

Don't Take That "Loan!"

Basic Problem

Your client's business, like many in the state, is confronting tough times and operational losses, with the bank breathing down one's neck threatening to call the loan. Any additional working capital loan is out of the question. The proverbial light bulb goes on in your financially distressed client's head, "I know where there's a lot of money." That source of funding is the payroll taxes that should be paid to the Internal Revenue Service (IRS) from withheld income tax and social security tax, as well as the state of Michigan and any local withholding and payroll taxes. These typically aggregate a large sum that can readily equate to 30 percent of payroll expenses. Such a "loan," of course on a "temporary basis" as your client will undoubtedly tell you, is the easiest loan in the world to obtain. The problem with using that tempting cash to fund operations and keep the business going is that it comes with horrific terms. For every "responsible person" of the business who can control what bills get paid, there is statutory joint and several civil liabilities for what is always a substantial amount, and it is not dischargeable in bankruptcy. There are also criminal sanctions.

Those withheld taxes are treated under the Internal Revenue Code (IRC) as trust fund monies. The IRS has an impressive statutory arsenal and no shortage of "can-do" attitude when it comes to enforcement. As one of my retired colleagues was fond of saying, "the twin pillars of the American tax system are Leavenworth and withholding, but not in that order." If an individual, who need not be an owner of the business, has the ability to control or direct which creditors are paid, then he or she is a "responsible person" under IRC 6672. There can be and often is more than one "responsible person." Any responsible person is personally, jointly, and severally liable for the unpaid payroll taxes, plus

statutory interest compounded daily. As to the employer itself, besides the unpaid tax and interest, it will additionally incur penalties that are somewhat draconian in nature. Congress succeeded decades ago in constructing a system in which the cost of non-compliance greatly exceeds the cost of compliance.

With the income tax, many taxpayers speculate whether the IRS will audit and, if audited, discover the "problems with the return," as only a small percentage of returns are audited. By contrast with payroll taxes, it is very simple. There is a 100 percent certainty the IRS will discover the problem when the payroll taxes are not turned over to the government.

The Consequences

Procedurally, there is a separate investigation by an IRS employment tax specialist whether given individuals are, or are not, responsible persons. If they are ultimately determined to be responsible persons, there are certain appellate rights within the agency, and one can also judicially contest a final agency determination. However, if someone is found to be a responsible person, it has dire consequences. Not only do they owe the money, plus interest from the date the employment taxes are formally assessed against them, but also, they face four substantial problems.

1. The business does not suddenly thrive and usually fails anyway.
2. The IRS collection machinery will go after them, hard. Their "equities" of trying to keep the business alive and save jobs will have absolutely no deterrent effect on active IRS enforcement. On the active enforcement side, the IRS can and will levy on assets. In the government's fiscal year ending September 30, 2000, there were less than 300,000 levies by the IRS for all types of taxes. The

most recent year's statistic was over 4,000,000 levies.

3. Their credit is trashed as a direct result of the inevitable federal tax lien. With an undischarged federal tax lien in today's economy, home mortgages, business loans (even with a personal guaranty), and car loans simply are not obtainable.

4. Michigan has its own version of the federal "responsible person" scheme, and the responsible persons will also face Michigan enforcement activities.

Why does the IRS, as one client phrased it, "go nuclear" about unpaid payroll taxes? First, from the IRS and Internal Revenue Code perspectives, it is misappropriation of trust fund monies. Second, the IRS has to give the employees 100 cents on the dollar credit for taxes withheld by the employer, but not paid over to the government.

What about bankruptcy? The U.S. Supreme Court long ago confirmed what everyone thought, employment tax cases are not dischargeable in bankruptcy.¹

Conclusion

Usually, the best advice for the owners and any other responsible persons at a financially troubled enterprise is absolutely, positively make sure all payroll taxes are timely paid in full no matter what and talk to bankruptcy counsel about resolutions with other creditors. If an individual is a potentially responsible person in an entity in which he or she has no ownership interest, the best course of action probably is to resign even with no new job offering. That may sound harsh, but it reflects reality.

NOTES

1. *United States v. Sotelo*, 436 US 268 (1978).



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