

Abstract: Business owners with employees could have to personally pay a harsh tax penalty if they aren't careful. It's called the Trust Fund Recovery Penalty, and it applies to the Social Security and income taxes required to be withheld by a company from its employees' wages. This article examines the risk and explains how business owners, managers and other parties can avoid penalties.

Could you be hit with the Trust Fund Recovery Penalty?

If you own or manage a business with employees, you could be personally responsible for paying a harsh tax penalty. It's called the Trust Fund Recovery Penalty (TFRP). It applies to Social Security and income taxes, which must be withheld from employees' wages.

These taxes are government property employers collect and hold in "trust" for the government until payment. If the funds aren't properly handled, the IRS can impose a TFRP equal to 100% of the unpaid taxes on *each* responsible party. Consequently, the penalty amounts can be significant.

A penalty with a long reach

The TFRP is among the more dangerous tax penalties not only because it's large but also because it applies to many actions and people involved in a business — and the IRS aggressively enforces it. Here are some questions and answers to help employers avoid incurring the penalty:

What actions are penalized? The TFRP applies to willful failures to collect or truthfully account for and pay over Social Security and income taxes required to be withheld from employees' wages.

Who's at risk? The IRS can impose a 100% penalty on anyone "responsible" for collecting and paying taxes. This includes corporate officers, directors, shareholders, partners and employees with such duties. Even voluntary board members of tax-exempt organizations may be liable under certain circumstances. Sometimes, responsibility has been extended to family members close to the business, attorneys and accountants.

How is responsibility determined? Responsibility depends on status, duty and authority. Anyone with the power to ensure taxes are paid can be held liable. Multiple people within a business can be deemed responsible — and each is at risk for the full penalty. If you know unpaid payroll taxes exist and have the authority to pay them but prioritize other payments instead, you could be deemed a responsible person.

While a taxpayer held liable may sue others for contribution, this must occur after paying the penalty in full. Such lawsuits are entirely separate from the IRS's collection process.

Definition of “willful”

Willful actions don’t require intent to evade taxes. The IRS defines “willfully” as knowingly prioritizing other expenses over withheld taxes. For example, bending to pressure to pay other bills instead of taxes is considered willful behavior.

Delegating actual tax responsibilities is no defense. Failing to deal with tax tasks can also be deemed willful.

Borrowing is never an option

Under pressure, it may be tempting to “borrow” from a tax withholding fund to pay an urgent expense. But don’t do it. All funds withheld from employee paychecks for tax purposes must be paid to the government in full and on time. Otherwise, you risk owing a hefty 100% TFRP. Contact us with any questions.

Sidebar: What can happen?

A recently decided U.S. District Court case illustrates the perils of not paying over employment taxes to the IRS. The case involved the owner of a home care services company. His duties included withholding employment taxes from employees’ pay. Over five quarters, he paid part of the taxes due, leaving an unpaid balance of \$1,177,947.

He was ultimately charged with a Trust Fund Recovery Penalty of 100% of the owed amount and sentenced to 12 months and one day in federal prison. The conviction stemmed from his willful failure to pay, evidenced partly by using company funds for personal expenses. (Office of Public Affairs|Press Release Number: 24-1594)