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Abstract
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Keywords
Payroll Taxes, New Business, IRS, Personal Liability

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Payroll Taxes and Personal Liability

by
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Many corporate officers and responsible employees may be exposing their personal assets to liability for unpaid corporate payroll taxes. The authors discuss where liability may arise and identify strategies to avoid personal liability.

Starting up any business can be risky. Statistics show that a significant number of new businesses will fail within the first three years of operations. In the restaurant industry, the rule of thumb has always been that within the first two years of operations 80 percent of all new restaurants will fail or change ownership. Even though a recent study shows that this may be an overestimate, there is still considerable risk in opening up a new restaurant.

One of the first financial problems any new business will encounter is that of insufficient cash flow. A study by Muller and Woods suggests that for long-term economic survival, a restaurant should plan for adequate cash flow for the first three years of operation. How this cash flow is managed will have an impact on both the business and its employees. If it is not properly managed, officers and employees of the corporation may be incurring additional liability and not realizing it.

When there is insufficient cash available to pay all creditors, a decision has to made as to which creditors should be paid. The group of creditors will consist of suppliers, financial institutions, and the federal government. The debt to the federal government will consist of income and Social Security taxes that the employer is required to withhold from the employee's paycheck, and the Social Security and unemployment taxes that the employer is required to pay.

The problem arises when corporate officers and employees prefer other creditors over the federal government. They will use funds that they have set aside to pay the federal government to pay suppliers. The plan is to pay the suppliers now and then later, when cash becomes available, remit what is due to the government. Corporate officials see this as a cheap way of borrowing money. However, in reality, this is a very expensive strategy.

When a business fails to remit withholding and payroll taxes to the government, there are a number of penalties to which it will be subject: failure to deposit, which is 10 percent of the delinquent
deposit; failure to file employer quarterly tax return, which is .5 percent of the amount due per month, up to 25 percent of the amount due; and failure to pay, which is 5 percent of the amount due, up to 25 percent of the amount due. Besides these penalties, interest will accrue on the amount due at a rate equal to the federal short-term rate plus 3 percent. With penalties and interest, a $10,000 tax liability can increase to $14,050 in six months. This creates an effective interest rate of about 81 percent.

The reasoning behind this strategy is that most corporate officials believe if they don’t pay their suppliers they will soon be out of business. They also believe if the corporation fails they have nothing to lose by not paying the taxes. There is the assumption that a corporation is a separate entity and the liabilities of the corporation cannot be passed on to the officers and employees. However, officials are failing to realize they are becoming personally liable for any trust fund taxes (income tax and Social Security withholdings) that have not been collected or remitted to the federal government. Section 6672 of the Internal Revenue Code makes any person required to collect, account for, and pay over any tax; one who willfully fails to do so is liable to a penalty equal to the total amount of the tax evaded or not collected, or not accounted for and paid over (the 100 percent penalty). Section 6671(b) defines a person as an officer or employee of a corporation, or a member of a partnership who is under a duty to perform the act.

IRS Assesses Responsibility Broadly

In order for a corporate officer or employee to be held personally liable, he or she must be the responsible person, the person who is responsible for collecting and/or remitting the withholding taxes to the federal government.

The IRS is going to use a very broad approach when assessing responsibility. Liability will not be confined to those who perform mere mechanical functions of collections and payment in accordance with the executive judgment of others whose duty it is to make decisions for corporations. It includes all those so connected to the corporation as to be responsible for controlling disbursements, including withholding, and paying taxes. Generally a responsible person is one “with ultimate authority over expenditure of funds since such a person can fairly be said to be responsible for the corporation’s failure to pay over its taxes,” or, more explicitly, one who has “authority to direct payments to creditors.” This duty is generally found in high corporate officials charged with general control over corporate business affairs who participate in decisions concerning payment of creditors and disbursement of funds. However, a corporate officer may be held to be a responsible person, even though he is not the disbursing officer.

The court has defined responsibility as a matter of status, duty, and authority. One major factor the courts will consider is the ability
to sign or co-sign checks. The court held a general manager of a club liable for unpaid payroll taxes, stating that he handled day-to-day operations, had check signing authority, and had the authority to pay the taxes before other creditors.14 In another case, the court held that the authority to co-sign checks brought about responsibility. The court stated that the ability to co-sign checks gives one the authority to decide which creditors should be paid.15 However, check signing authority alone will not make an individual a responsible person. Those who just sign checks and have no managerial authority will not be held to be a responsible person.16

The following facts may be relied upon in determining whether persons are responsible for payment of taxes withheld from wages of employees: identity of officers, directors, and shareholders of the corporation; duties of officers as outlined by corporate bylaws; ability of the individual to sign checks of the corporation; identity of the individual who hired and fired employees.17

Willfulness Must Be Proved

Before the responsible person can be held liable, the IRS must also prove that he or she willfully failed to account for or pay over the taxes. For purpose of the 100 percent penalty, the Internal Revenue Service says willfulness exists when “money withheld from employees as taxes, in lieu of being paid over to the government, was knowingly and intentionally used to pay the operating expenses of the business, or for other purposes.”18 The Supreme Court has defined willfulness as a voluntary, intentional violation of a known legal duty.19 Other courts have interpreted this to mean that it is not necessary that there be bad motives, wicked design, or intent to defraud or to deprive the government of taxes. If the responsible person knows that taxes are due and owing, and writes checks to other creditors and suppliers, there is willfulness.20

Willfulness has also been interpreted in a broader sense. In one case, failure by an officer of a corporation to investigate after receiving notice that withholding taxes have not been remitted to the government was considered willfulness.21 Corporate officers should also be aware that after receiving notice, they cannot escape liability by delegating the responsibility to remit the taxes to another. In Mazo v. United States, corporate officers were held liable for unpaid taxes even though they claimed the controller had stated that he had taken care of the matter for them. The court held they were under a duty to ensure that the taxes were paid before payments were made to other creditors.22

In some situations, corporate officials have given the creditor the right to approve or disapprove the release of funds in consideration for keeping the business operating. However, this type of arrangement will not absolve corporate officials from liability for unpaid taxes.23
A corporate employee who is held to be the responsible person cannot escape liability by stating that his superior ordered him not to pay the payroll taxes. A responsible person who follows the directions of a superior not to pay withholding taxes to the government does so at his own risk. An otherwise responsible person does not lose that status, even if instructed by a superior officer not to pay taxes. The key to willfulness is does the responsible person know, or is he aware, that the money owing to the government for unpaid withholding taxes is being used for other corporate purposes.

Willfulness will not be found where the responsible person has no knowledge that taxes have not been paid, or where the taxpayer, relying on advice of competent counsel, doesn't pay the taxes due. There is no willfulness where there has been an honest mistake and/or mere negligence. That is, the failure to exercise ordinary care in respect to collecting, truthfully accounting for, or paying over the taxes will not establish willfulness.

Personal Liability Can Be Assessed

A corporate officer or employee who is held to be a responsible person and willfully fails to account for or pay the federal government the payroll taxes due will be personally liable for the unpaid taxes. To be personally liable means that the corporate officer or employee may be required by the IRS to pay the taxes. If the corporate officer fails to pay the tax after it has been assessed and a demand for payment has been made, a tax lien can be placed on all his property, real and personal. At this point, property may be seized and sold by the IRS to satisfy the tax. The IRS may file a tax lien on his home, levy his personal bank account, or even garnish his wages. Tax liens will exist until the taxes are paid or until the six-year statute of limitations for collections has passed, and will attach to all property acquired after that time.

Even though it is the corporation that owes the tax, the IRS is not bound to try to collect the tax from the corporation first. If the IRS believes that collection of the taxes is in jeopardy, the IRS can assess the penalty against the responsible person before proceeding against the corporation. In many cases, the IRS will hold more than one person responsible for the tax. The IRS strategy is that the more people they can hold liable, the greater the chance the tax will be collected. In these cases, all the individuals will be held to be jointly and severally liable for the penalty. The government may collect the full amount from any of the individuals. Some officers may try to limit their liability by filing for personal bankruptcy. However, the amount due under the 100 percent penalty is considered a tax and therefore cannot be discharged under the federal bankruptcy laws.

Solid Cash Management Strategies Must Be Developed

Because of the extent of the liability, corporate officers should be aware of what strategies they can follow when they find themselves
in this situation. First, when cash is not available to pay the tax, the corporation should still file the employee quarterly payroll tax returns. This eliminates the failure to file penalty. If some cash is available, partial payments should be made. This will decrease the amount of personal liability. When partial payments are made, the payments should be designated for trust funds taxes, since it is the trust fund taxes for which an officer or employee can be held personally liable. If the corporation is behind in its tax payments and an assessment has been made against it, the corporation should try to negotiate an installment payment schedule with the IRS. It is also important that the payments are designated to pay trust fund taxes first in order to reduce personal liability.

In some instances it may be to the advantage of the corporate officer or employee to consider resigning in order to avoid personal liability. If resigning is not an option, a second alternative would be to have his or her name removed from all bank accounts. This will not guarantee a lack of personal liability, but it may help reduce the amount of exposure.

Payroll tax liability can be devastating. This is an issue that needs to be thoroughly looked into and reviewed before any business venture is entered. As part of the planning of a new business, it would be best to have a signed agreement between the officers as to individual responsibilities for paying payroll taxes. This agreement should also state what procedures will be followed when there are cash shortages.

Payroll taxes can be a liability nightmare for the unsuspecting corporate officer or employee. However, careful planning before the business opens and while it is in operation can help minimize and reduce personal liability. Officers and responsible employees should adopt the solid strategies outlined above to avoid becoming victims of unexpected tax liability.

References

Ibid.
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2Internal Revenue Code, Sec. 6651(a)(1).
3Internal Revenue Code, Sec. 6651(a)(2)
4Internal Revenue Code, Sec. 6601, 6621.
5Internal Revenue Code, Sec. 6672.
6Internal Revenue Code, Sec. 6671(b).
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9Monday v. United States, 421 F.2d 1210 (7th Cir. 1970).
10Bloom v. United States, 272 F.2d 215 (9th Cir. 1959), Cert. denied, 363 U.S. 803.
11Mazou v. United States, 551 F.2d 1151 (5th Cir. 1979).
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