of tax moneys which will be withheld from the wages of employees. These funds will not belong to the employers. It may well prove desirable to provide a method by which these funds will be turned over by employers, and reach their way into the Treasury, more rapidly and more currently than . . . on a quarterly basis. The purpose of section 1631 is to provide a flexible method by which this objective may be accomplished without placing undue strain on the administrative tax collection machinery.

S. REP. No. 221 states:

In order to enable employers to deposit the amounts withheld from employees with the Government at an early date, the Secretary of the Treasury may authorize incorporated banks . . . to receive the amounts withheld at such times and under such conditions as he may prescribe. If the Secretary provides proper depositories for these funds, the employers will not have to hold the funds in their possession until their returns are filed with the collector.

Id. at 7.

⁹⁴ Treas. Reg. § 31.3402(a)-1(c) 1971 states:

[A]n employer is required to deduct and withhold the tax notwithstanding the wages are paid in something other than money . . . and to pay over the tax in money. If wages are paid in property other than money, the employer should make necessary arrangements to insure that the amount of tax required to be withheld is available for payment in money.

tions 7512 and 7215 is consistent with the theory that there is a general requirement that funds be physically retained when net wages are paid.⁹⁵ The language of section 7501, which indicates that taxes are a "special fund in trust," and its legislative history appear to support the proposition that there is a duty to withhold funds when wages are paid.⁹⁶

The regulations fail to state whether these arrangements must be made before payment of wages or merely before the time for payment of the taxes.

Treas. Reg. § 3102-1 (1971) states: "The employer is required to collect the tax, notwithstanding the wages are paid in something other than money, and to pay over the tax in money." While both regulations require the employer "to collect the tax, . . . , and to pay over the tax in money," the first cited regulation does not contain commas. Whether the clause "in money" is intended to modify the duty to deduct and withhold as well as the duty to pay over is questionable. The regulations are characterized as "artfully ambiguous" based on the suspicion that the drafters of the regulation were unsure of the scope of the duty to collect but wanted to suggest that it was a duty to withhold or collect money.

⁹⁵ I.R.C. §§ 7512 and 7215 were both enacted in 1958. Under § 7512 the IRS may, under certain conditions, require that an employer do three things: (1) collect taxes withheld on wages and collect certain excise taxes, (2) deposit them in a separate bank account within two banking days, and (3) keep the deposits in that account until payment to the United States. Section 7215 imposes criminal penalties for the violation of § 7512. Exceptions to imposition of the § 7215 penalty are provided for situations when there was reasonable doubt that the law required the tax to be collected (e.g., if it is questionable whether the wage recipient was an employee or independent contractor) and when the lack of funds was due to circumstances beyond the person's control after the wage payment (e.g., theft, embezzlement, destruction of the business by flood, fire or other casualty, or the failure of a bank in which the person had deposited the funds prior to transferring them to the trust account for the government). Section 7215 specifically provides that a lack of funds existing immediately after the payment of wages (whether or not created by the payment of such wages) shall not be considered to be circumstances beyond the control of a person. *See S. REP. NO. 1182, 85th Cong., 2d Sess., reprinted in [1958] U.S. CODE CONG. & ADMIN. NEWS 2187, 2192.*

After summarizing the liability of responsible persons under §§ 6672 and 7202 of the Code, the Senate Report states: "The new feature of the penalty provided by the new section 7215 is that it is not limited to the 'willful' failure cases to which the other penalties are applicable." *Id.* at 2191. This statement in the Senate Report indicates that the willfulness defense under § 6672 may be more readily available to taxpayers than the defenses to criminal liability under § 7215. On the other hand, although liability under § 6672 should probably not be found as readily as liability under § 7215, it is consistent with the legislative history of § 7215 to treat the lack of funds created by payment of net wages as violative of the duties imposed by both § 6672 and § 7215.

⁹⁶ I.R.C. § 7501 provides that "the amount of tax so collected or withheld should be held to be a special fund in trust. . . ." The legislative history of that section says:

Under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and he cannot be treated as a trustee Section [607] of the bill [§ 7501 of present law] impresses the amount of taxes withheld or collected with a trust

3. *The Scope of Duty*

Assuming there is a duty to withhold funds, it is necessary to define "funds" in order to determine the scope of the duty to collect and withhold.⁹⁷ Since there is no duty to segregate withheld funds,⁹⁸ the definition of "funds" will also determine the extent of permissible use of withheld funds.

Although the Supreme Court refused in *Slodov* to decide whether section 7501 can serve as an independent basis for liability of responsible persons, it did conclude that section 7501 "may be regarded as informing the scope of the duty imposed by § 6672."⁹⁹ The duties imposed on the responsible person under section 6672 are thus presumed to be the same as the duties of the employer to collect and withhold under section 3102(a) and 3402(a), as modified by section 7501.¹⁰⁰ Prior to the enactment of section 7501 the liability of the person collecting

S. REP. NO. 558, 73d Cong., 2d Sess. 53 (1934).

Trust law requires that "every trust must have some property as its subject-matter." G. BOGERT, *LAW OF TRUSTS* 69 (5th ed. 1973). Further:

[t]he res of a trust may be a claim against the settlor or against a third person, but difficulties arise if an attempt is made to have a trustee hold a claim against himself . . . in trust since [this] involves the legal impossibility of the same person being obligor and obligee

Id. at 71-72. Also, a debtor usually owes his creditor *any* money but a trustee controls definite or definable property for the benefit of his beneficiary. *Id.* at 76. Based on this analysis of trust law it would appear that "the amount of tax so collected or withheld" was viewed by Congress as involving the withholding of specific property.

⁹⁷ For example, is the duty satisfied by retaining sufficient assets to cover the liability for withheld taxes or must cash be retained?

⁹⁸ "There is no general requirement that the withheld sums be segregated from the employer's general funds, however, or that they be deposited in a separate bank account until required to be paid to the Treasury." *Slodov v. United States*, 98 S. Ct. 1778, 1783 (1978). That § 7501 deems the amount withheld to be a "special fund" appears to contradict the lack of any duty to segregate withheld sums. Segregation of assets to fund a liability "is accomplished by transferring assets from a general asset account, such as cash or marketable securities, to a new specially labelled account, such as 'Special Fund'." R. AMORY & C. HARDEE, *MATERIALS ON ACCOUNTING* 130 (3d ed. Herwitz & Trautman 1959). Perhaps the lack of any duty to segregate can be based on the failure of the IRS to issue regulations requiring segregation and consequent long-standing practices.

⁹⁹ *Slodov v. United States*, 98 S. Ct. 1778, 1789 n.18.

¹⁰⁰ For a discussion of these sections, see notes 91 and 96 *supra*. There is nothing in the Code to suggest that the duty to withhold is different for the employer corporations than it is for responsible persons, even though liability of the corporation is determined under I.R.C. §§ 3102(b) and 3403 whereas a different liability for responsible persons (for willful failure) is set out in I.R.C. § 6672.

and withholding taxes took the form of a debt.¹⁰¹ Section 7501 deems the withheld funds to be a trust; the person collecting and withholding the taxes thus becomes a trustee.¹⁰² But the trustee of the withheld tax funds is unlike most other trustees in that he has no duty to segregate the withheld funds from "the employer's general funds."¹⁰³

For what funds is the section 7501 trustee responsible? Since the trustee is under no duty to segregate withheld funds into a specific account, the definition could be as broad as the total assets of a business or as narrow as cash or its equivalent.

In an accounting sense, the term "funds" is ambiguous.¹⁰⁴ As stated in a leading accounting treatise:

In a sense, funds may be defined as any positive asset or net asset classification. For practical purposes, however, the following comprise all the viable alternative concepts [alternative to the working capital concept] of funds: (1) total current assets, (2) total money (quick) assets, (3) net money (quick) assets, (4) total assets, and (5) cash and its equivalent.¹⁰⁵

If the term "funds" is given the broadest meaning, total assets, the duty of the employer to withhold funds would apparently be satisfied as long as the business had assets immediately after the payment of wages equaling the liability for the withheld taxes. The duty of accounting would be satisfied by merely recording on the employer's books the liability for the unpaid withheld taxes.

If the term "funds" were given the meaning of net assets (total assets less total liabilities), the duty to withhold would be satisfied if the business had sufficient net assets to cover the liability for withheld taxes. The choice of the net asset definition could be premised on the theory that withholding taxes requires the withholding of assets in excess of those claimed by

¹⁰¹ See S. REP. NO. 558, 73d Cong., 2d Sess. 53 (1934) (quoted in note 96 *supra*).

¹⁰² See S. REP. NO. 558, 73d Cong., 2d Sess. 53 (1934) (quoted in note 96 *supra*).

¹⁰³ *Slodov v. United States*, 98 S. Ct. 1778, 1783 (1978).

¹⁰⁴ See sources cited in note 105 *infra*.

¹⁰⁵ S. DAVIDSON, *HANDBOOK OF MODERN ACCOUNTING* 4-25 (chapter by Anton and Jaedicke 1970). The legal and common usage definitions of "funds" also show a variety of slightly different meanings. See *BLACK'S LAW DICTIONARY* 802 (4th ed. 1951); *WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY* 921 (1966).

other creditors. It is suspected by this author that in most cases where withheld funds are not paid over to the Government, there were no net assets (liabilities exceeded assets) at the time net wages were paid. Thus acceptance of this definition of funds would usually mean that the responsible person breached his duty by failing to withhold funds at the time net wages were paid.

Funds could be defined as total current assets. Since the liability for withheld taxes is a current liability, only current assets will satisfy the withholding duty. By definition, assets which are not current assets would not be available for the payment of the liability for the withheld taxes.¹⁰⁶ A further narrowing of this definition of funds to working capital (net current assets or the excess of current assets over current liabilities) could be justified by the contention that the duty imposed is to withhold funds which are available for the payment of the withheld tax liability. Such funds are those in excess of funds claimed by other creditors.

Funds could also be defined as total money assets. Inventories and prepaid expenses are excluded from the total current assets (without reduction for liabilities) to arrive at total money assets.¹⁰⁷ Such a definition of funds could further be narrowed to "cash or its equivalent" or net money assets. Net money assets are total money assets minus current liabilities. Cash or its equivalent is total money assets (without reduction for liabilities) minus accounts receivable.¹⁰⁸ Cash or its equivalent will usually consist only of cash on hand and in banks and marketable securities.

Although a broad definition of "funds" (*e.g.*, total assets) would make the duty to withhold easy to meet, it could result in more frequent failure to pay over. This would result because no identifiable fund, other than "total assets," would be regarded as being held for the payment of withholding taxes.

¹⁰⁶ In general, current assets are those funds which can be "considered to offset maturing debt which has properly been set up as a current liability." COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULLETIN No. 43, ch. 3, § A(6) n.1 (1953). Liability for withheld taxes would be a current liability. *Id.* § A(7).

¹⁰⁷ S. DAVIDSON, *supra* note 105, at 4-25.

¹⁰⁸ *Id.*

Such funds would be used in ordinary business operations and, if no funds were available to pay taxes, the withheld funds would have been depleted. Since there is no duty to segregate withheld funds, the use of funds (total assets) in business operations would not constitute a breach of duty by the responsible person. The resulting failure to pay over would be non-willful. To hold the responsible person liable for risking total assets in the business operations would contradict the lack of a duty to segregate such assets and, in effect, turn the responsible person into a guarantor of the tax liability.

A definition of funds narrower than total assets would both increase the probability of pay over and impliedly restrict the responsible person's right to use such funds. Since identifiable funds would be withheld, it is more likely that they would be held intact until time to pay over than would withheld "total assets." Also, any conversion of such funds into non-fund business assets could result in section 6672 liability. Thus, if funds are defined as total money assets (cash, securities and accounts receivable), expenditure of total money assets for raw materials or inventory would constitute a conversion of such funds into non-fund assets and the responsible person would be liable for willfully depleting such funds if total money assets were reduced below the amount of the outstanding trust fund tax liability. Defining funds as total money assets would allow the responsible person to convert cash into securities or accounts receivable (since there is no duty to segregate withheld funds), but not to convert total money assets into non-money type assets. Viewed in this manner, the duty to withhold funds is a duty to set aside those funds until the time to pay them over. The lack of a duty to segregate withheld funds allows changes in the composition of such funds, but not conversion of such funds into non-fund assets if such conversion depletes the fund below the amount of the trust fund tax liability.

The narrowest definitions of the term "funds" appear to be net money assets and cash or its equivalent. It is difficult to determine as a general rule whether the adoption of the net money assets or the cash or its equivalent concept of funds would provide the IRS with greater security for the trust fund tax liability. Net money assets might (non-willfully) disappear

if accounts receivable became uncollectable.¹⁰⁹ Cash or its equivalent might be (non-willfully) consumed if marketable securities decline in value. Acceptance of an even narrower definition, *e.g.*, net cash or its equivalent, would mean that the responsible person would be liable for failure to withhold if he withheld funds but they were subject to superior claims of other creditors at the time they were withheld and were subsequently claimed by such creditors. Since the priorities of various claims may be in doubt or may be satisfied out of future receipts, it is arguable that, as a policy matter, the responsible person should not be held liable for withholding funds in which others had priority if the priority of those claims is in doubt.

Conservative tax planning requires that the duty to withhold be interpreted by responsible persons as a duty to withhold cash or its equivalent. Such a narrow interpretation of funds ensures that an identifiable fund will be retained by the responsible person. Most existing court decisions are consistent with this interpretation of the duty to withhold.¹¹⁰ As a conse-

¹⁰⁹ See, *e.g.*, *Newsome v. United States*, 431 F.2d 742, 746 (5th Cir. 1970), wherein the responsible person had relied on the collection of accounts receivable which had been overstated by the accountants by about \$100,000.

¹¹⁰ The requirement that cash or its equivalent be withheld is consistent with the notions that withheld funds not be subjected to common business risks and that the voluntary preference of creditors other than the government which results in a lack of funds to pay the tax liability subjects the responsible person to § 6672 liability. Most courts adhere to these ideas. See, *e.g.*, *Sorenson v. United States*, 521 F.2d 325, 327-28 (9th Cir. 1975); *Newsome v. United States*, 431 F.2d 742, 748 (5th Cir. 1970); *United States v. DeBeradinis*, 395 F. Supp. 944, 951 (D. Conn. 1975), *aff'd*, 538 F.2d 315 (2d Cir. 1976); *Korman v. United States*, 35 A.F.T.R.2d 75-424, 75-425 (E.D.N.Y. 1974); *Bernardi v. United States*, 33 A.F.T.R.2d 74-523, 74-526 (N.D. Ill.), *aff'd per curiam*, 507 F.2d 682 (7th Cir. 1974). The shortcoming of these cases is that they fail to recognize certain defenses; in *Sorenson*, for example, the court failed to recognize that the willful failure was a failure to withhold cash or its equivalent and not the preference of other creditors over the government. See *Slodov v. United States*, 98 S. Ct. 1778, 1787 & n.14 (1978).

If there were no duty to withhold funds, or the term "funds" included more than just cash or its equivalent, use of all of the business' cash to pay net wages would not by itself constitute a willful failure to collect and withhold. In this situation the responsible person would have satisfied his duty to withhold by not paying the amount of withheld taxes to the employee and by having on hand sufficient funds to pay the liability (*e.g.*, total assets, net assets, net worth, etc.). Since there is no duty to segregate withheld funds, the responsible person would not violate any duty if he used funds in the business operations. By recording the liability for the withheld taxes on the employer's books and reporting the liability on the Quarterly Return, the responsible person would satisfy his duty to account truthfully for these taxes. At the time deposit

quence of this interpretation, responsible persons would be liable under section 6672 for a willful failure to withhold when they use all available cash to pay net wages or if they "willfully" dissipate cash and cannot pay withholding taxes. Reasonable doubt regarding the existence of a duty to withhold, for example, if there is ambiguity about the wage earner's status — whether employee or independent contractor — should make failure to withhold non-willful.¹¹¹ However, conservative tax planning requires that cash or its equivalent be withheld even if there is such reasonable doubt; otherwise, the taxpayer will have the burden of establishing the reasonableness of such doubt to the IRS or the courts at a later date.

D. *The Duty to Pay Over*

A willful failure to pay over withheld funds gives rise to section 6672 liability. Of course, a willful failure to withhold establishes an independent basis for section 6672 liability. If a responsible person willfully failed to withhold funds at the time net wages were paid he would be liable under section 6672. The willfulness or non-willfulness of his failure to pay over would

of payment is required, the responsible person would have the duty to use "funds" as defined above (*i.e.*, net assets, net worth, etc.) to meet the deposit or payment requirements. In order to avoid emasculating § 6672, the courts would probably limit the lack of any duty to pay over the after-acquired funds, *see* notes 120-22 and accompanying text *infra*, to *Slodov*-type situations where the responsible person assumed control after net wages had been paid. If the responsible person were allowed to use withheld funds in the business operation, *e.g.*, by adoption of a net worth definition of funds, his use of funds in such manner would not constitute a violation of his duties, but should impose on him a duty to use all such funds available at the time the duty to deposit or pay over arises, even if some of the funds were generated after the wages were paid. Because of the inconsistency between the lack of duty to pay over after-acquired funds and a broad definition of "funds," it is arguable that "funds" must be interpreted as cash or its equivalent.

¹¹¹ Reasonable doubt as to the existence of a duty to withhold is a defense to criminal liability for failure to withhold under I.R.C. §§ 7512(b), 7215. Since such failure to withhold is not a conscious violation of a *known* duty, failure to withhold under such circumstances is not willful. *See* the discussion of the definition of willfulness at text accompanying notes 65-83 *supra* and the discussion of reliance on subordinates, accountants, and attorneys at text accompanying notes 123-26 *infra*. *See also* Revenue Act of 1978, H.R. 13511, 95th Cong., 2d Sess. (1978) 530, *reprinted in* (C.C.H.) Standard Federal Tax Reports No. 36 (Extra edition Aug. 10, 1978), which restricts IRS challenges to an individual's treatment of another as an independent contractor unless the taxpayer has no reasonable basis for not treating such individual as an employee. This restriction is in force until 1980. This provision sets out specific statutory standards for treating an individual as an independent contractor.

be irrelevant. Whether the responsible person's failure to pay over withheld funds is willful depends on whether he had withheld funds to pay over. If such funds were available at the time to pay over, failure to pay over would be willful. If such funds were not available, the willfulness of the failure to pay over would depend upon whether any depletion of withheld funds during the responsible person's tenure was willful or non-willful. The responsible person could be either the same person who withheld funds (the former manager), or a person who assumed control after net wages had been paid (a new manager).

The non-willful depletion of withheld funds defense is likely to have a very limited application because of the short time period between the payment of wages and the time for depositing or paying over withheld funds.¹¹² Whether a willful failure to deposit funds is conceptually characterized as a willful failure to pay over or as a willful breach of the continuing obligation to withhold funds should not matter. Only a non-willful dissipation of funds between the time wages are actually paid and the time for deposit or pay over of withheld taxes should constitute a defense to section 6672 liability.

1. *Non-Willful Depletion of Withheld Funds by Old Managers*

The legislative history of section 7215 suggests several situations in which the dissipation of withheld funds before the date for depositing or paying over such funds could be considered non-willful for section 6672 purposes.¹¹³ Theft or embezzlement of the withheld funds, destruction of the business by flood, fire or other casualty, or the failure of a bank in which

¹¹² See note 59 *supra* and accompanying text for the applicable timetables.

¹¹³ See note 95 *supra* for the legislative history of § 7215 which discusses the interpretation of "circumstances beyond the control" of the person responsible for trust fund taxes. Although not directed at the interpretation of "willfulness" under § 6672, willfulness under § 6672 should not be interpreted more narrowly than "circumstances beyond his control" is interpreted for purposes of § 7215. See S. REP., *supra* note 95. One of the purposes in enacting § 7215 was to eliminate, in criminal cases, some of the "weaknesses" in § 6672. It was the intent of Congress not to allow defenses to § 7215 criminal liability which are allowable as defenses to civil liability under § 6672. Thus, all the defenses to criminal liability under § 7215 presumably should be available as defenses to § 6672 civil liability.

withheld funds were deposited constitute a non-willful loss.¹¹⁴ The *Slodov* opinion indicates that the responsible person does not have personal fault for favoring the superior interests of other creditors over the government.¹¹⁵ Thus, this situation is another that results in the nonwillful depletion of funds. "Surely Congress did not intend to hammer the responsible person with the threat of heavy civil and criminal penalties to pay over proceeds in which the Code does not assert a priority interest."¹¹⁶ Thus, the failure of the responsible person to pay over funds in which other creditors have superior interests may not be a willful failure to pay over and the use of funds to pay such creditors may not be a willful depletion of withheld funds. The scope of the duty to withhold may have some bearing on whether these depletions of funds are non-willful. Thus it should be the *withheld* funds that are destroyed by fire, embezzled, or paid to superior creditors before such depletion is non-willful. For example, if the duty is to withhold cash and only the inventory is destroyed, the duty to pay over should still be present.

Other situations in which the willfulness of a depletion of funds depends upon the scope of the duty to withhold are: (1) when the funds are invested in marketable securities which decline in value, and (2) when the accounts receivable of the business become uncollectable. If the duty to withhold is a duty to withhold cash or its equivalent, then the decline in value of the securities would be a non-willful depletion. If the duty to withhold is a duty to withhold only cash, a decline in the value of the securities would be irrelevant to the question of failure to pay over taxes: the cash should still be available, regardless of the securities market. If the duty to withhold is merely the duty to withhold net money assets, uncollectability of accounts receivable would make a duty to pay over non-willful. However, if it is a duty to withhold cash or its equivalent, the uncollectability would be irrelevant: A failure to pay over due to accounts receivable being collectible would not excuse a responsible person if he had a duty to withhold cash or its equivalent.

¹¹⁴ See notes 95 and 113 *supra* for discussion of this non-willfulness.

¹¹⁵ *Slodov v. United States*, 98 S. Ct. 1778, 1791 (1978).

¹¹⁶ *Id.*

It should be noted that the non-willful depletion of withheld funds defense is only valid to the extent that there has been a reduction of the funds below the amount of taxes withheld. The duty to deposit and pay over would remain as to any funds that were on hand when the duty to collect and withhold accrued and still in existence at the time the duty to deposit or pay over arises.¹¹⁷

2. *Non-willful Depletion of Funds by New Managers*

Slodov held that persons who assume control after net wages have been paid but when the withheld funds are not available to pay the tax liability from those wages are not liable under section 6672.¹¹⁸ The new managers did not have the duty to withhold funds, they were not responsible for any depletion of withheld funds (since the funds had already been depleted), and they had no duty to pay over after-acquired funds. The lack of withheld funds may have been caused by the failure of the old managers to withhold funds or by their depletion of withheld funds. In either case, the prior responsible persons would be liable under section 6672 if their failure to withhold or the prior depletion of withheld funds was willful.

If withheld funds were available to pay the trust fund tax liability at the time the new responsible person assumed control, he would be liable if he willfully allowed such funds to be depleted and the tax liability went unpaid.¹¹⁹ The willfulness in this situation would be determined according to the principles outlined in the previous section of this article dealing with depletion of funds by old managers.

¹¹⁷ Withheld funds can be conceptualized as an unsegregated portion of the corporation's total cash and securities. If the withheld taxes were \$20 and the total cash and securities were \$100, embezzlement of \$85 cash would leave the responsible person liable under § 6672 only for the remaining \$15 of trust funds. See *Newsome v. United States*, 431 F.2d 742, 746 (5th Cir. 1970).

¹¹⁸ 98 S. Ct. at 1791.

¹¹⁹ Cf. *Slodov v. United States*, 98 S. Ct. 1778, 1791 (1978):

We hold that a 'responsible person' under § 6672 may violate the 'pay over' requirement of that statute by willfully failing to pay over trust funds collected prior to his accession to control when at the time he assumed control the corporation has funds impressed with a trust under § 7501. . . .

3. *Funds Acquired After Depletion of Withheld Funds*

In *Slodov*, a person who acquired a business with a liability for unpaid withholding tax and insufficient funds to pay those taxes had no liability under section 6672 for failing to use after-acquired funds to pay the tax liability. The Court refused to impose a trust on after-acquired property¹²⁰ and refused to impress a fiduciary duty on the responsible person to pay this after-acquired cash.¹²¹ Even those who are not new managers are under no duty to pay over after-acquired property.¹²² Thus, an old manager who withheld taxes need not pay over after-acquired property provided that the withheld funds were not willfully depleted by him. If the back taxes are not voluntarily paid in this situation, the IRS must use its collection procedures to recover the tax from the employer.

E. *Reliance on Others as a Defense to Willfulness*

1. *Reliance on Subordinates, Accountants, and Attorneys*

In many instances an individual charged with responsibility under section 6672 will claim that any dereliction on his part was not "willful" because his actions were based on the advice of others. For example, advice of counsel to the effect that there was no tax liability was held to preclude a finding that the failure to pay over the withheld taxes was willful.¹²³ The same holding was extended to a person who acted upon the advice of his attorney and a special deputy tax collector to the effect that he was not required to collect the tax.¹²⁴ Similarly, when the responsible person delegated to subordinates the duty to collect and pay over the taxes, some cases have held the failure to pay over the taxes was not a willful act by the responsible person.¹²⁵ The above cases consistently require an aware-

¹²⁰ *Id.* at 1789.

¹²¹ *Id.* at 1789-90.

¹²² *Id.* at 1790-91 (neither § 6672 nor § 7501 imposes a trust on after-acquired cash).

¹²³ *Cross v. United States*, 204 F. Supp. 644 (E.D. Va.), *rev'd*, 311 F.2d 90 (1962). The court of appeals reversed the lower court on the grounds that the party charged with responsibility had been told by the IRS that a tax liability did in fact exist. Thus, it appears that the advice of counsel, standing alone, would have been an acceptable defense.

¹²⁴ *Gray Line Co. v. Granquist*, 237 F.2d 390 (9th Cir. 1956).

¹²⁵ *See, e.g., Wiggins v. United States*, 188 F. Supp. 374 (E.D. Tenn. 1960); *Dan-*

ness of the tax liability and an awareness of nonpayment prior to a finding of willful conduct. By contrast, another case which involved a responsible person who knew of the existence of the unpaid tax liability but relied on the advice of others not to pay the tax held that nonpayment by the responsible person was willful.¹²⁶

This distinction between reliance on advice as to the existence of the unpaid tax and reliance on others as to the need to pay over the tax when due is consistent with both the conscious act and personal fault concepts of willfulness. There is no personal fault if one does not know that a tax obligation exists or that an existing one is unpaid. Similarly, there is no conscious act if one does not have full knowledge of the outstanding tax obligations. Neither concept would excuse one who consciously chose not to collect or pay the taxes when due.

2. *Reliance on Representations by IRS Agents*

a. *Representations Regarding the Existence or Minimization of Tax Liability*

Reliance on statements by IRS agents that no tax liability exists, like reliance upon subordinates and other experts, can serve as a basis for showing lack of willfulness.¹²⁷ There should be no personal fault or conscious act when the responsible person has reasonably relied on an IRS agent as to the nonexistence of any tax liability.¹²⁸

iels v. United States, 149 F. Supp. 644 (D. Ariz. 1956). See also Adams v. United States, 35 A.F.T.R.2d 75-1174, 75-1177 (W.D. Wis. 1974). But see Lawrence v. United States, 299 F. Supp. 187, 191 (N.D. Tex. 1969), and the text accompanying notes 78-84 *supra* for a discussion regarding reckless disregard for obvious or known risks.

Reasonable doubt that the law required the responsible person to collect or withhold the taxes (if it were questionable whether the wage recipient were an employee or an independent contractor, for example) should be a defense to willfulness under § 6672. See also note 95 *supra* for the legislative history of I.R.C. § 7215 and for other examples of non-willful conduct.

¹²⁴ Hirsch v. United States, 396 F. Supp. 170 (S.D. Ohio 1975). See also Newsome v. United States, 431 F.2d 742 (5th Cir. 1970), in which liability was found. Accountants had overstated accounts receivable by about \$100,000 and the responsible person used corporate funds to pay other creditors, relying on future collection of the \$100,000 receivables to pay trust fund taxes.

¹²⁷ See Gray Line Co. v. Granquist, 237 F.2d 390 (9th Cir. 1956).

¹²⁸ See text accompanying notes 65-77 *supra* for discussion of these two standards of liability.

A more difficult question is presented when the IRS agent tells the responsible person that he may continue in business and the IRS will reduce or eliminate his personal liability. Taxpayers have been successful in avoiding section 6672 liability when an IRS agent agreed to minimize taxpayer's liability by applying all tax collections toward the liability for withheld taxes and the collections were not so applied.¹²⁹ Similarly, a taxpayer should be protected from section 6672 liability if the IRS agrees to minimize his personal liability by attaching corporate assets and the IRS subsequently fails to attach the corporate assets.¹³⁰

Two possible reasons for protecting taxpayers exist in these situations. First, the government should be estopped from enforcing taxpayer's liability to the extent taxpayer's reliance on the agent's promises caused taxpayer to forego an opportunity to extinguish his liability. The difficulty with this estoppel theory is that estoppel will not lie against the government for statements by a government agent which exceed his authority. In *Federal Crop Ins. Corp. v. Merrill*,¹³¹ a federal statute expressly prohibited the benefits (insurance on reseeded crops) promised by the government agent. Although no statute expressly prohibits IRS agents from minimizing liability through the specific application of tax collections, the attachment of assets, or even broad "hold harmless" representations, IRS agents have "no powers to suspend the liability of the tax statutes."¹³² However, since the IRS does have discretion regarding the application of tax payments and the use of enforcement procedures, they should at least be held to the promises they had authority to make.

The second reason for relieving taxpayer of liability that

¹²⁹ *Slodov v. United States*, 552 F.2d 159, 162-63 (6th Cir. 1977), *rev'd on other issues*, 98 S. Ct. 1778 (1978); *McKenzie v. United States*, 536 F.2d 726 (7th Cir. 1976). See also *Tozier v. United States*, 16 A.F.T.R.2d 5626, 5633 (W.D. Wash. 1965).

¹³⁰ See *McCarty v. United States*, 437 F.2d 961 (Ct. Cl. 1971); *Tozier v. United States*, 16 A.F.T.R.2d 5626 (W.D. Wash. 1965). In many cases the taxpayer has not been successful in establishing the existence of such misleading representations. See, e.g., *Monday v. United States*, 25 A.F.T.R.2d 70-548, 70-553 (7th Cir. 1970); *Spivak v. United States*, 370 F.2d 612, 614 (2d Cir. 1967); *United States v. DeBeradinis*, 36 A.F.T.R.2d 75-5109, 75-5116 (D. Conn. 1975).

¹³¹ 332 U.S. 380 (1947).

¹³² *Carrol v. United States*, 67-2 U.S. Tax Cas. ¶ 9656 at 85,199 (S.D.N.Y. 1967).

he might have extinguished but for his reliance on representations by an IRS agent lies in the responsible person's lack of personal fault. The *ultimate* nonpayment of the liability for withheld taxes was caused by the taxpayer's reliance on the representations of the IRS agent, not the personal fault of the responsible person. Although taxpayer, by allowing the tax deficiency to arise, was guilty of a "conscious violation of a known duty," he might have corrected that violation by using available cash or liquidating assets to get cash to pay the outstanding liability. Reliance on the express promises of the IRS agent, which the IRS failed to fulfill, was the final determinative cause for nonpayment of the trust fund tax liability. Under this rationale, the government could be held to its representations, including its "hold harmless" representations, if the taxpayer passed up the opportunity to use business assets or receipts in reliance thereon. The issue of hold harmless representations may be academic since the IRS will in most cases allow business continuation without making any promises¹³³ or with statements confirming the responsible person's continuing liability.¹³⁴

b. *Representations Regarding the Continuation of Business*

After notification to and consultation with the corporate managers concerning the delinquency in trust fund taxes, the IRS sometimes postpones pressing its demands for the immediate payment of unpaid taxes and allows the business to continue operations. For example, the evidence in *Slodov* indicated that the IRS advised the petitioner to continue in business if he could meet current tax obligations.¹³⁵ The motivation may be an effort to prevent increased unemployment in an economically depressed area¹³⁶ or a desire to increase the potential of recovering back taxes.¹³⁷ For example, if a corporation had \$20,000 in net free assets and owed \$25,000 for FICA and income taxes withheld from employees, \$7,000 for the em-

¹³³ In *Slodov* the Supreme Court expressly found that the IRS had not made a "hold harmless" representation. *Slodov v. United States*, 98 S. Ct. 1778, 1783 (1978).

¹³⁴ *Id.* at 1782.

¹³⁵ *Id.*

¹³⁶ See, e.g., *Tozier v. United States*, 16 A.F.T.R.2d 5626, 5630 (W.D. Wash. 1965).

¹³⁷ See *Slodov v. United States*, 98 S. Ct. 1778, 1787 (1978).

ployer's share of FICA taxes, and \$50,000 for corporate income taxes, the IRS might allow continuation of business operations to maximize its chances of collecting more than \$20,000 of the total tax liability of \$82,000. The corporate officers might be motivated to continue business operations by a desire to protect their own jobs¹³⁸ as well as the interests of the company's investors, creditors, clients, and employees.

In *Slodov* the Supreme Court expressed concern over penalizing the responsible person who continues business operations for "doing what the Government regards as maximizing its [the government's] chances for recovery."¹³⁹ The Court thus raises the question of the existence and scope of an authorized continuation of business defense to section 6672 liability. If there is some form of authorized business continuation defense, is it available to both old and new managers?

i. *Nature and Scope of Authorized Business Continuation Defense*

In *Slodov* the Supreme Court held that the responsible person who acquires a business with a liability for unpaid withholding taxes and insufficient withheld funds to pay that liability has no personal fault for failing to use after-acquired funds to pay the tax liability. The lack of a duty to use after-acquired funds to pay the existing trust fund tax liability means that the liability of the responsible person with respect to such existing liabilities will not be increased by his continuation of the business. However, business continuation may alter the risk which the responsible person has with respect to such existing tax liabilities. For example, if a corporation owed \$27,000 in trust fund taxes and had only \$20,000 in available funds, by continuing the business there is a risk that the available funds will be depleted. Should the risk of loss of the \$20,000 be shifted to the government on the theory that by allowing business continuation there was an implied promise to hold the responsible person harmless for his use of this \$20,000 in business operations? Since both the IRS and the responsible person presumably had something to gain by continued business operations, at least

¹³⁸ See *United States v. Sotelo*, 98 S. Ct. 1795, 1802 n.13 (1978).

¹³⁹ 98 S. Ct. at 1788.

when the responsible person was the one who decided to continue operations, it does not appear unfair to leave the risk of deterioration of the financial condition on the responsible person. But what if the responsible person had been opposed to business continuation and the decision to continue operations was made by the owners or other managers? Should the liability of the responsible person continue unchanged even though he had wanted to use the \$20,000 to pay part of the trust fund tax liability and to sell \$7,000 of assets to pay the remainder of the liability? Under such circumstances the taxpayer is not in fact the responsible person since he could only pay the tax liability with the consent of another person who refused to consent. However, if the taxpayer had the power to pay over the withheld \$20,000 when that amount was due, then he would have been a responsible person at that time.

The fact that the risk assumed by the responsible person when he failed to withhold or pay over may be altered by circumstances beyond his control at a later date should not relieve him of his liability. It is the opinion of this author that the liability of a responsible person should not be decreased merely because the IRS allowed business continuation. Risk of financial deterioration of the business should continue to be shouldered by the responsible person. In this manner the IRS will be given the greatest flexibility in maximizing the chances of collecting the unpaid taxes; it may attempt immediate collection or it may allow business continuation without relieving the responsible person of his personal liability for his failure to withhold or pay over trust fund taxes at the appropriate time. The IRS should be bound by express hold harmless representations but such promises should not be implied from the mere authorization to continue business. Interpreted in this manner the authorized business continuation defense merely restates the lack of any duty to pay over after-acquired funds.

That a taxpayer might be misled into believing he is following the proper course after being authorized by the IRS to continue business operations is not difficult to imagine. Fairness to the taxpayer requires that he be given an express warning of the nature of the risk he assumes by continuing business operations. The taxpayer should be warned that he will continue to be personally liable for the unpaid trust fund taxes to

the extent he was liable before the agreement with the IRS to continue business. If the IRS so decides, it should even be allowed expressly to condition business continuation on the payment of back taxes out of subsequently acquired, first-available receipts. However, the attachment of such an express condition is likely to be a rare occurrence since it would often lead to immediate business termination.

ii. *Applicability to Old and New Managers*

The *Slodov* opinion raises the question of whether authorized business continuation should produce different consequences for old managers than for new managers. Specifically, does the defense apply to protect only responsible persons who are new managers, *i.e.*, managers who acceded to control after net wages were paid and at a time when no funds were available to pay the back taxes? Or does it apply to protect a continuation of business by the old managers, *i.e.*, those who paid the net wages?

Clearly, the Supreme Court was not expressly creating an all-encompassing rule applicable to both old and new managers in *Slodov*:

When the same individual or individuals who caused the delinquency in any tax quarter are also the 'responsible persons' at the time the Government's efforts to collect from the employer have failed and it seeks recourse against the 'responsible employees,' see IRS policy statement P-5-60, IRS Manual, MT 1218-56, there is no question that § 6672 is applicable to them. It is the situation that arises when there has been a change of control of the employer enterprise, here corporations, prior to the expiration of a tax quarter, or at a time when a tax delinquency for past quarters already exists that creates the question for our decision.¹⁴⁰

Nevertheless, the policies supporting the decision require an extension of the protection afforded in *Slodov* to old as well as new managers who continue business operations with the consent of the IRS. The distinctions between old and new managers are insufficient to warrant differentiating between them for purposes of section 6672.

¹⁴⁰ *Id.* at 1784.

The Supreme Court stated two reasons for finding that the new managers had no personal fault. One was that liability would discourage changes of ownership and management of financially troubled corporations.¹⁴¹ A second was a wish to facilitate the infusion of additional outside funds into the business.¹⁴²

Neither of these arguments offers a sound basis for treating new managers more favorably than the old managers. Regarding discouragement of changes of management, treating the old and new managers alike would have a neutral effect. By holding new managers to less strict standards of liability the decision appears to encourage changes in management.¹⁴³ The objective should be neither to encourage nor discourage changes in management. Since both old and new managers can be responsible persons, identical standards for measuring their personal fault would have a neutral effect on changes in management.

That an infusion of equity or debt financing might accompany the change in ownership is not a valid reason for treating new managers differently from the old. Neither old nor new managers have an obligation to contribute funds to the business.¹⁴⁴ It is arguable that by allowing the old managers to continue the business they might also contribute additional funds to the business. Furthermore, if the owners are not the managers of the business, infusion of additional funds by the owners is as likely to occur with new or old managers. The *Slodov* situation is not distinguishable, on these policy

¹⁴¹ See text accompanying note 144 *supra*.

¹⁴² *Id.*

¹⁴³ Finally, there can be little doubt that the Court's ruling today will result in changes in management and ownership which are in fact nothing but subterfuges to avoid using the company's funds to pay outstanding trust fund tax obligations. The investors in any corporation seriously in arrears will also have a strong incentive to arrange changes of management, whether sham or real, in order to permit funds acquired by the corporation to be used for purposes other than satisfying its tax obligations without exposing its managers to personal liability. In addition, changes of ownership, often more formal than real, will frequently be arranged for no purpose other than to permit the concern to use future funds without regard to its pre-existing tax obligations.

Slodov v. United States, 98 S. Ct. 1778, 1794 (1978) (White, J., dissenting).

¹⁴⁴ *Id.* at 1788.

grounds, from the more common situation where the existing responsible persons are authorized by the IRS to continue the business operations after notice of the unpaid tax liability.

On the basis of underlying policies, identical standards of liability should be applied to both old and new managers for business continuations. However, application of identical standards of fault will usually have different consequences for each category of responsible person.

The personal fault of the old managers will usually be found in the failure to withhold funds or the failure to deposit or pay over such funds at the applicable due date. Only a non-willful dissipation of withheld funds between the time taxes were withheld and the due date for deposit or payover, an unlikely occurrence, will relieve them of their existing personal fault.¹⁴⁵ New managers, on the other hand, will have no existing personal fault at the time business continuation is allowed if, as in *Slodov*, withheld funds had been depleted before they assumed control.¹⁴⁶ Thus, old managers usually will already have personal fault at the time business continuation is allowed but new managers will usually not have such personal fault. Authorized business continuation should not expand or *diminish* the personal fault of old or new managers, thus the old managers' liability is not relieved and the new managers' liability is not increased. Of course, if the old managers' personal fault were excused by a timely non-willful dissipation of withheld funds, the liability of the old managers should not be reinstated because he continued business operations. Similarly, if the new managers had personal fault, *e.g.*, withheld funds were not depleted prior to their accession to control, such personal fault should not be relieved by authorized business continuation. Viewed in this manner, the authorized business continuation defense involves no more than application of the general principle that there is no personal fault for a failure to use after-acquired funds to pay off existing trust fund tax liabilities. Although the policy reasoning used by the Supreme Court to distinguish liability of old and new managers is not sound, application of the after-acquired funds doctrine to old

¹⁴⁵ See notes 112-19 *supra* and accompanying text for a discussion of the depletion of funds.

¹⁴⁶ *Id.*

and new managers will usually result in differences in liability of such persons.

c. *Failure of the IRS to Attempt to Collect Taxes from the Employer*

The failure of the IRS to attempt to collect the back taxes from corporate assets does not relieve the responsible person from liability.¹⁴⁷ Even when the responsible person requests that the IRS seize assets in the hands of third persons, the courts have concluded that "this defense that the IRS has a duty to act as a collection agency for the defendant is without merit."¹⁴⁸ The ultimate rejection of this defense is illustrated by *Teel v. United States*, in which liability remained despite the failure of the IRS to exercise the priority of its lien over the assets of the corporation in a receivership proceeding.¹⁴⁹

To be consistent with *Slodov's* concept of personal fault, the failure of the IRS to attempt to collect the unpaid taxes from corporate assets in bankruptcy or receivership should be

¹⁴⁷ *Monday v. United States*, 421 F.2d 1210 (7th Cir.), cert. denied, 400 U.S. 821 (1970) (IRS failed to attempt collection of accounts receivable); *Datlof v. United States*, 370 F.2d 655 (3d Cir. 1966); *Cash v. Campbell*, 346 F.2d 670 (5th Cir. 1965); *Spiegel v. United States*, 16 A.F.T.R.2d 5667 (N.D. Ga. 1965). But cf. *Tozier v. United States*, 16 A.F.T.R.2d 5626 (W.D. Wash. 1965) (IRS released property which it had previously levied and attached).

¹⁴⁸ *United States v. DeBeradinis*, 395 F. Supp. 944, 953 (D. Conn. 1975).

¹⁴⁹ 529 F.2d 903, 906 (9th Cir. 1976). Cf. *Spivak v. United States*, 370 F.2d 612 (2d Cir. 1967) (taxpayer held liable even though the IRS compromised its claim during bankruptcy proceedings for the corporation since taxpayer had notice of the proposed compromise and failed to object); *Bernardi v. United States*, 33 A.F.T.R.2d 74-523 (N.D. Ill. 1973) (dicta that responsible person is not relieved from liability even if the IRS does not use due diligence in bankruptcy proceeding since liability of responsible person is distinct from liability of corporation). Characterization of liability of the responsible person as distinct from that of the corporation fails to recognize that the duty to attempt collection is owed by the IRS to both the corporation and the responsible person.

Liability of a responsible person should not be based merely on the fact that assets were transferred to a receiver in bankruptcy before they had been liquidated by the responsible person to pay the trust fund tax liability. After-acquired funds are not impressed with a trust, see note 122 *supra*, and thus § 6672 liability arguably must be based upon a failure to withhold cash or its equivalent, or a misapplication of such withheld funds. If neither of these duties have been breached the responsible person should not be liable under § 6672 — even if the withheld funds were transferred to a receiver before payment to the IRS. In *Slodov*, the IRS conceded and the Supreme Court agreed that the responsible person does not have a duty "to liquidate corporate assets to satisfy the tax obligations." 98 S. Ct. at 1788-89.

a valid defense under section 6672. The policy allowing the IRS a flexible approach in determining how best to maximize tax collections is no longer applicable after the business is in the process of dissolution.¹⁵⁰ While the responsible person may be at fault for his failure to withhold, collect, or pay over,¹⁵¹ the government exhibits greater fault in not taking advantage of its last chance to collect from corporate assets in bankruptcy.

The stated policy of the IRS is that "[t]he 100% penalty will be asserted against responsible officers and employees of the corporation only if such taxes cannot be collected from the corporation itself."¹⁵² Thus, the IRS violates its own policy when it attempts to ambush the corporate officers with section 6672 personal liability rather than collect from the corporation. As a practical matter, it would be difficult to ground an estoppel defense to section 6672 liability on this policy since very few responsible persons will know of its existence and be able to claim reliance on it. However, there is a sufficient connection between the inaction by the IRS and the taxpayer's nonpayment of taxes to warrant estoppel in this case. The IRS policy statement reflects the reasonable expectation of taxpayers: the expectation that the IRS will not consciously let the corporate assets get beyond its reach and then punish the taxpayer with personal liability. Although most taxpayers presumably do not know about the IRS policy statement, they probably do rely on a belief that the IRS will attempt to collect the unpaid taxes from the corporation's assets after those assets are beyond the control of the responsible person and the corporation is in the process of dissolution.

Nonpayment of taxes with the reasonable expectation that those taxes will be collected out of corporate assets (assuming there are sufficient assets available) is no more a "willful" nonpayment than would be the delivery of cash to a clerk to pay the taxes where the clerk later absconds with the funds. In

¹⁵⁰ The responsible person's defense to liability for the government's failure to collect from corporate assets prior to bankruptcy or receivership must be based on express representations of the IRS. See text accompanying note 130 *supra* and discussion of authorized business continuation at text accompanying notes 135-46 *supra*.

¹⁵¹ Teel v. United States, 529 F.2d 903 (9th Cir. 1976).

¹⁵² IRS Policy Statement P-5-60 (MT 1218-56, approved Nov. 5, 1965), reprinted in 1 (C.C.H.) I.R.M. 130-25, -26.

neither case would the nonpayment be willful because in neither case would nonpayment be intentional.

Responsible persons are advised to liquidate corporate assets and pay all past due tax liabilities prior to transferring any assets to a receiver, even though they may have no such duty. The IRS may fail to assert the priority of its liens in bankruptcy and such failure by the IRS may not relieve the responsible person of his liability. Even if the IRS does assert the priority of its liens, the claims for unpaid taxes withheld from employees' wages will often be merely a fourth priority claim in bankruptcy.¹⁵³

III. SUGGESTED REFORMS

A. Application of Tax Payments

The current practice of the IRS is to apply tax payments and collections against non-trust fund tax liabilities before applying them to trust fund liabilities.¹⁵⁴ Courts have sustained this exercise of discretion on the grounds that the IRS is merely attempting to maximize tax collections by not relieving responsible persons of their liability under section 6672.¹⁵⁵ Only in the case of timely payments accompanied by written directions regarding application of funds will the IRS apply those payments against trust fund tax liabilities.¹⁵⁶ One consequence of these allocation policies is that persons familiar with the tax laws may make timely payment with appropriate instructions and thereby eliminate their personal liability under section 6672. Less conniving taxpayers, unaware of the operation of section 6672 and IRS allocation policies, might pay much larger total amounts and yet fail to extinguish any of their liability under section 6672. It is possible that a taxpayer who has been

¹⁵³ See generally J. MOORE & L. KING, *supra* note 6, at § 64(A).

¹⁵⁴ See *Slodov v. United States*, 98 S. Ct. 1778, 1788 n.15 (1978); *Kalb v. United States*, 505 F.2d 506, 509 (2d Cir. 1974), *cert. denied*, 421 U.S. 979 (1976); *Liddon v. United States*, 448 F.2d 509, 513 (5th Cir.), *cert. denied*, 406 U.S. 981 (1971); *Monday v. United States*, 421 F.2d 1210 (7th Cir.), *cert. denied*, 400 U.S. 821 (1970); *Hirsch v. United States*, 306 F. Supp. 170, 172-73 (S.D. Ohio 1975); *United States v. DeBeradinis*, 395 F. Supp. 944, 952 (D. Conn. 1975).

¹⁵⁵ See *O'Dell v. United States*, 326 F.2d 451, 456 (10th Cir. 1964); *Hirsch v. United States*, 306 F. Supp. 170, 173 (S.D. Ohio 1975).

¹⁵⁶ See, e.g., *United States v. DeBeradinis*, 395 F. Supp. 944, 952 (D. Conn. 1975). See also cases cited in note 154 *supra*.

authorized to continue business operations by the IRS will pay over trust fund taxes on current wages and that the IRS will apply those payments to past due taxes, trust fund or otherwise.¹⁵⁷

All tax payments and collections, including late payments and enforced collections, should be applied first against trust fund tax liabilities. Even though the amounts paid or collected may not be traceable to "trust funds,"¹⁵⁸ it is an unreasonable exercise of discretion by the IRS to allocate these receipts to non-trust fund tax liabilities for several reasons. Congress has singled out the employee's share of taxes on wages for special treatment because of the alleged importance of collecting such taxes. This importance reinforces the idea that tax payments should be applied to trust fund liabilities first. Also, such application would eliminate the distinction between those aware of section 6672 and those unaware. Finally, in the case of IRS authorization to continue business operations, application of trust fund taxes from current wages to past due taxes violates the section 7501 trust concept. When the IRS allocates receipts to non-trust fund tax liabilities, the nonpayment of the trust fund taxes is caused more by the IRS allocation method than by the personal fault of the responsible person.

B. *Suggested Legislative Changes*

Wage and employment tax withholding is an integral part of our self-assessment system of taxation. For fiscal year 1977, withheld income and F.I.C.A. taxes comprised approximately fifty percent of gross Internal Revenue Collections.¹⁵⁹ Withheld income taxes constituted about eighty percent of individual income tax collections.¹⁶⁰ Arguably, withheld taxes are different from other taxes. The Social Security Law requires that the

¹⁵⁷ See *Slodov v. United States*, 98 S. Ct. at 1788 n.15.

¹⁵⁸ Actual tracing of funds is required in determining priorities of creditors regarding the § 7501 trust fund. See *id.*; *United States v. Randall*, 410 U.S. 513, 517 (1971).

¹⁵⁹ COMMISSIONER OF INTERNAL REVENUE ANN. REP. 14 (1977). Gross Internal Revenue collections in 1977 were about \$355 billion, corporate income taxes \$60 billion, individual income taxes \$187 billion, F.I.C.A. taxes \$78 billion, and other taxes \$30 billion. The total withheld from employees' wages was \$184 billion, composed of \$145 billion withheld income taxes and \$39 billion F.I.C.A. taxes. *Id.*

¹⁶⁰ *Id.* Withheld taxes accounted for about 83% of total individual income tax collection in 1976. COMMISSIONER OF INTERNAL REVENUE ANN. REP. 137 (1976).

employee be given credit for F.I.C.A. earnings regardless of whether the F.I.C.A. tax was collected.¹⁶¹ Employees can get refunds of income taxes withheld from their wages even if such withheld amounts are not paid to the government by the employer.¹⁶²

Assuming the withholding system is a necessary component of our tax system, section 6672 would appear to be a useful tool in implementing the withholding system. Fear of personal liability for nonpayment of withheld taxes should induce compliance with the duty to withhold and pay over such taxes. The problem with section 6672 is that it does not create fear of personal liability, often because taxpayers do not know about section 6672 or because they believe the business will produce sufficient funds in the future to pay this liability. The Trust Fund Compliance Program¹⁶³ of the IRS does help place the responsible person on notice of delinquencies in this handling of trust fund taxes. The warning could be made even more effective by including express notification of section 6672 liability to responsible persons. In addition, better publicity of the section 6672 penalty by the IRS to responsible persons is needed *before* any delinquency occurs.

Ambiguity in sections 3102(a) and 3402(a) as to precisely what must be withheld¹⁶⁴ is partially responsible for the hidden-trap nature of section 6672 liability. If the duty to withhold is to be treated as a duty to withhold cash or its equivalent, then the statute should expressly so state, rather than leaving the interpretation of the duty to withhold to be drawn by inference from decided cases and regulations.

¹⁶¹ Benefits are based, in part, on earnings. 42 U.S.C. §§ 402, 414, 415 (1976). Earnings include amounts deducted from employees' wages. 20 C.F.R. §§ 404.1026(c), .801 (1978).

¹⁶² I.R.C. § 31 states "[t]he amount withheld under section 3402 as tax on the wages of any individual shall be allowed to the recipient of the income as a credit against the tax imposed by this subtitle." Treas. Reg. § 1.31-1 (1960) says that "[i]f the tax has actually been withheld at the source, credit or refund shall be made to the recipient of the income even though such tax has not been paid over to the Government by the employer." Dicta in several cases support the regulations. *Moore v. United States*, 465 F.2d 514, 517 (5th Cir. 1972); *Dillard v. Patterson*, 326 F.2d 302, 304 (5th Cir. 1963); *United States Fidelity & Guar. Co. v. United States*, 201 F.2d 118, 120 (10th Cir. 1952).

¹⁶³ MS 5(10)G-22 (approved Feb. 6, 1976), *reprinted in* 4 (C.C.H.) I.R.M. 24,069-21.

¹⁶⁴ See text accompanying note 94 *supra* for a discussion of this ambiguity.

The lack of any duty to segregate withheld "funds" contributes further to the problem of unawareness. Accepted accounting practice is consistent with the interpretation of the duty to collect and withhold as a duty merely to avoid paying withheld amounts to the employee rather than requiring funding of the liability with cash or its equivalent.¹⁶⁵ When a corporation pays wages it often simply makes an accounting entry charging the wage expense account for the gross wages, credits cash for the net wages paid, and credits a payables account to reflect the unpaid tax liability.¹⁶⁶ Generally, no separate fund is created; no cash or other assets are earmarked for payment of the withheld amounts. A responsible person could hardly be expected to know that he had "willfully" failed to collect and withhold taxes on wages paid at this time since the accounting records suggest he has done all he is required to do.

Arguably, current accounting practices are deficient in that they fail to reflect a duty to actually withhold "cash or its equivalent." Accountants could footnote the cash account or make an entry reflecting a transfer of cash from the general cash account to a special withheld tax funds account. Such an entry on the books, without any segregation of actual funds, would reflect the duty to withhold cash or its equivalent without earmarking specific dollars for the payment of that liability. However, making such a bookkeeping entry without the segregation of actual funds still exposes the responsible person to the risk that he will look to the bank statement to determine available cash for payment of other creditors and inadvertently expend the trust fund. The requirement of segregation of actual funds at the time wages are paid would inform the responsible person of his duty to collect and withhold funds at that time and would also eliminate the possibilities of an expenditure of such withheld funds. Even though there is no duty to segregate withheld funds at this time, accountants should advise their clients to transfer funds into a separate bank account entitled "Withheld taxes—trust fund account" at the time payrolls are prepared.

¹⁶⁵ "Amounts withheld from employees by law or by agreement give rise to liability accounts which substitute for the amount that would otherwise have been paid to the worker." S. DAVIDSON, HANDBOOK OF MODERN ACCOUNTING 24-9 (chapter by L. Vance 1970).

¹⁶⁶ *Id.* at 24-9.

Imposition of a duty to segregate withheld tax funds at the time wages are paid should further the congressional purpose of assuring the collection of trust fund taxes without imposing a substantial burden on employers, the IRS, or responsible persons. Since the employer and responsible person presumably have a duty not to reduce cash below the liability for withheld taxes, imposition of a duty to earmark specific dollars or other assets to meet that obligation should not appreciably affect the cash flow of business. The imposition of a duty to segregate is also consistent with the section 7501 trust concept and the fact that the "trust" is not recognized unless the tracing requirement is satisfied. Such a duty will go a long way toward the elimination of the hidden-trap nature of section 6672.

CONCLUSION

Applications of section 6672, as currently interpreted, often impose a harsh penalty on morally innocent and unsuspecting business managers. The harshness of that penalty is highlighted by the Supreme Court's decision that such penalties are non-dischargeable in the personal bankruptcy of the responsible person.¹⁶⁷ Although the decision in *Slodov* does make "personal fault" a prerequisite to finding "willfulness," it is likely that the personal fault concept will not, in most cases, provide different results than would the prior interpretations of willfulness.

In addition to the emphasis given to the concept of personal fault, *Slodov* is important for suggesting a theoretical framework for analysis of the duties of a responsible person. The lack of a duty to pay over after-acquired funds is consistent with an apparent interpretation of the statutory scheme as requiring the responsible person to withhold *funds* equal to the liability for withheld taxes when wages are paid.

At the present time, the exact status of this duty is unclear. Reform is badly needed to inform responsible persons of their duties. Section 6672 will continue to fall short of its intended purpose until the persons subject to liability are made aware of their duties. This awareness should be provided, in part, by congressional action.

¹⁶⁷ United States v. Sotelo, 98 S. Ct. 1795 (1978).

