The IRS Trust Fund Recovery Penalty

What it is, how it works, and how to avoid it.

# What is it?

In IRS lingo, it is a penalty in the same amount of the Trust Fund balance due. Clear as mud?

As all employers know, it costs more than $24,000 to pay your employee $24,000 per year. One of the biggest added costs is “FICA” or “Federal Insurance Contributions Act” aka Employment Tax. FICA is simply Social Security Tax and Medicare Tax. It is made up of two parts, employ**ee** paid, and employ**er** paid.

As an employer, when you hire someone, they are generally a “W-2 employee”. That means you hold Social Security (SSA), Medicare (Med), and W-4 withholding (WH), from their paychecks. The SSA & Med is only ½ of the total FICA. The other ½ is paid by the you, the employer.

W-4 withholding is the tax typically associated with annual 1040’s & refunds. The employer does not contribute to this.

The employee gets paid $24,000 per year, which would be ~$462.00 per week. Out of that $462 you would withhold SSA at 6.2% ($28.64), Med at 1.45% ($6.70), and WH at (hypothetically) 5% ($23.10). Employee’s take home pay is $403.56.

The withheld tax ($58.44) is the amount the employee owes the government. It is the employee’s money that they are paying to the government. As the employer, you owe an equal amount of SSA & Med ($35.34). The total tax bill is $93.78.

Of that total tax bill, the $35.34 is not trust fund. The $58.44 however, is. The $58.44 is money that the employee has entrusted you to pay to the government on their behalf. It is not owed by you but by the employee. It is not your money, but the employees’.

# How does the penalty work?

The penalty is set in the same amount as the trust fund part of the balance due. Using our example above, if you did not pay any of the taxes for that one employee, you would have a balance due of $4,876.56. Of that amount, $3,038.88 is trust fund.

An IRS Revenue Officer will open a trust fund investigation. The purpose is to determine who is liable for the trust fund balance. They are looking for 3 things to determine that liability – Responsibility, Willfulness, and Collectability.

The most complex of these is responsibility. We’ll deal with that after the other two.

WILLFULNESS

Willfulness, on the surface sounds straight-forward. However, when you consider the Internal Revenue Code definitions and court rulings, you see that the bar is much lower than “it wasn’t on purpose”.

Willfulness is being aware, or should be aware, of the unpaid taxes and deliberately choosing not to pay the taxes or recklessly disregarded and obvious risk that the taxes would not be paid.

Examples are great ways to show the scope of willfulness.

1. A person’s failure to investigate or correct mismanagement after being notified that withheld taxes have not been paid.
2. Paying the net wages to employees when funds are not available to pay the withholding taxes.
3. Paying the utilities when withheld taxes have not been paid.

Employee wages and utility bills are simply other creditors of the business. Paying employees or utilities instead of the withheld tax is a willful choice to pay them over the government.

COLLECTABILITY

This one is actually *not* complicated. The revenue officer will look at whether or not the potentially liable person has the ability, or reasonably may in the future, have the ability to pay the penalty.

If the amount of the trust fund recovery penalty is $250,000 and the person makes minimum wage, it is highly unlikely their income will exceed their allowable expenses to the point where they can make a meaningful contribution to the penalty. Therefore, don’t waste everyone’s time assessing it.

RESPONSIBILITY

A "responsible person" is one who has the duty to perform or the power to direct the act of collecting, accounting for, or paying over trust fund taxes. 10 things that evidence responsibility are as follows.

1. Signing payroll checks, Form 941 returns, or operations checks.
2. Having signature authority on the company’s bank account.
3. Preparing 941 returns.
4. Authority to decide which checks are paid.
5. Awareness of the non-payment of withheld tax.
6. Making federal tax deposits.
7. Authority to hire & fire employees.
8. Simply having the position of a high-ranking official, i.e., CEO, President, or VP.
9. Expectation of authority in financial policy decisions.
10. “Effective power to pay the taxes owed”. This is when a person has the authority to exercise significant control over the company’s financial affairs, whether or not such control is in fact exercised.