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## NOTES

### **THE WRATH OF I.R.C. § 6672: THE RENEWED CALL FOR CHANGE—IS ANYONE LISTENING? IF YOU ARE A CORPORATE OFFICIAL, YOU HAD BETTER BE**

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#### INTRODUCTION: THE CABIN BOY ON A SINKING SHIP

This is a story about Nathan Unger: At the ripe age of twenty-two, after receiving his bachelor's degree from Queens College, Nathan was hired as an assistant to the Controller by Robert Landau Associates (RLA), a marketing and advertising agency that provided promotional and sports-licensing services to corporate clients. Even though Nathan never was certified as a public accountant, a year later he was promoted to Controller, a position he held for two years. A few years later, Nathan climbed the corporate ladder further and was promoted to Senior Vice-President and CFO. Nathan, however, never owned any equity shares in RLA. The primary and sole shareholder of RLA was Robert Landau, who was also the President and CEO. Unfortunately for Nathan, Robert Landau was also a

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cocaine addict and an alcoholic, who in the height of his dependency ingested between five and eight grams of cocaine and over a quart of alcohol a day. Not surprisingly, RLA began to experience financial difficulty and eventually went bankrupt. Nathan Unger, who did not own a single share of stock in the corporation, suddenly found himself in a tangled web of liability. At the age of twenty-eight, he found himself liable for a whopping \$1,046,367.30, which accounted only for unpaid withholding and Federal Insurance Contribution Act (FICA) taxes. This total did not include statutory interest and additions accruing from the date of the assessment of the penalty. The Internal Revenue Service (IRS) went so far as to seize all of Nathan's assets, which only amounted to approximately \$20,000. Nathan's only recourse: pay some of the liability and bear the burden in court to prove that he was not liable for the unpaid payroll taxes.<sup>1</sup>

Nathan's experience is not uncommon for an employee of a business in financial trouble. When bills have to be paid and cash flow becomes a problem, businesses often end up shuffling creditors. This list of creditors includes the IRS, the creditor for the trust fund containing the withholding funds. Employers are required to withhold income taxes and FICA taxes from employee wages;<sup>2</sup> further, the employer must match each employee's portion of the FICA taxes.<sup>3</sup> The employer is required to place these amounts in trust for the government,<sup>4</sup> and the corporation must forward these funds to the U.S. Treasury.<sup>5</sup> The employees receive credit for the withheld taxes even if the corporation does not actually pay them.<sup>6</sup>

Because the withholding tax fund seems to be a ready source of cash, financially strapped firms find it a very attractive source of funds to use for

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1. See *Unger v. United States*, No. 90 Civ. 0384(WK), 1994 WL 52574, at \*3 (S.D.N.Y. Feb. 17, 1994). The above is the true story of Nathan Unger and is still continuing through the legal system. See *Unger v. United States*, No. 90 Civ. 0384(WK), 1999 WL 1072488 (S.D.N.Y. Nov. 29, 1999) (denying Government's motion for summary judgment against Unger).

2. See I.R.C. §§ 3102(a), 3402(a) (1994).

3. See Timothy S. Kingcade, *Trust Fund Recovery Penalty: Personal Liability for an Employer's Failure to Pay Its Employees' Withholdings to the IRS*, FLA. B. J., Oct. 1996, at 60, 60.

4. See I.R.C. § 7501 (1994).

5. See *id.* These funds must be forwarded to the U.S. Treasury based on a "deposit schedule." The deposit schedule determines whether a corporation deposits the withholding taxes on a monthly, semiweekly, or next-day basis. A corporation's deposit schedule is determined from the total taxes reported on Form 941 (Employer's Quarterly Federal Tax Return) in a four-quarter lookback period. See INTERNAL REVENUE SERV., DEP'T OF THE TREASURY, CIRCULAR E, EMPLOYER'S TAX GUIDE 17-19 (2000) [hereinafter IRS CIRCULAR].

6. See Kingcade, *supra* note 3, at 60.

operating expenses.<sup>7</sup> Corporate officers often attempt to “borrow” from the trust fund taxes to help stave off other creditors and remain in business. Most corporate officers, however, do not realize that this is a Pandora’s Box that can result in personal liability for thousands or even millions of dollars in unpaid payroll taxes. Internal Revenue Code § 6672 allows the IRS to assess corporate officers *personally* for the totality of the *corporation’s* unpaid tax liability for conduct that is deemed both responsible and “willful.”<sup>8</sup>

This Note will demonstrate the problematic nature of this statute. Furthermore, this Note will attempt to show how a corporate officer can avoid liability within the current confines of judicial interpretations of I.R.C. § 6672. Part I will detail the history of the statute and the current justification asserted for the 100% penalty against the corporate officer. Part II will describe the current law and what it takes for an employee or officer to be considered both “responsible” and “willful” for the withholding taxes. Part III will describe the problematic consequences that result from the current interpretation of the law. Furthermore, Part III will discuss the procedural aspects of the statute that create additional challenges for corporate taxpayers. Part IV will suggest the various methods corporate officers may use to attempt to shield themselves from personal liability. Part IV also discusses the IRS’ lack of success in collecting the unpaid taxes. Part V will argue that because the only advice to corporate officers to avoid liability is impractical and almost impossible to follow, the interpretation of the law should change, either congressionally or judicially. Part VI summarizes the problems with the statute. This Note concludes that the inadequacies of the current interpretation and the lack of success in collection of the unpaid tax indicate a heightened need for focus on this area and a corresponding need for change.

## I. HISTORY AND JUSTIFICATION OF I.R.C. § 6672

The Internal Revenue Service currently characterizes I.R.C. § 6672 as an alternate means of collecting unpaid corporate employment taxes.<sup>9</sup> In light of the frequency with which criminal statutes employ the term “willful,” the statute might be thought to contain sanctions, such as

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7. See David M. Walker, *The Section 6672 100% Penalty: How to Avoid Going Down with the Ship*, 46 TAX LAW. 801, 802 (1993).

8. I.R.C. § 6672(a) (1994).

9. See Beth K. Neelman, Note, *The Availability of Injunctions in Bankruptcy to Restrain Collection of I.R.C. § 6672(a) Penalties*, 7 CARDOZO L. REV. 613, 617–18 (1986).

imprisonment or fines. The only penalty imposed by the statute, however, is equal to the total amount of unpaid withholding taxes.<sup>10</sup> Accordingly, as currently interpreted by both the IRS and the courts, the statute is noncriminal in character. It is merely an “alternate collection device.”<sup>11</sup>

#### A. HISTORY

To begin, it is important to note that I.R.C. § 6672 was not judicially construed until about thirty years after it was enacted.<sup>12</sup> The evolution of liability for the failure to pay withholding taxes appears to have originated from statutes concerning criminal tax penalties. From the first laws concerning the raising of revenue through the income tax, Congress has attempted to differentiate between the “intent to defeat or evade” taxes and “neglect” or “refusal” to act.<sup>13</sup> The substance of I.R.C. § 6672 first arose in § 1308 of the Revenue Act of 1918.<sup>14</sup> The statute from the Revenue Act of 1918, which initially covered excise taxes, imposed a 100% penalty on any “person who willfully refuses to pay, collect or truly account for and pay over any’ excise tax.”<sup>15</sup> The present-day statute, I.R.C. § 6672, contains almost identical language.<sup>16</sup> The original statute imposed three graduated penalties, with all but the least severe applicable as criminal penalties.<sup>17</sup> The first penalty (noncriminal) imposed a fine of up to \$1,000 for failure to comply with the statute.<sup>18</sup> The second provision, a criminal provision, allowed for imprisonment for up to one year and a fine of \$10,000 if the refusal to comply was “willful or constituted a willful attempt” to evade or to defeat the tax.<sup>19</sup> The third provision, also criminal, provided for a 100%

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10. See Gerald P. Moran, *Willfulness: The Inner Sanctum or Unnecessary Element of Section 6672*, 11 U. TOL. L. REV. 709, 712 (1980).

11. The IRS usually characterizes the statute as an “alternate collection device” for the unpaid taxes rather than as a “penalty.” When a statute is termed a “penalty,” however, the IRS imparts an intent close to the “willfulness” prong that resembles the level of intent in *Cheek v. United States*, 498 U.S. 192 (1991). In *Cheek*, the Court held that the term “wilfully” as used in the criminal tax statutes has been interpreted to mean an act done with bad faith or with an evil motive; by contrast, the Court has defined willful in the ordinary tax context as a “voluntary, intentional violation of a known legal duty.” *Id.* at 201 (quoting *United States v. Bishop*, 412 U.S. 346, 360 (1973)).

12. See Moran, *supra* note 10, at 711.

13. *Id.* at 727.

14. See Mary A. Bedikian, *The Pernicious Reach of 26 U.S.C. Section 6672*, 13 VA. TAX REV. 225, 233 (1993).

15. James E. Hungerford, Note, *Howard v. United States: Who Should be Responsible for the 100 Percent Penalty?*, 12 U. PUGET SOUND L. REV. 451, 454 (1989) (quoting Revenue Act of 1918, ch. 18, §1308, 40 Stat. 1057, 1143).

16. I.R.C. § 6672 (1994).

17. See Moran, *supra* note 10, at 732.

18. *Id.* at 732–33.

19. *Id.* at 733 (emphasis added).

penalty if the refusal to comply was *willful*.<sup>20</sup> This third provision is the ancestor of I.R.C. § 6672.

The difference in language between the first provision (the noncriminal sanction) and the second and third provisions (criminal) is the existence of “willful” behavior.<sup>21</sup> The inclusion of a “willful” requirement evidenced Congress’ desire to require a level of intent close to that required for criminal intent to defraud the government.<sup>22</sup>

The 100% penalty provision later evolved to incorporate failure to pay Social Security taxes.<sup>23</sup> Subsequently, the Current Tax Payment Act of 1943 added failure to pay the withholding portion of income taxes to the statute.<sup>24</sup> In the 1954 Internal Revenue Code, however, Congress severed the 100% penalty from the other criminal penalties because it did not provide for imprisonment<sup>25</sup> and the criminal origin of the provision was obscured.<sup>26</sup> In an attempt to organize the Code more logically, Congress removed the statute from where it originally resided with the criminal provisions and grouped it with other assessable noncriminal penalties.<sup>27</sup> In the legislative history of the 1954 revisions, however, Congress expressed no desire to change the meaning of the statute.<sup>28</sup> Moreover, Congress has used graduated sanctions and the terms of art that appear in the statute in a consistent fashion, indicating that both the severity and language of § 6672 should still impart a definition of intent similar to current criminal tax provisions.<sup>29</sup> As a result of the rearrangement of the code, in combination

20. *Id.*

21. *See id.*

22. *See id.* at 734.

23. *See* Hungerford, *supra* note 15, at 454 (citing Social Security Act of Aug. 14, 1935, ch. 531, § 807(c), 49 Stat. 620, 638).

24. *See* Moran, *supra* note 10, at 747 (citing Current Tax Payment Act of 1943, Pub. L. No. 68, ch. 120, 57 Stat. 126).

25. Hungerford, *supra* note 15, at 454–55.

26. *See* Moran, *supra* note 10, at 747–48.

27. *See id.* at 749.

28. *Id.* at 749–50.

29. *See id.* at 753 n.151. The current statutes in the following table illustrate the gradation from civil to criminal; their language also supports the conclusion that § 6672 should contain a heightened intent standard:

Code Section	Criminal Status	Penalty
§ 6651(a)(1)	noncriminal	Provides a 5–25% penalty for late filing if such failure is due to “willful neglect” and not excusable for reasonable cause.
§ 6694(a)	noncriminal	If any understatement of tax liability is due to negligence or intentional disregard of the rules, the tax return preparer shall be fined \$250. The taxpayer bears the burden of proof.

with the lack of imprisonment as a sanction, the meaning of the statute's terminology was sacrificed in favor of procedural ease. Thus, it is important to note that although the statute now appears under the "Assessable Penalties" portion of the code, the statute was originally part of the criminal tax penalties.<sup>30</sup>

#### B. JUSTIFICATION: THE "SHOW ME THE MONEY" RATIONALE

The tax revenue raised in 1998 by the government totaled about \$1.78 trillion.<sup>31</sup> The total amount of unpaid tax assessments reached approximately \$222 billion as of September 30, 1998.<sup>32</sup> Of that liability, about \$49 billion of the unpaid assessments are unpaid withholding taxes.<sup>33</sup> The IRS needs these funds because employees are still credited with the payment and the government is therefore obligated to pay these amounts to eligible recipients. Withholding taxes are not simply a debt, but are actual wages of the employee held in trust by the employer for the government.<sup>34</sup> The government has to pay the employee regardless of whether the government actually receives the corresponding funds from the corporation. Therefore, to ensure that employees receive their social security benefits, the government has to use other funds as subsidies to the extent that withholding taxes are not collected.<sup>35</sup> Consequently, many programs may be lacking funds because those funds are being used to cover the missing withholding funds owed by corporations.

§ 7201	criminal	If any person "willfully attempts in any manner to evade or defeat any tax" that person may be found guilty of a felony punishable by a fine of up to \$100,000 and up to five years in prison. The government bears the burden of proof.
§ 7202	criminal	A felony sanction is applicable where any person required to collect, account for, or pay over the tax willfully fails to carry out those duties. The government bears the burden of proof.
§ 7203	criminal	A person who willfully fails to file a return may be found guilty of a misdemeanor punishable by a fine of up to \$25,000 or up to a year in prison or both. The burden of proof is on the government. See <i>United States v. Gorman</i> , 393 F.2d 209, 213 (7th Cir. 1968).

30. See Bedikian, *supra* note 14, at 235.

31. See Professor Thomas Griffith, Taxation Lecture at the University of Southern California Law School (Aug. 24, 1999) (on file with the author).

32. See *Unpaid Payroll Taxes: Billions in Delinquent Taxes and Penalty Assessments Are Owed: Hearing Before the House Subcomm. on Gov't Mgmt., Info., & Tech., Comm. on Gov't Reform*, 106th Cong. 18 (1999) [hereinafter Kutz] (statement of Gregory D. Kutz, Associate Director, Governmentwide Accounting and Financial Management, Accounting & Info. Mgmt. Div., U.S. Gen. Accounting Office).

33. *Id.* at 19.

34. See *McGlothin v. United States*, 720 F.2d 6, 8 (6th Cir. 1983).

35. See Kutz, *supra* note 32, at 17.

Congress enacted this statute in order to collect the taxes due, reasoning that “someone from the corporation should pay rather than the government.”<sup>36</sup> The statute permits the taxing authority to reach those responsible for the corporation’s failure to pay taxes that are owed.<sup>37</sup> The IRS considers § 6672 to be an alternate collection device for the withholding taxes.<sup>38</sup> Because the main goal of § 6672 is to collect payment for the tax, actual responsibility is not necessarily important to the IRS. A penalty equal to the entire amount of withholding taxes owed can be assessed and collected against one individual even if more-culpable employees exist.<sup>39</sup> Actual responsibility is unconnected to IRS attempts to use the statute to encourage prompt payment and to deter corporate officers from using the trust fund taxes to pay other liabilities. Moreover, the statute promotes collection regardless of actual responsibility by allowing the IRS to pierce the corporate veil.<sup>40</sup> When the corporate veil is pierced, the shareholders no longer enjoy limited liability; the shareholders’ equity is no longer the only asset available to pay the taxes.

The judiciary has supported the IRS’ use of this statute as a means to obtain unpaid withholding taxes. Judges have often commented that the results may be harsh and the powers of the IRS “draconian,”<sup>41</sup> but they maintain that the government’s need to collect taxes is paramount.<sup>42</sup>

The statute, however, is an ineffective means of deterring corporations from using the trust fund taxes to pay for other liabilities. Deterrence theory asserts that punishment reduces crime because once persons contemplating committing crimes learn of the threatened punishment, they decide not to commit them.<sup>43</sup> For successful deterrence, the punishment threatened must be greater than the gain from committing the crime.<sup>44</sup> In order for this to occur, a person must have knowledge of the threat of punishment.<sup>45</sup> Furthermore, deterrence theory requires that people perceive the threat of punishment accurately.<sup>46</sup> Most corporate officers are unaware of the potential to be held personally liable for the entire unpaid

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36. Hungerford, *supra* note 15, at 470.

37. *See White v. United States*, 372 F.2d 513, 516 (Ct. Cl. 1967).

38. Hungerford, *supra* note 15, at 470.

39. *See id.*

40. For a more detailed discussion about how the statute pierces the corporate veil, see Part III.E.

41. *Phillips v. United States*, 73 F.3d 939, 943 (9th Cir. 1996).

42. *See Hungerford*, *supra* note 15, at 455–56.

43. *E.g.*, RICHARD G. SINGER & JOHN Q. LA FOND, CRIMINAL LAW, EXAMPLES & EXPLANATIONS 19 (1997).

44. *See id.*

45. *See id.*

46. *Id.* at 20.

withholding tax liability. Therefore, the statute has a functional weakness independent of its questionable advisability as a policy matter.

## II. JUDICIAL INTERPRETATION OF THE ASSESSMENT OF LIABILITY UNDER I.R.C. § 6672

Judicial interpretation of the statute allows the government to impose personal liability upon corporate persons who satisfy the conditions of the statute. The relevant statutory provision reads as follows:

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, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded . . . .<sup>47</sup>

Courts have interpreted the statute to require both that a person be “responsible” for the collection and payment of the taxes and that the individual’s failure to comply be “willful” in order to establish liability.<sup>48</sup> This Part addresses judicial interpretation of the responsibility requirement and then focuses on the willfulness requirement.

### A. RESPONSIBILITY

The concept of “responsibility” has been construed broadly by the courts. One court first termed responsibility as a matter of “status, duty and authority.”<sup>49</sup> Subsequent courts have indicated that responsibility rests with the individual who ultimately decides which bills will be paid,<sup>50</sup> and some courts have indicated that significant control over funds is sufficient to make someone a responsible party.<sup>51</sup> Furthermore, more than one individual may be considered “responsible” under the statute.<sup>52</sup> The IRS, however, is not obligated to pursue every person who would satisfy the responsibility prong.<sup>53</sup> The test turns on whether the person has “significant control over the enterprise’s finances.”<sup>54</sup> The test has been

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47. I.R.C. § 6672(a) (1994).

48. *E.g.*, *United States v. Kim*, 111 F.3d 1351, 1357 (7th Cir. 1997).

49. *Mazo v. United States*, 591 F.2d 1151, 1156 (5th Cir. 1979).

50. *See, e.g.*, *Purcell v. United States*, 1 F.3d 932, 937 (9th Cir. 1993).

51. *See, e.g., id.*; *Gephart v. United States*, 818 F.2d 469, 475 (6th Cir. 1987).

52. *See Thibodeau v. United States* 828 F.2d 1499, 1503 (11th Cir. 1987).

53. *See Howard v. United States*, 711 F.2d 729, 735 (5th Cir. 1983).

54. *Fiataruolo v. United States*, 8 F.3d 930, 939 (2d Cir. 1993) (quoting *Hochstein v. United States*, 900 F.2d 543, 547 (2d Cir. 1990)) (emphasis omitted).

expanded further to encompass “all those connected closely enough with the business to prevent the [tax] default from occurring.”<sup>55</sup> Indicia of responsibility include holding corporate office, owning stock in the company, serving on the board of directors, possessing authority to sign checks, being able to hire and fire employees, and exercising control over corporate financial affairs.<sup>56</sup> The court will assess the officer’s duties, prerogatives and prior history in order to determine responsibility,<sup>57</sup> however, no single factor is dispositive.<sup>58</sup> Additionally, the courts have also expanded who qualifies as a “responsible person” under the statute<sup>59</sup> to include creditors, employees, accountants, and attorneys in addition to officers, directors, and shareholders.<sup>60</sup>

Furthermore, courts have indicated that delegation of duties fails as a defense to personal assignment of liability.<sup>61</sup> In *Purcell v. United States*, a corporate president was held liable for failure to pay withholding taxes even though he had delegated all matters of responsibility to his Chief Financial Officer.<sup>62</sup> To make matters worse, the CFO in the case was an embezzler. Thus, the corporate president was effectively held doubly liable under I.R.C. § 6672: Not only was his CFO embezzling, but the President was also liable for the unpaid tax fund embezzled by the CFO.<sup>63</sup>

Neither does following the orders of a supervisor or CEO allow a defendant to escape liability.<sup>64</sup> Check-signing authority is considered a strong indicator of responsibility: Even if a check signer is instructed not to pay the taxes by a superior, the check signer may still be held responsible.<sup>65</sup> All that is required of the responsible person is that the individual could have “impeded the flow of business to the extent necessary to prevent the corporation from squandering the taxes.”<sup>66</sup> Nor is the responsible person

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55. *Bowlen v. United States*, 956 F.2d 723, 728 (7th Cir. 1992).

56. *See United States v. Kim*, 111 F.3d 1351, 1362 (7th Cir. 1997); *Williams v. United States*, 931 F.2d 805, 810 (11th Cir. 1991). This list of indicia is not exhaustive. *See United States v. Rem*, 38 F.3d 634, 642 (2d Cir. 1994).

57. *See Howard*, 711 F.2d at 734–35.

58. *See Rem*, 38 F.3d at 642; Larry A. Makel & James C. Chadwick, *Lender Liability for a Borrower’s Unpaid Payroll Taxes*, 43 BUS. LAW. 507, 513–15 (1988).

59. *See Walker*, *supra* note 7, at 804.

60. *See id.* Academic commentary has paid particular attention to lender liability. *See, e.g.*, Makel & Chadwick, *supra* note 58. The extension of liability to banks, accountants, and other individuals outside the corporation demonstrates the breadth of the statute.

61. *See, e.g.*, *Purcell v. United States*, 1 F.3d 932, 937 (9th Cir. 1993).

62. *Id.* at 935.

63. *See id.* at 943.

64. *See id.* at 937.

65. *See Howard v. United States*, 711 F.2d 729, 734 (5th Cir. 1983).

66. *Thomas v. United States*, 41 F.3d 1109, 1113 (7th Cir. 1994).

allowed to rely unreasonably on assurances made by others that the taxes are being paid.<sup>67</sup> Consequently, an otherwise responsible person does not escape liability even if instructed by a superior officer not to pay the taxes.<sup>68</sup>

Successor liability also presents a complicated issue under the statute. Successor liability concerns unpaid tax liabilities already in existence when new management takes over a company. If they do not comport to specific judicially defined behavior in handling tax liability, acquiring companies may be placed in danger of becoming liable even though the tax liability already existed.<sup>69</sup> In *Slodov v. United States*, the Supreme Court held that a responsible person under § 6672 may violate the 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.”<sup>70</sup> The Supreme Court did limit liability for acquiring companies that used after-acquired funds for purposes other than satisfying the preexisting tax liability when there are no funds with which to satisfy the tax obligation at the time of the change in control.<sup>71</sup> The Court, however, specified that after-acquired funds must not be “directly traceable to [the] collected taxes.”<sup>72</sup> The Court did not require new management to be a personal guarantor of tax liabilities upon acquisition of a company.<sup>73</sup> Becoming a guarantor of tax liabilities would certainly chill changes of ownership and management of financially troubled corporations.<sup>74</sup> In addition, requiring new management to act as guarantors of already existing tax liabilities might lead to reticence of investors to infuse much-needed equity into troubled firms.<sup>75</sup> The Court, however, held that if funds were available when the new management took over, the new management might be liable for failing to use the available funds to pay the tax liability.<sup>76</sup>

Although courts appear reluctant to hold an individual responsible when there are more-culpable individuals not before the court, under the

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67. See *United States v. Rem*, 38 F.3d 634, 643 (2d Cir. 1994).

68. See *Gephart v. United States*, 818 F.2d 469, 475 (6th Cir. 1987).

69. See *Slodov v. United States*, 436 U.S. 238, 253–59 (1978).

70. *Id.* at 259.

71. See *id.* at 259–60.

72. *Id.* at 260.

73. See *id.* at 253–54.

74. *Id.* at 253.

75. *Id.* at 254.

76. See *id.* at 259.

statute, it does not matter if a more culpable person exists.<sup>77</sup> Simply put, the court must assign responsibility if the defendant appearing before the court has control over the company's finances.<sup>78</sup> In *Howard v. United States*, the court found that even though the CEO, Jennings, had ultimate control over all payments and was the majority shareholder, the defendant, Howard, was held responsible and therefore liable because he had issued several small checks without the CEO's approval.<sup>79</sup> The defendant, who was held liable for the entire tax debt, was a director, minority shareholder, Treasurer, and Executive Vice-President of the company. The defendant was instructed by the CEO as to the payments to be made and was not to make payments without the express approval of the CEO.<sup>80</sup> The court also expressed reluctance to assign liability to an officer in *Buffalow v. United States* who did not "turn square enough corners" when dealing with the IRS.<sup>81</sup> Asserting that the defendant did not have a "bad heart," but rather that the "tax engine is blindly voracious; it does not always look into a man's heart before it devours him," the court still held the defendant liable.<sup>82</sup>

Some courts, however, are realizing the trap that I.R.C. § 6672 sets for corporate officials. The court in *De Alto v. United States* indicated that it was not going to assign responsibility based upon job title alone; the court looked beyond mechanical titles to find the ultimate authority within the company.<sup>83</sup> Furthermore, the court concluded that holding corporate office did not suffice as evidence to sustain a finding of responsibility.<sup>84</sup> Instead, the court asked whether the plaintiff had the authority to ensure that payments were directed to the IRS and not to other creditors.<sup>85</sup>

The responsibility prong appears to be a broad and far-reaching definition that places liability upon individuals when common sense would indicate otherwise. Because of the broad variety of factors that make someone "responsible," the IRS may focus on the easiest-to-reach pocket rather than on the most culpable party. In addition, incentive problems are

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77. See, e.g., *Howard v. United States*, 711 F.2d 729, 737 (5th Cir. 1983); *Unger v. United States*, No. 90 Civ. 0384(WK), 1999 WL 511768 (S.D.N.Y. 1999).

78. See *Howard*, 711 F.2d at 737.

79. *Id.* at 731.

80. See *id.*

81. *Buffalow v. United States*, 109 F.3d 570, 575 (9th Cir. 1997).

82. *Id.*

83. 40 Fed. Cl. 868, 875-76 (1998). See also *Alsheskie v. United States*, 31 F.3d 837, 839 (9th Cir. 1994) (noting that determining whether an individual is responsible requires looking past titular designation).

84. See *De Alto*, 40 Fed. Cl. at 875.

85. See *id.*

readily apparent under the responsibility prong. Frequently, an officer is faced with two equally unattractive options when instructed to pay other creditors rather than the IRS. Exhibiting some of the court-stated indicia of responsibility, this officer may be forced to choose between termination and not paying the taxes. The officer may choose to remain employed, intending to pay the taxes as soon as business turns around, but later be prosecuted by the IRS for following orders not to pay the withholding tax liability.

### B. WILLFULNESS

Not only have courts interpreted I.R.C. § 6672 to require that a person be responsible, but a person must also be “willful” to be held liable under the statute. The current definition of willfulness under § 6672 is more relaxed than is the definition used for other violations of the tax code. The courts have construed “willfulness” under § 6672 to mean the “voluntary, conscious and intentional act” of paying creditors other than the IRS when the company is financially troubled.<sup>86</sup> No evil motive or fraudulent purpose is necessary to satisfy the willfulness prong.<sup>87</sup> The government is not required to prove that the responsible person deliberately sought to defraud the government. If a person deemed responsible discovers the existence of unpaid taxes, the responsible person has an immediate duty to use all unencumbered funds to pay the taxes.<sup>88</sup> If the responsible person fails to pay the back taxes, that person becomes liable for the unpaid withholding taxes. The Ninth Circuit has realized the potentially harsh consequences of the current interpretation of willfulness: “Undoubtedly, the standard is a harsh, even somewhat counterintuitive one, but it is the law.”<sup>89</sup>

A strong criticism of the statute centers on the current interpretation of “willful.” The principal source for the definition of willfulness in most statutes has come from its use in criminal provisions, where the word

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86. *Phillips v. IRS*, 73 F.3d 939, 942 (9th Cir. 1996) (quoting *Davis v. United States*, 961 F.2d 867, 871 (9th Cir. 1992); *Klotz v. United States*, 602 F.2d 920, 923 (9th Cir. 1979)).

87. *See id.*

88. *See United States v. Kim*, 111 F.3d 1351, 1357 (7th Cir. 1997).

89. *Buffalow v. United States*, 109 F.3d 570, 573 (9th Cir. 1997). Various comments concerning the court’s reluctance to assess the penalties signal the need for changing the statute or its current judicial interpretation. The Ninth Circuit further remarked that “[i]f a responsible person . . . uses corporate funds . . . even to meet the payroll . . . our precedents require that the failure to pay withholding taxes be deemed ‘willful.’ This may seem oppressive to the employer and employees, and amount to ‘unwittingly’ willful, which seems an oxymoron, but the proposition is established law.” *Phillips*, 73 F.3d at 942 (citations omitted).

connotes a “voluntary, intentional violation of a known legal duty.”<sup>90</sup> Additionally, willful includes “some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer.”<sup>91</sup>

The statute was born as part of the criminal tax provisions,<sup>92</sup> and it is argued that the statute should require a higher level of “intent” than is now currently required.<sup>93</sup> With the reorganization and codification of the Code in 1954, Congress appears to have lost the original meaning imparted to the term “willful.”<sup>94</sup> The reorganization removed § 6672 from the other criminal provisions because it lacked imprisonment as a punishment. Therefore, its placement in the Code today might lead to the easy (though incorrect) conclusion that the provision differs from criminal provisions. Comparing the penalties of § 6672 to other penalties within the code illustrates that the 100% liability provision is more like its criminal counterparts than its civil counterparts.<sup>95</sup>

Consequently, the definition of willfulness essentially appears to place strict liability on a corporate officer once responsibility has been established. The severity of the penalty along with this strict liability standard demonstrates the need for scrutiny of the current judicial interpretation of the statute.<sup>96</sup>

### III. UNSETTLING IMPLICATIONS OF § 6672

#### A. UNJUST RESULTS

The interpretation of the statute has led many judges to conclude that the IRS is able to exercise a “Draconian enforcement power” over the taxpayer.<sup>97</sup> Furthermore, many judges express regret over having to assign liability to what appears to be a hapless victim. In *Unger v. United States*, the court lamented the fact that it felt bound by precedent to assign liability to the corporate officer, stating that “[i]t is difficult to understand how a

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90. Anthony Michael Sabino, *When Tax Evaders Go Bankrupt: The Bankruptcy Exception to Debt Discharge and “Willfulness” in Tax Crimes*, 27 SUFFOLK U. L. REV. 5, 5 (1993) (quoting *United States v. Bishop*, 412 U.S. 346, 360 (1973)).

91. *Spies v. United States*, 417 U.S. 492, 497–98 (1943).

92. *See supra* Part I.A.

93. *See Moran*, *supra* note 10, at 722.

94. *Id.* at 749.

95. *See supra* note 29 and accompanying text.

96. For a discussion of possible interpretations that would assign blame to the truly culpable parties, see *infra* Part V.

97. *Phillips v. IRS*, 73 F.3d 939, 943 (9th Cir. 1996).

rational government could so treat its own citizen. It certainly could not do so to a prisoner of war.”<sup>98</sup>

The frequency with which the statute appears to result in injustice is far too great to be ignored. In *Hochstein v. United States*, the Court of Appeals for the Second Circuit assigned liability to Hochstein, the Controller of the corporation, in the amount of the entire unpaid withholding assessment, equal to about \$30,000.<sup>99</sup> Hochstein’s salary was just \$35,000.<sup>100</sup> The majority held that Hochstein was a “responsible” person even though a financing firm effectively took control of the company.<sup>101</sup> Furthermore, there was evidence that Hochstein specifically requested funds from the financing company for the payment of the tax liability.<sup>102</sup> The financing company refused his request and only provided enough funds to pay net wages, even after Hochstein indicated that the unpaid taxes were of the highest priority.<sup>103</sup> Consequently, although Hochstein technically made the decision not to pay the taxes by paying only the net wages, he merely signed checks for the financing company that truly controlled the company. Hochstein was then found to satisfy the willfulness prong because he “pa[id] other creditors with knowledge that withholding taxes [were] due.”<sup>104</sup> The majority used Hochstein’s ability to sign checks to pin liability upon a mere scribe.<sup>105</sup>

This decision illustrates the problematic scope of liability under I.R.C. § 6672. Can we really believe that Congress wanted to impose the full unpaid tax liability upon a person who barely earns that amount in a year? The imposition of liability upon Hochstein by the court shows the far-reaching scope of liability under the current interpretation of the two-pronged test of responsibility and willfulness. In order to avoid liability, the court reasoned that Hochstein should have paid the taxes with the funds earmarked by the financing company for the employees’ wages. This reasoning by the Second Circuit demonstrates that the statute is not grounded in reality. The reality in Mr. Hochstein’s situation was that someone else controlled the finances; according to the Second Circuit, to avoid his current situation, Hochstein should not have paid full wages but

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98. *Unger*, 1994 WL 52574, at \*6.

99. 900 F.2d 543, 545 (2d Cir. 1990).

100. *Id.* at 550.

101. *See id.*

102. *Id.*

103. *Id.* at 549, 550.

104. *Id.* at 548.

105. *See id.* at 551.

rather should have apportioned some of the wage funds to pay the taxes.<sup>106</sup> Thus, during a period of financial hardship, a corporate official must always continue to pay taxes even when the funds are not available.

The statute appears to cause unjust results and continues to receive criticism. The problems stem from several shortcomings aside from the expansive definition of responsibility and the low standard of intent. Other criticisms that explain the unjust results of the statute include the failure to account for the totality of the circumstances,<sup>107</sup> the assignment of the burden of proof upon the taxpayer, the inability to discharge the liability under the Bankruptcy Code, the lack of a right of contribution, and the elimination of corporate limited liability.

#### B. BURDEN OF PROOF

After the corporation fails to forward the withholding taxes, the IRS begins collection by asserting the penalty against a corporate officer or employee with check-signing authority.<sup>108</sup> The individual's check-signing authority provides the IRS with the inference that the individual preferred other creditors over the IRS.<sup>109</sup> Therefore, the Service has fulfilled both the responsibility and the willfulness prongs in a single bound. Before the penalty can be asserted, the IRS must send the potentially responsible person notice providing an opportunity to request a conference with the Service Appeals Office.<sup>110</sup> In order to challenge the assessment made by the IRS, the taxpayer has two choices: (1) post a bond to prevent collection of the tax; or (2) pay a portion of the unpaid tax for a single employee for a single quarter, file a claim for refund, and if the claim is denied, file a refund suit in district court or claims court.<sup>111</sup> The United States will usually file a counterclaim for the full unpaid tax assessment.<sup>112</sup> The taxpayer may then proceed to contest the IRS' claim in court.

The taxpayer bears the burden of proof in challenging the IRS claim and must refute the presumption that the officer is indeed both responsible and willful. The initial assessment is taken as *prima facie* evidence and the

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106. *Id.* at 550. Hochstein had few viable options in this situation. If Hochstein had paid the employees less, the employees probably would have quit. If Hochstein had fired the employees, he would have hastened the company's demise. *Id.*

107. In Hochstein's case, accounting for the totality of the circumstances would have allowed consideration of who held the "real" financial control in the company. *See id.*

108. *See Walker, supra* note 7, at 805.

109. *See id.*

110. *See id.* (citing Rev. Proc. 84-78, 1984-2 C.B. 754).

111. *See id.* at 805-06.

112. *See id.* at 806.

taxpayer must refute the claim or give good reason why the initial assessment by the IRS was an error. The burden of proof remains with the taxpayer because the right of the government to collect taxes is paramount.<sup>113</sup>

The burden of proof should not have to be assumed by the taxpayer. First, defeating the presumption is almost impossible due to the broad reach of the statute. Second, the enormity of the penalty bolsters the rationale for the IRS to have the burden of proof when assigning liability for an unpaid tax debt. Third, the IRS has unfettered discretion when making its initial assessment. The statute does not require the IRS to seek out the most culpable individual. The IRS has the choice to prosecute those with the deepest pockets or those who are easiest to access. If the culpable individual is able to evade liability, is it necessarily the logical that the IRS' assessment of another individual should be given the same weight and that the next corporate officer should be forced to meet the same burden of proof?

Furthermore, the burden of proof in criminal tax provisions rests with the government. The graduation of penalties from civil to criminal should dictate that the burden of proof rests with the government under I.R.C. § 6672. The harshness of the penalty combined with its economic severity indicates the injustice of allocating the burden of proof to the taxpayer.

### C. DISCHARGEABILITY UNDER THE BANKRUPTCY CODE

A central purpose of the Bankruptcy Code is to allow a debtor to get a "fresh start."<sup>114</sup> Not all debts can be discharged in bankruptcy, however. Section 17a(1)(e) of the Bankruptcy Act specifies that taxes that the bankrupt has collected or withheld from others, but has not paid over, are nondischargeable in bankruptcy.<sup>115</sup>

In *United States v. Sotelo*, the Supreme Court, reversing the Seventh Circuit Court of Appeals, held that an individual found liable under I.R.C. § 6672 cannot discharge the liability in bankruptcy.<sup>116</sup> The Supreme Court rejected the taxpayer's contention that the liability denomination was a

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113. See *Psaty v. United States*, 442 F.2d 1154, 1159-60 (3d Cir. 1971). See also *Bedikian*, *supra* note 14, at 247 (citing *Phillips v. Commissioner*, 283 U.S. 589 (1931); *Cohn v. United States*, 399 F. Supp. 168, 170 (E.D.N.Y. 1975)).

114. *Bedikian*, *supra* note 14, at 255.

115. See *United States v. Sotelo*, 436 U.S. 268, 274 (1978) (citing Bankruptcy Act § 17a(1), ch. 541, 30 Stat. 550 (1898) (codified as amended at 11 U.S.C. § 523(a)(1) (1994))).

116. *Id.* at 282.

“penalty” rather than a tax.<sup>117</sup> The Court of Appeals had reversed the bankruptcy judge, denying that the penalty was “in substance a tax.”<sup>118</sup> The Court of Appeals recognized that § 17a(1)(e) should not prevent the debt from being discharged because it was the corporation that was obligated to withhold the taxes.<sup>119</sup> The Supreme Court, however, did not find this to be persuasive and held that the finding of liability made § 17a(1)(e) applicable. Focusing on the statutory language, the Supreme Court held that the natural reading of § 17a(1)(e) led to the conclusion that the taxpayer necessarily had “collected or withheld from others as required by the laws of the United States . . . but has not paid over.”<sup>120</sup> The Supreme Court also looked to the legislative history of §17a(1)(e) of the Bankruptcy Code, which indicated that Congress had intended to make withholding tax obligations nondischargeable in bankruptcy.<sup>121</sup>

Both public policy and congressional intent played central themes in the decisions of both the Supreme Court and the Court of Appeals. The Court of Appeals noted that inequity could potentially arise were an individual to be held liable for a corporation’s tax liability.<sup>122</sup> The court realized that the liability could greatly exceed the present and future resources of an individual.<sup>123</sup> The Supreme Court appeared to find the rationale persuasive but refused to affirm the Court of Appeals, citing reluctance to override “specific policy judgments made by Congress in enacting the statutory provisions.”<sup>124</sup> The Supreme Court also feared that affirming the Court of Appeals decision would have the effect of allowing a corporation and its officers to escape all liability for unpaid withholding taxes.<sup>125</sup> In a dissenting opinion, Justice Rehnquist cited the potential “lifelong liability” imposed by the majority opinion upon the shoulders of

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117. *See id.* at 274.

118. *Id.* at 272. If the taxes are deemed a penalty, then the debtor can discharge the debts in bankruptcy; if the taxes are still considered “taxes,” then the amount owed is not dischargeable in bankruptcy. *Id.* at 273. Thus, the debtor in *Sotelo* argued that the taxes should be considered a penalty and therefore dischargeable in bankruptcy. *Id.* at 271.

119. *See id.* at 274.

120. *Id.* at 273.

121. *See id.* at 275. The court relied on a letter from the Assistant Secretary of the Treasury stating that “[t]he Department does not believe that it is . . . administratively desirable to permit employers and other persons who have collected money from third parties to be relieved of their obligation to account for an[d] pay over such money to the Government.” *Id.* at 276 (second alteration in original).

122. *See id.* at 279.

123. *See id.*

124. *Id.*

125. *See id.* at 280.

an individual deemed liable under § 6672.<sup>126</sup> Justice Rehnquist appeared to side with the Court of Appeals, contending that making the penalty nondischargeable in bankruptcy interferes with the policy of allowing a debtor “a fresh start,” which was intended by Congress under the 1966 amendments to the Bankruptcy Act.<sup>127</sup>

Consequently, the Supreme Court’s holding in *Sotelo* forecloses any hope for the corporate official in a financially troubled time. The corporate official found liable under I.R.C. § 6672 will be denied dischargeability and a fresh start.

#### D. CONTRIBUTION

Another problematic procedural aspect of the statute is the lack of a defined right of contribution. Although the interpretation dictates that often times more than one person is responsible under the statute, the IRS does not have to assess all of the potentially responsible officers. The IRS has complete discretion to single out one individual to assess even though another officer might be more culpable.<sup>128</sup> Even though the individual may not be the most culpable, the Service will often assign the penalty to the individual with the most liquid assets as a means of ensuring that the total tax liability is paid.<sup>129</sup>

Case law establishes that there is no federal right to contribution unless specifically provided for in the statute.<sup>130</sup> Internal Revenue Code § 6672 does not provide the individual responsible for the entire penalty with any relief. Consequently, federal courts have determined that a federal right to contribution does not exist under I.R.C. § 6672.<sup>131</sup>

Some debate exists, however, as to whether a right to contribution exists under state law. The district court in *Swift v. Levesque* found that the statute did not specifically prohibit contribution under state law.<sup>132</sup> On fairness grounds, the court held that a single person should not be liable for the full 100% penalty when there is another person who is potentially

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126. *Id.* at 290–91 (Rehnquist, J., dissenting).

127. *See id.* at 290–92 (Rehnquist, J., dissenting).

128. Walker, *supra* note 7, at 804 (citing *Neier v. United States*, 91-1 U.S. Tax Cas. (CCH) ¶ 50,234, at 87,936 (D. Kan. 1991)).

129. Walker, *supra* note 7, at 819.

130. *Id.* (citing *Tex. Indus., Inc. v. Radcliff Materials, Inc.*, 451 U.S. 630, 645–47 (1980)).

131. *See Sinder v. United States*, 655 F.2d 729 (6th Cir. 1981); *United States v. Amerson*, 808 F. Supp. 217 (W.D. Mo. 1991); *Conley v. United States*, 773 F. Supp. 1176 (S.D. Ind. 1991).

132. 614 F. Supp. 172, 173 (D. Conn. 1985).

equally at fault.<sup>133</sup> The court also realized that because the IRS has characterized the statute as an alternate collection device, allowing a person to sue for contribution will not impair the collection of the tax.<sup>134</sup> On the other hand, other district courts have disagreed with the view that the statute is merely a collection device and have disallowed a right to contribution.<sup>135</sup> These courts believe that a person who has satisfied the willfulness prong should not be allowed to shift the burden; the statute is a vehicle for deterrence, thereby encouraging responsible individuals to ensure the payment of trust fund taxes.<sup>136</sup>

A right to contribution should exist under state law. Contribution is the means least offensive to the IRS of easing the heavy burden on a taxpayer caught in the liability trap of the statute. As the court in *Swift* noted, a right to contribution will surely not impair the collection of the taxes and may, in fact, assist in the collection of taxes.<sup>137</sup> Those opposed to a right of contribution point out that such a right could increase litigation; moreover, the deterrent effect would be lessened because contribution responsible persons to share the burden.<sup>138</sup> This Note maintains, however, that the harsh economic consequences should require courts to allow a potentially liable corporate officer to have the chance to bring evidence that another officer was equally or more culpable. Considerations of fairness should reign over the claims of potential increases in the cost of litigation.

Allowing a right to contribution may result in the expected penalty becoming commensurate with the statute's deterrent effects. Because many employees are ignorant of their liability for the 100% penalty, the threat of punishment is not perceived accurately. The misperception of the magnitude of the penalty results in underdeterrence by the statute. Allowing contribution would reduce the size of the penalty, thereby aligning the deterrent effect with the reduced penalty paid by an individual as a result of contribution.<sup>139</sup>

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133. See Walker, *supra* note 7, at 820–21.

134. See *id.*

135. See Conley, 773 F. Supp. at 1177; *Marine Bank v. United States*, 739 F. Supp. 1257, 1259 (C.D. Ill. 1990); Walker, *supra* note 7 at 820–21.

136. See Conley, 773 F. Supp. at 1177; *Marine Bank*, 739 F. Supp. at 1258.

137. *Swift*, 614 F. Supp. at 177. Allowing a right to contribution can increase the number of people available to pay the tax debt. Simply put, the IRS can reach into more pockets to get its money.

138. See Walker, *supra* note 7, at 822.

139. See SINGER & LA FOND, *supra* note 43, at 19.

## E. PIERCING THE CORPORATE VEIL

Corporations are defined by the principle of limited liability, which allows participants to separate business assets from personal assets.<sup>140</sup> Therefore, an individual's liability for a corporation's obligations is limited to the person's investment in the corporation.<sup>141</sup> The doctrine of limited liability serves important goals. First, it serves to encourage capital formation because investors are able to invest in risky, though desirable, enterprises without having to risk their other assets.<sup>142</sup> Second, without limited liability, management would be hesitant to undertake high-risk projects, even though the project may promise net positive returns.<sup>143</sup> Third, investment diversification allows for spreading risk; the cost of investing is reduced because of a decreased need for intense investigation and monitoring.<sup>144</sup> Finally, limited liability shields all corporate investors equally.<sup>145</sup> Consequently, courts often recognize limited liability even if it is the motivating reason for the incorporation.<sup>146</sup>

Limited liability may be the default rule for corporations; however, the doctrine is not absolute and courts may sometimes disregard the rule and "pierce the corporate veil" to hold shareholders, officers, and directors personally liable for corporate obligations.<sup>147</sup> Courts will pierce the corporate veil to protect outsiders dealing with a corporation; misrepresentation by a corporation is the most critical factor that leads to the removal of the limited liability shield.<sup>148</sup> Disregarding limited liability essentially places creditor expectations above insider interests in limited liability.<sup>149</sup> Courts should not take this step without careful contemplation because piercing the veil can chill capital formation and risk-taking.<sup>150</sup>

The statute, through the imposition of personal liability upon officers, effectively disregards the pressures and incentives they face in financially troubled times. Officers have been held liable even when they have been directed by a superior officer not to pay the taxes. The courts presuppose

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140. LEWIS D. SOLOMON & ALAN R. PALMITER, CORPORATIONS: EXAMPLES & EXPLANATIONS 473 (1999).

141. *See id.* at 474.

142. *Id.*

143. *Id.*

144. *Id.*

145. *Id.* at 475.

146. *See id.*

147. *Id.* at 535.

148. *Id.* at 536.

149. *See id.*

150. *See id.*

that the choice is easy for the average person to make when faced with the options of following orders (thus risking liability) or being fired for paying the taxes. The pressure of the loss of a job has not been accorded enough weight in the liability calculus. The courts also assume that the individual who pays another creditor to remain in business is necessarily indicating an intent not to pay withholding taxes. Often times, individuals have expressed that they were merely trying to survive through a difficult period and that their intention was to pay the taxes as soon as humanly—or rather financially—possible.

#### IV. THE REALITY OF § 6672 FOR THE CLIENT AND THE IRS

##### A. ADVISING A CLIENT: HOW TO EVADE THE 100% PENALTY

Corporate officers must beware: The 100% penalty is hard to beat once the IRS has undertaken enforcement action. The corporate lawyer must inform clients of the potential for liability. Clients should be informed that unpaid payroll taxes merit piercing the corporate veil and that clients can and will be held liable for the corporation's entire unpaid tax debt. Unfortunately, the best advice a lawyer can give to a client to avoid liability under I.R.C. § 6672 is to *pay the taxes*.<sup>151</sup> Another suggestion of limited use to financially distressed companies is to avoid getting into financial trouble in the first place so that funds are available to pay the taxes. The most practical advice for most clients is to be aware of the potential repercussions for failing to pay withholding taxes. The fear of personal liability may in fact encourage corporations simply to declare bankruptcy instead of using the withholding taxes to keep other creditors at bay. If a corporation does fail to pay the withholding taxes, however, the client needs to take action immediately after discovering that the taxes have not been paid.<sup>152</sup>

If an individual is going to be interviewed by a revenue officer, counsel should assist the individual to articulate clearly his or her corporate

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151. This is serious advice given in a law review article. See M. Robyn Cotrona, *The Price of Employees: Employment Tax Withholding and the Trust Fund Penalty*, 69 FLA. B. J. 27, 29 (1995). Unfortunately, this advice sounds like that given to teenagers about abstinence being the best way to avoid pregnancy and sexually transmitted diseases. Most people caught in § 6672's reach do not intend to evade taxes; however, when the pressure is on and debts are mounting, the withholding taxes are an extremely attractive cash source.

152. See Richard Daguanno, *Employee Withholding Taxes: Who is Responsible?*, 68 MICH. B. J. 496, 500 (1989).

duties and functions.<sup>153</sup> The officer should also terminate his or her check-signing authority immediately,<sup>154</sup> since the IRS often uses check-signing authority as prima facie evidence of being a responsible person. Furthermore, the officer should resign from the company after finding out that the taxes have not been paid.<sup>155</sup> This will demonstrate to the court that the individual was not willfully ignorant. If the individual cannot be persuaded to resign, the individual should refrain from engaging in discussions about the corporation's finances.<sup>156</sup> Not discussing finances indicates that the individual did not make the decision to pay a creditor over the IRS. Which creditors are to be paid is a topic to be avoided at all costs. Refraining from discussions about the company's finances, however, can be a double-edged sword: The court may hold that avoiding the topic proves that the client was attempting to remain willfully ignorant. The court can and will find the individual "willful" if the court finds that a reasonable person would have investigated whether the taxes were being paid under the circumstances.<sup>157</sup>

A client that has already received a notice of assessment is facing an uphill battle. Procedurally, the best opportunity for a responsible person to resolve the penalty through settlement is during an appeals conference.<sup>158</sup> It is during an appeals conference that the IRS must consider the costs and possible hazards of litigating the case.<sup>159</sup> The individual may be able to convince the IRS to settle for an amount less than the entire debt.

This advice hardly makes for a foolproof defense. The advice also does not appear grounded in reality; most clients will resist the idea of resigning and many would laugh if told to stay out of financial trouble. The lack of practical advice to shield a corporate officer indicates that the statute is problematic. The statute does not currently provide any sympathy for financially troubled corporations and the totality of the circumstances facing both the corporate officer and the corporation itself plays almost no role in the determination of liability. Nor does the statute take into account the officer's intentions or best efforts to pay the taxes. The best advice to avoid liability demonstrates the statute's inability to take account of financial realities. The likelihood that this advice will be taken should convince the courts and legislature to herald change.

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153. *See id.* at 498.

154. *See id.* at 500.

155. *Id.*

156. *See id.*

157. *See United States v. Rem*, 38 F.3d 634, 643 (2d Cir. 1994).

158. *See Kingcade*, *supra* note 3, at 62.

159. *See id.*

In addition to informing the client of the potential for personal liability, payroll audits can play an important role in protecting a client from liability. Periodic payroll audits can serve several important functions: verify compliance with corporate policies and procedures, ensure clerical accuracy, and detect payroll fraud.<sup>160</sup> Therefore, not only will a periodic payroll audit help avoid unintentional errors that result in fines, but the audits may also highlight an employee committing payroll fraud. Depending on the size of the company, the audit can be handled by an internal audit department, but the larger the company, the more a company should consider having an outside accounting firm conduct the audit.<sup>161</sup> Aside from helping shield corporate officials from liability, an audit serves many other beneficial purposes that outweigh the cost of performing the audit.

#### B. OUTSOURCING PAYROLL TO AVOID LIABILITY

Outsourcing is the practice of contracting work to vendors and suppliers.<sup>162</sup> Common examples of outsourcing include contracting with an outside vendor or supplier to provide building maintenance and cleaning, temporary staffing, and computing maintenance and supply.<sup>163</sup> Companies have two choices for processing payroll: an in-house software program or an outside payroll service provider.<sup>164</sup> If a company chooses in-house payroll processing, management must buy, modify, install, and maintain the program; a company will often spend at least three to four times the price of the software installing and configuring it to work with the existing system.<sup>165</sup> Additionally, a program must be updated and upgraded continuously to ensure that changing payroll tax laws and the company's needs are met.<sup>166</sup>

On the other hand, an outside vendor keeps companies updated on new tax laws and modifies software programs without major software

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160. *Are You Making the Most of Payroll Audits to Detect Fraud & Ensure Compliance?*, PAYROLL MANAGER'S REPORT, June 2000, LEXIS, News Library, News Group File. Detecting payroll fraud can help a corporate official mitigate the worst-case scenario: an employee embezzles money and leaves the company in a financial crisis with no money to pay the taxes. The corporate official might then become liable for the unpaid tax liability. Therefore, a payroll audit can be a lifesaver in many ways.

161. *Id.*

162. AM. MGMT. ASS'N, OUTSOURCING: THE AMA SURVEY 1 (1997).

163. *See id.* at 9.

164. Robert Mannarino, *Outsourcing*, PAYROLL EXCHANGE, Feb. 1993, at 26, 27.

165. *Id.*

166. *Id.*

conversions.<sup>167</sup> Outsourcing payroll has become an increasingly viable and valuable option due to advancements in computer software technology.<sup>168</sup> Consequently, the increased range of services offered through outsourcing has led to the proliferation of the Professional Employer Organization.<sup>169</sup> A Professional Employer Organization (PEO) takes over human resource and payroll obligations for a company and allows a company to focus on strategic goals and minimize unnecessary risks. The services of the PEO (and outsourcing) become more attractive than maintaining in-house operations when a company spends too much time, money, and managerial effort on internal administrative tasks, thereby preventing the company from focusing on efforts more important to its business.<sup>170</sup> The PEO recognizes that companies are forced to spend an increasing amount of time on government mandates, regulatory risks, and administrative burdens.<sup>171</sup> The PEO also recognizes that few companies have the time or resources to ensure proper filing of taxes every payday or the ability to keep up with the changing federal, state, and local payroll tax regulations.<sup>172</sup> Over one-third of all businesses are assessed payroll-related fines and penalties each year, totaling over \$2 billion.<sup>173</sup> Furthermore, companies rarely have the resources to investigate unemployment insurance claims, so they pay higher unemployment insurance taxes than they should.<sup>174</sup> Consequently, an increasing number of companies are turning over their payroll obligations to outside companies that specialize in payroll and the accompanying regulatory scheme.

Aside from freeing companies from the burden of administering payroll, a PEO offers the benefit of relieving a company of the risk of fines and penalties for incorrect or late filings because the PEO will pay any fines or penalties that are due to errors on the part of the PEO. In addition, PEO's are often able to reduce unemployment compensation costs. For companies with employees in several states, a PEO assumes the risk of fines and makes efforts to keep abreast of regulatory changes. Each year, the federal and state governments make numerous changes to the law that prove to be an enormous burden for in-house payroll departments, and the

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167. *Id.*

168. *See id.*

169. *See id.*

170. *Id.*

171. AUTOMATIC DATA PROCESSING, BUSINESS SOLUTIONS (1996).

172. AUTOMATIC DATA PROCESSING, TOTAL TAX PLUS (1997), available at <http://www.adp.com/ma/tax/tpover.htm>.

173. *Id.*

174. *Id.*

risk of error increases with the number of different jurisdictions within which the company does business.

A PEO may appear to be the panacea for the § 6672 problem. While a PEO is one of the better solutions against liability, the solution is not without problems. First of all, outsourcing payroll is not free. Obviously, there is a fee to be paid to the PEO for the assumption of payroll obligations. Most small companies cannot afford the services of a PEO. Also, should the PEO default on the payments to the IRS, the company is still liable under agency doctrine. Several Minnesota companies learned this lesson when a payroll processor went bankrupt.<sup>175</sup> The payroll processor was experiencing financial difficulties and used the taxes it should have deposited to pay its own corporate debts.<sup>176</sup> When the processor filed for bankruptcy, the companies discovered that the payroll taxes were never deposited and the IRS required the companies to pay the withholding taxes a second time.<sup>177</sup> In other words, the company is still liable if the agent fails to perform as required.

In sum, outsourcing is an attractive response to the complex task of assimilating all federal and state tax legislation applicable to a company's payroll. Outsourcing is probably the best way for a client to protect against liability for failure to pay withholding taxes—but this advice is not foolproof.

### C. SUCCESS IN COLLECTING UNPAID TAXES

Withholding taxes are not considered revenue raised by the government. Withholding taxes are taxes that are held in trust and will eventually be returned to the employee in the form of social security or unemployment insurance.<sup>178</sup> In order to ensure collection, I.R.C. § 6672 allows the IRS to find corporate individuals liable. It appears, however, that even with the expansive interpretation of the statute, the government fails to collect a significant portion of the unpaid taxes.<sup>179</sup> As of September 30, 1998, businesses still owed the federal government about \$49 billion in payroll taxes.<sup>180</sup> Internal Revenue Service records show that over 1.8

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175. Marjorie J. Griffing, *When to Use a Common Pay Agent or Common Paymaster*, PAYROLL MANAGER'S REPORT, May 2000, LEXIS, News Library, News Group File.

176. *Id.*

177. *Id.*

178. *See* Kutz, *supra* note 32, at 17.

179. *See id.* at 16.

180. *See id.*

million businesses are responsible for the unpaid taxes.<sup>181</sup> Corporations represent about 56% of the number of businesses with unpaid payroll taxes.<sup>182</sup> Interestingly enough, there appears to be a substantial number of individuals who are responsible for not paying withholding taxes at multiple businesses.<sup>183</sup> Reports from IRS officers indicate that there appear to be two groups of people who have not paid withholding taxes at multiple businesses: (1) individuals who lack the skills necessary to manage a business properly and thus have not flagrantly disregarded their responsibility to pay the taxes; and (2) individuals who have intentionally disregarded their responsibility to forward payroll taxes.<sup>184</sup> Furthermore, evidence suggests that those individuals who failed to forward payroll taxes to the IRS still receive significant federal personal benefits and payments.<sup>185</sup> Common sense would suggest that individuals that owe the government money should not be receiving any funds.

The statute allows the IRS complete discretion in attempting to collect, yet even with the statute's assistance, the IRS collects a woefully small proportion of the unpaid taxes. Clearly, the statute is not an effective means of collection. Moreover, the statute should protect corporate officers who did not attempt to defraud the government. The IRS should therefore focus its enforcement efforts on individuals who have been found delinquent at multiple businesses. Such behavior evinces a pattern of failing to pay the taxes; thus, it is far more likely that these individuals intentionally disregarded paying payroll taxes.

Currently, the IRS has two programs to prevent payroll tax delinquencies: the Small Business Tax Education Program and the FTD Alert Program. The Small Business Education Program offers tax workshops to individuals desiring to start up businesses.<sup>186</sup> The FTD Alert program attempts to detect delinquencies by identifying required deposits that have not been made.<sup>187</sup> The IRS, however, appears unable effectively

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181. *Id.* at 20.

182. *Id.* at 22.

183. *See id.* at 30.

184. *See id.* at 32–33.

185. *See id.* at 34.

186. *See id.* at 37.

187. *See id.* The FTD alert targets larger employers that deposit semiweekly because they reported more than \$50,000 in payroll taxes on their quarterly tax form. *Id.* Currently, businesses pay withholding taxes on either a monthly, semiweekly, or next-day schedule. The deposit schedule is determined from the total taxes reported in a four-quarter lookback period. If a business reports \$50,000 or less for a lookback period then the corporation is a monthly depositor. Under a monthly deposit schedule, the deposit on payments made during a month should occur by the fifteenth day of the following month. If a business reports between \$50,000 and \$100,000 in a lookback period, the deposit

to pinpoint problem situations. The IRS does not possess a link or interface between individual and business databases.<sup>188</sup> By being able to spot a continuing offender, or a potentially failing business, the IRS could play an active role to ensure that the funds are paid properly instead of waiting until the damage has been done and then scavenging for an individual to assess. Early detection could prevent the assessment against a potentially hapless officer.

#### D. HEIGHTENED NEED FOR SCRUTINY NOW

At the end of the last century, with the Dow Jones wavering above 10,000, the United States was riding out a wave of economic prosperity. On the whole, businesses and the economy have experienced tremendous growth. But we are already seeing signs of a potential slowdown of the economy; consumer confidence has declined and the stock market has been anything but stable.<sup>189</sup> Therefore, the time to address the problems with the statute is now. Once the economic tide turns, additional businesses will find themselves in financial trouble. With financial trouble comes the increased chance that the withholding trust fund taxes are the only available source of ready funds to keep creditors at bay and the business afloat. Corporations might find themselves forced to file bankruptcy or else to use the trust fund taxes to turn the fate of the company around. In a stagnant or declining economy, the number of corporate officers assessed for unpaid withholding taxes will increase.<sup>190</sup>

Before the economy reaches that point, Congress or the courts must act to rectify the problematic nature of this statute. A corporate officer in a financially troubled company needs a heightened definition of willfulness that takes the totality of the circumstances into account—not simply whether creditors other than the IRS were paid. The strict liability interpretation of the statute imposes sanctions that are too severe and economically harsh. The courts have recognized the harsh reality of the penalty and it is time to realize that this is more than an “alternate

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schedule is semiweekly. Under the semiweekly schedule, liability for wages paid from Wednesday through Friday must be deposited by the following Wednesday. If tax liability exceeds \$100,000, then the tax must be deposited on the next banking day. See IRS CIRCULAR, *supra* note 5, at 18–19.

188. See Kutz, *supra* note 32, at 25.

189. See Yochi J. Dreazen, *Consumer Confidence Plunges to Two-Year Low*, WALL ST. J., Dec. 29, 2000, at A2. Dreazen notes that the December drop in consumer confidence, which was fueled by a decrease in household expectations about the future health of the economy, marked the third consecutive decrease in the index. He further comments that a decline in consumer confidence suggests that spending will decrease in 2001 and may signal a more severe economic slowdown. *Id.*

190. See Walker, *supra* note 7, at 803.

collection device.” Action must be taken before the occurrence of an economic downturn that increases the potential for assessments against corporate officers in financially troubled companies.

## V. SOLUTIONS

One response to the myriad substantive and procedural problems associated with § 6672<sup>191</sup> would be to adopt a two-part test of duty and authority.<sup>192</sup> This proposal would eliminate status as a requirement, focusing on the individual who had the duty and authority to pay the taxes rather than on the individual who had the duty and authority to pay other creditors.<sup>193</sup> The proponents of this approach believe that the new test would prevent the extension of liability to a person who was acting upon specific instructions from a superior not to pay taxes.<sup>194</sup> Although the proposed test might be a step in the right direction, this test would not necessarily provoke the needed change in the interpretation of the statute. The proposed two-pronged test of duty and authority could still be interpreted broadly to produce results similar to the current problematic results.

The statute as currently interpreted is a source of frustration and unjust results. The lack of sound and practical advice to avoid liability demonstrates the need for reform. The statute should be interpreted differently in order to deal with the practical realities of the financial world. Imputing liability for the entire amount of the unpaid taxes does not make sense when an officer whose annual salary is perhaps one-tenth of that amount becomes ensnared by the IRS. Furthermore, these debts are not dischargeable in bankruptcy. Consequently, the willfulness prong should be brought in line with the definition given in criminal tax provisions. The legislative history of the statute further supports an increased level of intent necessary to find “willfulness.”

The severity of the economic penalty imposed is a further indication that the definition of willfulness should encompass more than evidence that the corporation paid other creditors. Instead, if the individual were able to produce evidence that reasonable efforts to pay the taxes were undertaken with diligence, the willfulness prong should be negated. In addition, under a criminal definition of willfulness, individuals should be able to exculpate

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191. See *supra* Part III.

192. See Hungerford, *supra* note 15, at 472.

193. See *id.* at 472–73.

194. See *id.* at 473.

themselves by introducing evidence of the totality of the circumstances surrounding the corporation.

Under the current statute, plaintiffs have attempted to offer severe financial hardship as a defense to liability.<sup>195</sup> Courts, however, have been reluctant to allow this as a means to avoid liability, because it would be “inconsistent with the purposes of Congress to protect the sources of revenue by permitting recovery from those individuals charged with the responsibility of transferring withheld funds to the Government.”<sup>196</sup> Indeed, economic hardship need not be permitted as a defense. Instead, the plaintiff should be able to introduce evidence to show that he or she undertook efforts that the average reasonable person would have undertaken. The jury could then evaluate the evidence introduced and decide whether the individual intended to defraud the government. The jury would not be able to find the officer liable—even if he or she was “responsible”—if the officer attempted to pay the taxes and was not able to do so because the funding was denied.<sup>197</sup> In other words, the jury would not be able to find the individual liable if there were a good faith attempt to pay the taxes. The statute should not severely penalize an individual who was, for all intents and purposes, going to pay the taxes but did not have the funds available because of financial troubles.

If courts are reluctant to impose the criminal standard of willfulness, then the 100% penalty should be modified. The current severity of the penalty in combination with the lack of success at collection demonstrates that the statute is unrealistic in its goals. Instead, the penalty could be calculated in either of two ways. First, the amount of the liability could be calculated as a percentage of the individual’s salary. The calculation could also reflect the individual’s salary as a percentage of the top salary offered. Alternatively, the calculation could be the individual’s salary as a percentage of the net revenue (before expenses) of the company.<sup>198</sup> Through these alternative formulas, individuals who are caught in the net of liability could be assessed for a reasonable amount of taxes instead of being held liable for the entire amount. This may actually assist the IRS in its collection efforts. An individual may be more inclined to pay off a

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195. See *Fran Corp. v. United States*, 998 F. Supp. 296 (S.D.N.Y. 1998).

196. *Monday v. United States*, 421 F.2d 1210, 1216 (7th Cir. 1970).

197. Other circumstances that might weigh in favor of a finding of reasonableness are as follows: the employee was threatened with firing if the employee used the funds to pay the taxes; the employee was attempting to make ends meet after an embezzling scandal; or the employee was possibly culpable but not to the extent that another, more senior employee was.

198. Using net revenue (before expenses) might help a financially troubled business. Such an approach would equate an individual’s tax liability with his or her status within the company.

relatively manageable debt of \$10,000 as compared with an overwhelming liability of \$1,000,000. Assigning liability for only a portion of the total taxes owed might result in the successful collection of the smaller amount, whereas the IRS might not receive anything from the individual assessed with the larger amount.

Furthermore, the jury might be given instructions to calculate an amount that is a percentage of the total taxes owed. The jury as the fact-finder could weigh the officer's culpability against the justification that the government needs the money to determine an amount appropriate for the individual to pay. The jury, after hearing the facts, may decide that the plaintiff should not be held liable for the entire amount of unpaid taxes.<sup>199</sup>

Liability for a percentage of the taxes appears to comport with other criminal and civil penalties that impose penalties of less than 100%.<sup>200</sup> A form of proportionate liability, this solution would allow a jury to decide if the officer was fully responsible for the failure to pay the taxes. The defense would be able to offer business hardship, management pressure, and other reasons as to why the officer should not be held fully responsible for the corporation's debt. Proportional liability would allow a jury to find an officer guilty of failing to pay the withholding taxes but would not assign the staggering amount of liability dictated under the current strict liability interpretation of the statute.

If courts appear reluctant to change the current interpretation because of separation of powers considerations, then that reluctance should be viewed as a call to arms for the legislature.<sup>201</sup> Assignment of the entire liability to an individual goes against the idea of limited liability (the very premise that corporations are based upon); it is unjust and should be remedied. The legislature should consider the significance of the legislative history of I.R.C. § 6672 and recognize the need for a heightened standard of willfulness. Congress should promulgate legislation that includes a defense to total liability through a totality-of-the-circumstances test that could incorporate good-faith efforts on the part of the officer to pay the taxes.

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199. The jury should take into account the totality of the circumstances surrounding the failure to forward the taxes. Factors would differ on a case-by-case basis but should include (and not be limited to) a good faith attempt to pay the taxes; orders not to pay the taxes by a superior officer; seniority of the individual being assessed; job title and education; previous finance and tax experience; and annual salary.

200. See statutes cited *supra* note 29 (discussing the penalties imposed by other tax statutes for failing to pay taxes).

201. See Bedikian, *supra* note 14, at 269 (explaining the importance of legislative reform in the face of judicial passivity towards I.R.C. § 6672).

Also, Congress could attempt to alter IRS procedures in order to allow earlier detection of delinquencies. The improvement of procedures could permit the IRS to identify individuals who have failed to pay withholding taxes at multiple businesses. Alternatively, the IRS allows electronic deposit for payment of taxes and even requires it for large businesses.<sup>202</sup> By requiring electronic deposit for all businesses, the IRS might be able to ameliorate the FTD Alert program to provide early and prompt information to IRS officers. The officers could then attempt to contact the company to provide education and information; they could also more effectively monitor and catch corporations with tax delinquencies. Preventing large delinquencies could also eliminate large liabilities being assessed against individuals.

## VI. CONCLUSION

Withholding taxes are proving to be dangerous for corporations and the individuals behind those corporations. Withholding taxes and the failure to pay over those taxes can land an individual in a legal morass under the current interpretation of I.R.C. § 6672. The growth of the outsourcing industry and PEO's is a sign that payroll is often too difficult, time-consuming, and costly for even sophisticated companies. The outsourcing industry is an economic response to dealing with the risk of maintaining an in-house payroll department. Advising a client to have an outside service perform payroll is solid advice, but it is costly for clients and does not entirely remove the risk of liability for tax delinquencies.

Many courts recognize that the statute needs to be remedied, but they differ as to what the source of the remedy should be: the legislature or the judiciary. The results are unjust and ineffective both for the plaintiff assigned liability and for the IRS attempting to obtain the funds owed to the government. That the courts are often dissatisfied with the results under the statute supports the call for change. A step in the right direction for most corporations may simply be awareness of the potential for liability. Moreover, the statute can be remedied in a variety of ways both procedurally and substantively in order to ensure more just results. The consequences of the statute could be softened by increasing early detection of offenders. With an increase in funding for the IRS, the Service might be able to spot troubled corporations early. Thus, notice can be given and the Service can step in before the problem becomes unmanageable. With early detection, the IRS would also realize additional opportunities to seize

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202. See IRS CIRCULAR, *supra* note 5, at 20.

corporate assets. With the assessment of the corporation's assets, the IRS would be able to obtain payment for the outstanding tax liability from the corporation rather than from the hapless official who is already sinking with the ship. It is far more palatable that the IRS seize corporate assets to satisfy the tax liability rather than extract the money from individuals. The consequences of this statute and the amount of litigation surrounding it underscore the exigency of change—and there are plenty of places to start.