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I. THE CASH FLOW DILEMMA

Employers are generally required to withhold income, Social Security, and Medicare taxes from their employees' paychecks. Employers hold these taxes "in trust" until they are deposited or otherwise paid over to the government.[1] Since one of the most common problems faced by owners and managers of businesses is the lack of adequate cash to satisfy their numerous immediate obligations, this system creates a temptation for the employer to use the withheld funds to cover its costs. Short-term bank loans are often either unavailable or unaffordable, and the employer's own debtors may be unable to pay or not yet obligated to pay.[2] Certain creditors, such as landlords, suppliers, shipping agents, and employees, must be paid on time or the business would cease to operate. When confronted with this dilemma, the employer may turn to the one source of cash immediately available: the taxes withheld from employee paychecks.[3]

This decision is usually seen as a short-term fix to a temporary cash flow problem; the employer believes it will be able to meet its tax obligations when due. If the employer manages to replenish its cash before the withheld taxes are due, the employer satisfies its obligation and avoids sanction. If the payment is late, the employer may be liable for penalties. On the other hand, if cash flow problems are permanent, the employer may be entirely unable to fulfill its obligation to pay over the withheld taxes. If the company fails to pay

1. I.R.C. § 7501(a) (2000).

2. IRA L. SHAFIROFF, INTERNAL REVENUE SERVICE PRACTICE AND PROCEDURE DESKBOOK 9-3 to 9-4 (3d ed. 2004).

3. *See, e.g.*, Slodov v. United States, 436 U.S. 238, 243 (1978) (noting that "[b]ecause the Code requires the employer to collect taxes as wages are paid, while requiring payment of such taxes only quarterly, the funds accumulated during the quarter can be a tempting source of ready cash to a failing corporation beleaguered by creditors" (citation and footnote omitted)). The taxes that are required to be withheld from employee wages are discussed *infra* Part II.B.1.

the taxes when required, a full range of tax collection devices are available to the Internal Revenue Service (IRS).

Withheld taxes are referred to as "trust fund taxes," in reference to Internal Revenue Code (Code) section 7501, which states, "the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States."[4] Under general trust principles, the employers' use of funds held in trust, as are "trust fund taxes," constitutes a misappropriation of those funds.[5] However, general common law trust principles cannot be applied wholesale to this context.[6] For example, despite the creation of a trust, there is no requirement that the trust fund taxes be segregated from the employer's general operating funds as soon as the trust taxes are incurred.[7] While the IRS has the right to demand segregation, and even criminalize the failure to do so, segregation does not help the government collect trust fund taxes that have already been misappropriated.[8] Generally, the withholding system only requires that the employer deposit the withheld taxes, pay the taxes with the quarterly employment tax return, or both.[9]

Collection is further complicated by the fact that, under the withholding system, employees are entitled to a credit against their personal tax liability for all taxes withheld from their paychecks, regardless of whether the employer actually pays the government.[10] The IRS has no recourse against employees for unpaid withheld taxes but, rather, must seek payment from the employer. To this end, the IRS has a number of statutory devices to effectuate collection.[11] For

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4. I.R.C. § 7501(a); *see also infra* Part II.A.

5. *See, e.g.*, Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequencecs*, 66 N.Y.U. L. REV. 1045, 1047 (1991) (discussing how best to deter breaches of fiduciary duties). In this Note, therefore, the use of trust fund taxes by the employer to pay the business creditors will be referred to as "misappropriation" or the "misappropriation problem." *See* SHAFIROFF, *supra* note 2, at 9-5 to 9-6 (noting that in addition to civil aspects, "the Internal Revenue Code also makes misappropriation of trust fund taxes a felony").

6. *See infra* Part IV.A.

7. Begier v. IRS, 496 U.S. 53, 61 (1990). The nature of the section 7501 trust compared to a common law trust is discussed *infra* Part IV.A, B.2-.3.

8. I.R.C. §§ 7512, 7215; *see infra* note 35. Whether a universal segregation requirement is practical, *see infra* note 199, is outside the scope of this Note. This Note deals with the devices currently available to the IRS to collect misappropriated trust fund taxes.

9. The deposit, reporting, and payment requirements for withheld taxes are discussed *infra* Part II.B.

10. Slodov v. United States, 436 U.S. 238, 243 (1978). The amount of a paycheck is the employee's "net wages," which are the gross wages less deductions for employment taxes.

11. Section 7501 states that the funds held in special trust "shall be assessed, collected, and paid in the same manner and subject to the same provisions and limitations (including penalties) as are applicable with respect to the taxes from which such fund arose." I.R.C. § 7501(a). Thus,

example, if the employer has other assets, the IRS may seize and sell those assets to satisfy the trust fund tax obligation.[12] Criminal sanctions are also available.[13]

This Note focuses on two other collection devices. The first device includes two mandatory penalty provisions assessed when the employer pays the trust fund taxes late.[14] Section 6651(a) imposes a monetary penalty on an employer who fails to timely pay the taxes due with the quarterly employment tax return.[15] Section 6656(a) imposes a monetary penalty on an employer who fails to timely deposit the trust fund taxes into a government depository.[16] Both penalty provisions are "additions to tax," and their assessment is mandatory unless the employer shows that the failure to pay[17] is "due to reasonable cause and not willful neglect."[18] The circuit courts are currently split as to whether an employer's financial difficulties may constitute reasonable cause, excusing the late payment of trust fund taxes.[19] This Note argues that, under trust and fiduciary principles, misappropriation of trust fund taxes can never be excused as reasonable, even if the misappropriation is absolutely necessary to keep the business operating.

The second collection device applies if the employer does not pay the trust fund taxes at all, and collection from it is not possible. Section 6672 allows the IRS to hold certain employees personally liable for the trust fund tax obligation. Under this "trust fund recovery penalty," any "responsible person" who willfully fails to

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there is available to the IRS the "full range of collection methods available for the collection of taxes generally." *Slodov*, 436 U.S. at 244.

12. *Slodov,* 436 U.S. at 244.

13. For example, the Code imposes up to five years imprisonment and a $10,000 fine on any responsible person who willfully fails to pay withheld taxes to the government. I.R.C. § 7202.

14. Penalty provisions are viewed as collection devices in that they are designed to ensure voluntary compliance with the tax laws. According to the IRS Policy Statement P-1-18, the IRS "'uses penalties to encourage voluntary compliance by' (1) helping taxpayers understand that compliant conduct is appropriate and that noncompliant conduct is not; (2) deterring noncompliance by imposing costs on it; and (3) establishing the fairness of the tax system by justly penalizing the noncompliant taxpayer." IRS, INTERNAL REVENUE MANUAL § 4.10.6.1 (2004), http://www.irs.gov/irm/index.html.

15. I.R.C. § 6651(a)(2)-(3). Section 6651(a)(2) applies when the taxpayer fails to pay the amount shown as due on a tax return. Section 6651(a)(3) applies to the amount of tax that should have been shown as due on a tax return. For the purposes of this Note, this difference is irrelevant.

16. *Id.* § 6656(a). For a discussion of the deposit requirements the Code imposes and the penalty for failing to timely deposit, see *infra* notes 51-54, 61-63 and accompanying text.

17. This Note, for simplicity, refers to both the failure to pay over the taxes with the tax return and the failure to pay the taxes to a depository bank as the "failure-to-pay" penalties.

18. I.R.C. §§ 6651(a)(2)-(3), 6656(a).

19. *See infra* Part III.B.

collect, truthfully account for, or pay the trust fund taxes may be held liable for the full amount of the employer's trust fund tax obligation.[20] This section is designed to ensure compliance "by subjecting the employer's officials responsible for the employer's decisions regarding withholding and payment" to personal liability for misappropriation.[21]

The plain words of the section 6672 do not include a reasonable cause exception excusing misappropriation because of financial difficulties. The Tenth Circuit, however, has recently implied such an exception in its reading of the willfulness requirement.[22] This Note argues that this development is antithetical to the general trust principle that misappropriation of trust funds is never excusable because of the financial difficulties of the trustee.[23] Consequently, the majority rule, that a reasonable cause exception for willfulness does not exist, should be adhered to without modification.

This Note proceeds as follows. Part II introduces the federal tax withholding system by explaining the types of taxes that must be withheld, the special characteristics of trust fund taxes (as opposed to direct taxes), and the penalty provisions applicable to them. Part III examines the definition of willfulness under trust fund recovery penalty, the majority rule rejecting a financial difficulties reasonable cause exception, and the recent break from the prevailing view. This section then compares recent divergent circuit court decisions on the question of whether financial difficulties can constitute reasonable cause for the failure-to-pay penalties, and examines how willfulness jurisprudence has affected this determination. Part IV concludes that, based upon trust and fiduciary duty of loyalty principles, no reasonable cause exception (for any provision) should excuse the misappropriation of trust fund taxes.

II. EMPLOYMENT TAXATION AND TRUST FUND TAXES

A. The Trust Fund Tax Concept

The Code often uses withholding, which requires a third party to collect and hold a portion of a disbursement of property

20. *See* I.R.C. § 6672. Section 6672 is often referred to as the "100 percent penalty"; yet the IRS calls it the "trust fund recovery penalty." *See* IRS, *supra* note 14, § 1.2.1.5.14. The wording of the statute is nearly identical to the criminal statute, section 7202; however, courts have interpreted the willfulness requirement differently. *See* I.R.C. § 7202; *infra* notes 74, 89.

21. Slodov v. United States, 436 U.S. 238, 247 (1978).

22. *See infra* Part III.A.2 (discussing *Finley v. United States*, 123 F.3d. 1342 (10th Cir. 1997) (en banc).

23. *See infra* Part IV.B.3.

representing the recipient's tax obligations, as a common system of tax collection.[24] The taxes collected are called "trust fund taxes" in reference to section 7501(a) of the Code, which provides that the third party holds the withheld taxes "in trust" for the government.[25]

The contours of the trust fund tax concept were largely defined by the Supreme Court in *Beiger v. IRS*.[26] In that case, American International Airways (AIA), a commercial airline, was subject to both the employer withholding requirements and the airline ticket excise tax collection requirement.[27] When AIA fell behind in its payment of these trust fund taxes, the IRS required it to segregate the taxes by depositing them into a separate bank account.[28] AIA established the account but regularly failed to deposit funds sufficient to cover all of the taxes owed.[29] AIA did, however, completely satisfy its trust fund tax obligations by supplementing the special account with funds from its general operating accounts.[30]

AIA eventually went bankrupt, and a trustee was appointed to liquidate the corporation.[31] The bankruptcy trustee, Beiger, sought to exercise his "avoidance power" and recover the amount of trust fund taxes paid by AIA during the ninety-day period prior to bankruptcy.[32] The Bankruptcy Court allowed Beiger to recover the trust fund taxes paid out of the general accounts of AIA, reasoning that a section 7501

24. *See, e.g.*, I.R.C. § 1441(a) (requires any person who pays any item of income, such as interest, rent, or dividends, to a nonresident alien or foreign partnership to deduct and withhold 30 percent of the amount paid as a tax); *id.* § 3402(q) (withholding of gambling winnings). Third parties also have tax collection responsibility upon the *receipt* of certain payments, representing federal excise taxes (taxes on the payor). For example, the tax on airline tickets is paid by the customer, and is collected by the airlines. *See id.* § 4261 (imposes a 7.5 percent tax on the amount paid for air transportation, which is collected by the airline when the ticket is paid for by the passenger).

25. *Id.* § 7501(a); *see* Begier v. IRS, 496 U.S. 53, 55-56 (1990). Because these taxes are imposed on someone other than the party who is required to collect and pay the taxes, they are often called "third-party taxes." *See* John W. Schmehl & Richard L. Fox, *Responsible Person and Lender Liability for Trust Fund Taxes—§§ 6672 and 3505*, 639-2d Tax Mgt. (BNA) A-1 (2000). Thus, the term "trust fund tax" only applies to third party taxes and not to direct tax obligations (the person who is required to pay the taxes is the same person on which the tax is imposed).

26. 496 U.S. 53 (1990).

27. *Id.* at 55.

28. *Id* at 56. The Court is referring to I.R.C. § 7512. *See* discussion *infra* note 35.

29. *Begier,* 496 U.S. at 56. The case does not discuss it, but violations of section 7512 can result in criminal penalties. *See infra* note 35.

30. *Begier,* 496 U.S. at 56.

31. *Id.*

32. *Id.* at 56-57. Under 11 U.S.C. § 574(b) (2001), a trustee may avoid certain preferential payments the debtor made prior to bankruptcy if it "would 'enable a creditor to receive payment of a greater percentage of his claim against the debtor than he would have received if the transfer had not been made and he had participated in the distribution of the assets of the bankrupt estate.' " *Id.* (quoting H.R. REP. NO. 95-595, at 177 (1977)).

statutory trust ("Code trust") is created only to the extent that the trust fund taxes are segregated from the employer's general operating funds.[33] The Supreme Court disagreed, holding that the Code trust is created at the time of collection (for excise taxes) or withholding (for employment taxes), rather than upon segregation.[34] Adopting the opposite rule would allow employers to avoid the creation of a trust by simply refusing to segregate.[35] Thus, while trust fund taxes may commingle with the company's general operating accounts, such commingling does not change the nature of the trust.[36]

Like all trusts, the taxes held in trust are the property of the beneficiary, the government, and not of the trustee.[37] The withheld taxes are never the property of the employer.[38] As a result, under general trust principles, using withheld funds to satisfy business expenses constitutes misappropriation of trust funds, which is a breach of the trustee's fiduciary obligation.[39] Code trusts are,

33. *See id.* at 57 (citing *In re* Am. Int'l Airways, Inc., 83 B.R. 324, 329 (E.D. Pa. 1988)).

34. *Id.* at 60-61. For employment taxes, withholding occurs at the time net wages are paid to the employees, and for airline ticket excise taxes, collection occurs when the customer pays for the airline ticket. *See id.* The Code trust was created at these moments of payment, and the fact that AIA did not place the taxes in a segregated account is irrelevant to the creation of the trust. *Id.* at 61. Segregation is discussed more thoroughly *infra* note 199.

35. *Begier*, 496 U.S. at 61. Moreover, such a reading would make the special segregation requirements of section 7512 superfluous. *See id.* Under this section, upon notice from the IRS, a party required to collect or withhold trust fund taxes must segregate the taxes by placing them in a separate bank account, where they must stay until paid to the government. I.R.C. § 7512(a)-(b) (2000). If the party fails to meet these requirements, it is subject to criminal sanction. *Id.* § 7215(a). This section provides for up to one year imprisonment and up to a $5000 fine for each offense. *Id.* The statute does not require a showing of intent to defraud or willfulness, but it does provide an exception for persons who show that there was reasonable doubt as to (1) whether the law required collection of the tax, or (2) who was required by law to collect the tax, and (3) the failure to comply was due to circumstances beyond the payor's control. *Id.* § 7215(b); United States v. Erne, 576 F.2d 212, 213 (9th Cir. 1978). Interestingly, however, the statute specifically provides that "a lack of funds existing immediately after the payment of wages (whether or not created by the payment of such wages) shall not be considered to be circumstances beyond the control of a person." *Id.* § 7215(b). Thus, in one of the few Code sections that specifically refer to trust fund taxes, financial hardship is rejected explicitly as an excuse for the failure to pay over the trust fund taxes.

36. Furthermore, once the trust is established, the employee or customer who was directly taxed receives credit for paying the tax regardless of whether the trustee actually pays the taxes to the government. Slodov v. United States, 436 U.S. 238, 243 (1978).

37. *See, e.g,* Gephart v. United States, 818 F.2d 469, 472 (6th Cir. 1987).

38. Income taxes are withheld from the employee's wages for the sole purpose of satisfying the employee's tax liability, and if there is excessive withholding during the tax year, the employee is entitled to a refund. *See* MERTEN'S LAW OF FEDERAL INCOME TAXATION § 47A:48 (2004). Similarly, the Social Security and Medicare taxes withheld are part of the wages of the employee, represent a direct tax on the employee, and at no time are the property of the employer. *Id.*

39. GEORGE G. BOGERT & GEORGE T. BOGERT, THE LAW OF TRUSTS AND TRUSTEES § 481 (2d rev. ed. 1978). The Supreme Court has left open the question of whether section 7501 establishes

however, fundamentally different from common law trusts.[40] Nevertheless, the Court clearly found that Congress intended to create a "trust" in the taxes.[41]

B. *Withholding of Employment and Income Taxes from Employees*

1. Employer Withholding Requirements and Liability

Taxpayers most noticeably encounter a withholding system every time they receive a paycheck from their employer. Under the Code, employers must withhold two types of taxes from the gross wages[42] they pay to their employees: Federal Insurance Contributions

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a basis of liability applicable to responsible persons independent of section 6672. *Slodov*, 436 U.S. at 256 n.18.

40. In *Begier*, the Supreme Court noted that, while common law trusts cannot exist without an ascertainable property interest, Code trusts are created in an abstract "amount" rather than in a particular interest in property. *Begier*, 496 U.S. at 62. For a detailed comparison of common law trusts and Code trusts, see *infra* Part IV.A.

41. *See Begier*, 496 U.S. at 62 ("Our holding that a trust for the benefit of the IRS existed . . . ."); *id.* at 62 n.4 ("The general common-law rule that a trust is not created absent a designation of particular property obviously does not invalidate § 7501's creation of a trust in the 'amount' of withheld taxes."). This innovative "amount" trust also imposes very different obligations on the employer-trustee as compared to the common law trustee. One serious problem in the creation of the "amount trust" is seen in bankruptcy proceedings. Common law tracing rules, which seek to trace the particular property, are unhelpful in the section 7501 trust concept, which has no particular assets identified as held in trust. *Id.* at 62-63. Nevertheless, in a bankruptcy proceeding, the IRS cannot simply take any asset to satisfy the trust fund obligation; it must show some connection between the section 7501 trust and the debtor's assets or be regulated to its ordinary claim in bankruptcy. *Id.* at 65-66; *see also Slodov*, 436 U.S. at 256 (holding that the rule requiring "a nexus between the funds collected and the trust created" is consistent with common law principles requiring tracing of misappropriated funds). Thus, the bankruptcy rules highlight the need for segregation. As in bankruptcy proceedings, the IRS could trace the trust in the amount to the funds resting in the separate bank account or other traceable fund. Larry A. Makel & James C. Chadwick, *Lender Liability for a Borrower's Unpaid Payroll Taxes*, 43 BUS. LAW. 507, 527 (1988); *see also* Wayne Rodney, Note, *The Non-Traceable 7501 Tax Trust and Bankruptcy Superiority*, 14 CARDOZO L. REV. 449, 450-51 (1992) (noting that the IRS may have the option of tracing trust funds into other property of the debtor rather than relying solely on its claim under Bankruptcy Code section 507(a)(7)(C) (2001)). If the IRS cannot collect the full amount in bankruptcy, it will have no choice but to seek satisfaction from the responsible persons under section 6672 of the Internal Revenue Code. *See id.* at 452 (discussing the importance of section 6672 in a bankruptcy proceeding).

42. I.R.C. §§ 3101, 3111, 3121 (2000). Gross wages generally are defined as "all remuneration for employment," though this rule is subject to numerous special exceptions and much litigation. *See id.* § 3121. Section 3101 imposes the FICA tax on employees based on wages received, and section 3111 imposes the tax on employers based on wages paid. *Id.* Wages are received at the same time they actually or constructively are paid, and the rate of tax imposed on the employer is equal to the rate of tax imposed on the employee. *See id.* §§ 3101, 3111; Treas. Reg. § 31.3121(a)-.3122(a) (as amended in 1964). Thus, it is said that the employer "matches" the amount withheld from the employee. Income tax withholding is computed differently than FICA withholding. *See infra* note 45.

Act (FICA) taxes, commonly referred to as Social Security[43] and Medicare taxes,[44] as well as employee federal income taxes.[45] In addition, there are two direct employment taxes imposed on the employer: the employer's share of FICA,[46] and the federal unemployment tax (FUTA).[47] These direct taxes are reported and deposited similarly as the trust funds taxes, and the failure-to-pay penalties will apply to both types of taxes.[48]

For withheld taxes, the employer is liable to the government for the amount that should have been withheld from the employee's

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43. The Social Security tax funds federal retirement and disability benefits. Peter J. Allman, *Withholding, Social Security and Unemployment Taxes on Compensation* 392-4th Tax Mgt. (BNA) A-1 (2003). Referred to by the Code as old-age, survivors, and disability insurance (OASDI), it taxes wages at a rate of 6.2 percent; thus, the total tax per dollar of compensation paid is 12.4 percent. *See* I.R.C. §§ 3101(a), 3111(a). However, the Code imposes OASDI only up to a statutory ceiling. *See id.* § 3121(a)(1); Cost-of-Living Increase and Other Determinations for 2003, 67 Fed. Reg. 65,620, 65,622 (Oct. 25, 2002). In 2003, wages in excess of $87,000 were not subject to the tax. *Id.*

44. The Medicare tax funds federal health and medical benefits. Allman, *supra* note 43, at A-1. Referred to by the Code as Hospital Insurance (HI), it has a tax rate of 1.45 percent, for a total tax per dollar of wages of 2.90 percent. I.R.C. §§ 3101(b), 3111(b). Unlike OASDI, all wages are taxed, regardless of amount. Allman, *supra* note 43, at A-10(1).

45. *See* I.R.C. § 3402(a). Income tax withholding, unlike FICA, is based on the amount gross wages exceed withholding exemptions, which approximate the personal and dependency exemptions the employee will claim, prorated to the payroll period. *See id.* § 3402(a)(2). This system disperses payment of an individual's income tax liability throughout the year by taking a certain percentage from each paycheck, instead of requiring an annual lump sum payment with the tax return. *See* Graske v. Comm'r, 20 T.C. 418, 420 (1953). The amount of tax that must be withheld can be computed under a variety of methods. The Code provides for the percentage method, *see* I.R.C. § 3402(b); Treas. Reg. § 31.3402(b)-1 (as amended in 1983); the wage bracket method, *see* I.R.C. § 3402(c); Treas. Reg. § 31.3402(c)-1 (as amended in 1983); the average wage method, *see* I.R.C. § 3402(h)(1); Treas. Reg. § 31.3402(h)(1)-1 (1970); the annualized wage method, *see* I.R.C. § 3402(h)(2); Treas. Reg. § 31.3402(h)(2)-1 (1970); the cumulative wage method, *see* I.R.C. § 3402(h)(3); Treas. Reg. § 31.3402(h)(3)-1 (as amended in 1983); and any other method that substantially approximates the percentage method or wage bracket method, *see* I.R.C. § 3402(h)(4);Treas. Reg. § 31.3402(h)(4)-1 (as amended in 1983).

46. *See supra* note 42. Because this tax is imposed on the employer, it is a direct tax and not a trust fund tax. I.R.C. § 7501. This tax is an excise tax "on the privilege of establishing and maintaining the relationship of employer and employee." *See* Jones v. Goodson, 121 F.2d 176, 179 (10th Cir. 1941).

47. This tax, which funds federal unemployment benefits, is similar to tbe employer's portion of FICA in that it is an excise tax with respect to the privilege of employing individuals. I.R.C. § 3301. Currently, if applicable, the tax is 6.2 percent on the first $7000 of wages paid to each employee in the year. §§ 3301, 3306(b)(1). Because FUTA is a tax only imposed on the employer, there is no withholding of FUTA tax, which makes it a non-trust fund tax. *See* § 7501. However, FUTA taxes are reported and deposited, so financial hardship will result in nonpayment of the FUTA taxes and additions of sections 6651 and 6656 penalties. One must clearly distinguish FUTA taxes from the trust fund taxes, however, in applying the reasonable cause exceptions under those sections.

48. When determining reasonable cause, the courts must note this crucial distinction and not apply trust fund misappropriation principles to direct taxes. Section 6672 only applies to trust fund taxes under section 7501. *See* I.R.C. §§ 6672, 7501.

gross wages; therefore, penalties attach if the wrong amount or no amount is withheld.[49] The employer is entitled to a credit if the tax is otherwise paid by the employee; however, this credit does not operate to abate any penalties or interest owed by the employer due to the failure to withhold.[50]

2. Deposit and Reporting Requirements

After collecting the employment taxes, employers must generally deposit them in a government-approved depository bank and report the amount collected to the IRS.[51] This requires the employer to deposit both the trust fund taxes and the employer's share of FICA with an authorized financial institution within a specified time after collection.[52] Small businesses are the only employers who are exempt from the duty to deposit taxes.[53] Failure to timely deposit the correct amount subjects the employer to the mandatory failure-to-deposit penalty.[54]

In addition to the deposit requirements, an employer must file a quarterly return with the IRS that reports the full amount of its employment tax liability.[55] If the employer has deposited the full

49. Treas. Reg. § 31.3102-1(c) (as amended in 1964); Treas. Reg. § 31.3402(d)-1.

50. I.R.C. § 3402(d); Treas. Reg. § 31.3402(d)-1. These general rules of employer liability are relaxed if the failure to withhold the taxes was due to the employer erroneously treating the employee as an independent contractor. *See* I.R.C. § 3509. This oft-litigated distinction is important because FICA and income tax withholding is only required with respect to compensation paid to employees. *See id.* §§ 3101, 3401, 3402. Generally, the common law rules of employment make this determination, although the Code defines some relationships. *See, e.g., id.* §§ 3121(b)(20), 3401(a)(17) (exempting from FICA and income tax withholding, respectively, services performed by individuals on a boat engaged in catching fish or other aquatic life under certain conditions); Marvel v. United States, 719 F.2d 1507, 1514 (10th Cir. 1983) (finding that employment under the Code is determined by reference to common law rules). Because this distinction is not always clear, section 3509 provides that if the employer fails to withhold due to a misclassification, its liability with respect to the employee's FICA taxes is limited to a percentage of the taxes that should have been withheld. *See* I.R.C. § 3509(a).

51. Treas. Reg. § 31.6302-1 (as amended in 2001).

52. *Id.* Employers are classified as either "monthly" or "semi-weekly" depositors. *Id.* Employers that have more than $50,000 in employment taxes during the "lookback" period—the year ending June 30th of the preceding year—are semiweekly depositors and must deposit the taxes generally within a few days after payroll is paid. *See id.* § 31.6302-1(b)(3). Monthly depositors must deposit the accumulated taxes on the 15th day of the following month. *Id.* § 31.6302-1(b)(2). FUTA taxes are also must be separately deposited every quarter whenever the tax in that quarter exceeds $100. *Id.* § 31.6302(c)-3.

53. *Id.* § 31.6302-1(f)(4) (allowing employers with less than $2500 in accumulated employment taxes to remit payment with a timely filed return).

54. I.R.C. § 6656(a).

55. It is the Form 941 return. *See* Treas. Reg. § 31.6011(a)-1 (as amended in 1976) (applying to FICA); Treas. Reg. § 31.6011(a)-4 (as amended in 1996) (applying to withheld income taxes).

amount of the employment taxes owed, no additional tax is due with the return. If, however, deposits were insufficient to satisfy tax obligations, taxes must be remitted with the return or the employer will be subject to the failure-to-pay penalty.[56] An alternative to the monetary penalty provision is the trust fund recovery penalty, which may be assessed against certain employees of the employer.[57]

C. Penalties Applicable to Failures To Meet Reporting and Depositing Obligations Because of Financial Hardship

1. Failure To Pay and Failure To Deposit

The failure-to-pay penalty, assessed when the employer fails to pay taxes due with its quarterly return, is the basic penalty provision that applies to all tax returns. It provides for up to a 25 percent penalty on the amount shown as tax, or that should have been shown as tax, on the return.[58] Assessment of this penalty can be excused only if the taxpayer can show that the failure to pay is "due to reasonable cause and not willful neglect."[59] Because any penalty assessment imposed by the IRS enjoys a presumption of correctness, the taxpayer has the burden of proving reasonable cause.[60]

Likewise, the failure-to-deposit penalty can be excused only if the taxpayer can show that the failure was due to reasonable cause and not willful neglect.[61] The penalty can be up to 15 percent of the underpayment[62] depending upon the number of days that the deposit

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Additionally, employers must file Form 940, the FUTA tax return, in January and pay any amounts due with that return. Treas. Reg. § 31.6011(a)-3(a) (as amended in 1972).

56. *See* Treas. Reg. § 31.6302-1(i)(2).

57. *See infra* Part II.C.2.

58. I.R.C. § 6651(a)(2)-(3). Section 6651 also includes a failure to file penalty of up to 25 percent. § 6651(a)(1). The amount assessed is determined under the following formula: 0.5 percent of the amount shown on the return will be assessed if the failure to pay is for less than one month, with an additional 0.5 percent for each additional month or fraction thereof, for a total penalty not to exceed 25 percent, or 60 months. § 6651(a). For the purposes of this Note, any differences in the rate structures between the failure-to-pay tax shown on a return and failure-to-pay tax that should have been shown on a return is irrelevant.

59. *Id.* § 6651(a)(2)-(3); Ferrando v. United States, 245 F.2d 582, 587 (9th Cir. 1957).

60. *See, e.g., In re* Callery, 274 B.R. 51, 60-61 (D. Mass. 2002); Dogwood Forest Rest Home, Inc. v. United States, 181 F. Supp. 2d 554, 560 (M.D.N.C. 2001). The Taxpayer Bill of Rights 3 places the hurden of production for the penalty assessment on the IRS; this requires it to come forward with evidence justifying the imposition of the penalty. However, tbe taxpayer retains the burden of production and proof as to reasonable cause. Pub. L. No. 105-206, § 3001, 112 Stat. 726 (codified as amended at I.R.C. § 7491); *see* SHAFIROFF, *supra* note 2, at 13-4, 13-40.

61. I.R.C. § 6656(a).

62. The underpayment is the difference between the amount deposited and the amount that should have been deposited.

is late.[63] The definition of "reasonable cause" is construed identically for both sections, and courts do not differentiate between the two when discussing the exception.[64] It is also important that neither penalty is exclusive and each may be assessed on the same underlying obligation.[65]

2. Trust Fund Recovery Penalty and Responsibility

The failure-to-pay penalties create an incentive for employers to pay on time. However, when the employer is insolvent and entirely unable to pay, the penalties are rendered ineffective in ensuring timely payment. The IRS can then utilize the "trust fund recovery penalty" as an alternative means to collect the taxes.[66] This penalty imposes personal liability for the full amount of unpaid taxes[67] on any person required to withhold or pay trust fund taxes who willfully fails to do so.[68] Importantly, the responsible person is liable only for the

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63. *Id.* § 6656(b). The amount of the penalty is determined as follows: 2 percent if the failure is for not more than five days, 5 percent if the failure is for more than five days but not more than fifteen days, and 10 percent if the failure is for more than fifteen days. *Id.* § 6656(b)(1). After a delinquency notice or demand for immediate payment, however, the penalty increases to 15 percent. *Id.*

64. *Dogwood Forest*, 181 F. Supp. 2d at 560 n.4. Outside of reasonable cause, section 6656 allows the IRS to waive the penalty for first-time depositors under limited circumstances. *See* I.R.C. § 6656(c)-(d). There is no comparable exception in section 6651. *Compare id.* § 6656 *with id.* § 6651.

65. *See, e.g.*, Brewery, Inc. v. United States, 33 F.3d 589, 591 (6th Cir. 1994) (finding the action for refund based on assessment of both the failure to timely pay and failure to timely deposit penalties to employee withholding and social security taxes). In fact, financial difficulties often lead to the assessment of penalties. If an employer uses the withheld taxes as business expenses and cannot meet deposit obligations, it is subject to the failure-to-deposit penalty. In addition, because the employer must remit any taxes it failed to deposit with its quarterly return, if its financial difficulties continue, it will also be subject to the failure-to-pay penalty. It is easy to see how quickly the penalty liability can amass to very burdensome amounts.

66. *See* IRS, *supra* note 14, § 1.2.1.5.14. The purpose of this penalty, according to the IRS, "is to encourage the prompt payment of withheld and other collected taxes, and to provide the Service with a secondary source of collection in the event that these taxes are not paid." *Id.* § 4.23.9.13(a)(2). Personal liability "serves a valuable prophylactic purpose: it encourages officers, directors, and other higb-level employees to stay abreast of the company's withholding and payment of employee's taxes." Sutton v. United States, 194 F. Supp. 2d 559, 563 (E.D. Tex. 2001) (quoting Barnett v. IRS, 988 F.2d 1449, 1457 (5th Cir. 1993)).

67. A responsible person's liability is reduced to the extent that the employer pays over a portion trust fund taxes. *See* Schmehl & Fox, *supra* note 25, at A-2.

68. *See* I.R.C. § 6672(a). Because the "responsible person" is liable for the full amount of the unpaid taxes, this penalty is commonly called the "100 percent penalty." *See, e.g.*, SHAFIROFF, *supra* note 2, at 9-3. When more than one responsible person exists, the liability is joint and several, though there is now a statutory right to contribution. Stuart Levine, *The Right to Contribution from Other Responsible Persons—How Far Does It Go?*, 86 J. TAX'N 76, 76 (1997). The lack of such a right was often cited as one of the unfair aspects of responsible person liability. Mary A. Bedikan, *The Pernicious Reach of 26 U.S.C. Section 6672*, 13 VA. TAX. REV.

amount of the underlying tax obligation, not any additional penalty amounts that may have been added, such as the failure-to-pay penalties.[69]

To escape liability, a person must negate one of the two elements of trust fund recovery penalty liability: responsibility or willfulness.[70] According to the Supreme Court, the responsibility element holds liable only "the employer's officials responsible for the employer's decisions regarding withholding and payment."[71] Nevertheless, federal courts have routinely extended liability beyond the actual decision makers.[72] The willfulness element requires that

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225, 248-50 (1993). In addition, the Code contains an exception to section 6672 for voluntary board members of tax exempt organizations. I.R.C. § 6672(e). Under this section, these board members are not liable for the trust fund recovery penalty if (1) they are "serving in a honorary capacity," (2) they do not "participate in the day-to-day or financial operations of the organization," and (3) they do not have actual knowledge of the failure to pay over the trust fund taxes. *Id.*

69. 4 BORIS I. BITTKER & LAWRENCE LOKKEN, TAX PRACTICE AND PROCEDURE ¶ 114.7, at 114-62 (2d ed. 2003). Thus, the trust fund recovery penalty acts as a collection device, ensuring the government receives what it originally was owed. *Id.* As such, the IRS may only once collect the amount of taxes owed. *E.g.*, United States v. Huckabee Auto Co., 783 F.2d 1546, 1548 (11th Cir. 1986) (citing United States v. Sotelo, 436 U.S. 268, 279 n.12 (1978)). In addition, while the trust fund recovery penalty is normally utilized only when the employer is insolvent, the liability it imposes on responsible persons is separate and distinct from the employer's liability, and as a result, the IRS is not required to first exhaust its remedies against the employer. *See id.* at 1548; Parr v. United States, 203 F. Supp. 2d 726, 733 (S.D. Tex. 2002). The IRS, however, has stated that its policy is to collect from the responsible person only if the taxes cannot be collected from the corporation itself, though it is not under a legal ohligation to do so. SHAFIROFF, *supra* note 2, at 9-22 & n.34.

70. *See* Schmehl & Fox, *supra* note 25, at A-1 (stating the two requirements for liability under section 6672). Like the failure-to-pay and failure-to-deposit penalties, the general rule is that once the recovery penalty has been assessed, the responsible person has the burden of disproving liability. *See, e.g.*, United State v. Running, 7 F.3d 1293, 1297 (7th Cir. 1993) (holding the taxpayer has both the burden of production and persuasion after assessment); Schmehl & Fox, *supra* note 25, at A-44 to A-45 (discussing the presumption of correctness). This rule is different, however, in bankruptcy. *See In re* Macagnone, 253 B.R. 99, 101 (M.D. Fla. 2000) (holding that the government has the burden of proving responsibility, but the burden shifts to the taxpayer to disprove willfulness); SHAFIROFF, *supra* note 2, at 9-31 n.50 (noting that the burden of proof is on the taxpayer to demonstrate that he or she did not willfully fail to perform her duties). The IRS, moreover, may have the burden of proving liability in "naked assessments" (such as when the taxpayer's file is lost). *See id.* In the Taxpayers Bill of Rights 3, the burden of production was shifted to the IRS with respect to any penalty or addition to tax imposed by the Code. *Id.* at 9-24. If the trust fund recovery penalty is viewed as a true penalty, then the burden is on the IRS, but if it is viewed as an employment tax, the burden is on the taxpayer. *Id.*

71. Slodov v. United States, 436 U.S. 238, 247 (1978). The Code defines a section 6672 "person" as "an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty" to collect and pay over the taxes in question. I.R.C. § 6671(b).

72. *See, e.g.*, Hochstein v. United States, 900 F.2d 543, 545, 547-48 (2d Cir. 1990) (holding defendant, who signed the checks, liable even though a financing company told him who to pay); Corrie L. Lyle, Note, *The Wrath of I.R.C. § 6672: The Renewed Call for Change—Is Anyone*

liability not be imposed without personal fault.[73] Despite a potentially large monetary sanction, courts classify the penalty as civil because no prison time is involved, and are therefore more comfortable construing the requirements broadly.[74]

Generally, responsibility is determined based upon the person's "status, duty, and authority,"[75] given the totality of the circumstances.[76] While precise principles are difficult to extrapolate from these fact-intensive cases, courts tend to focus on the person's duty and authority with regard to the financial affairs of the business.[77] Generally, a responsible person must have the actual power to pay the taxes, exerting significant, though not exclusive,[78] control over the company finances.[79] While no single factor is

Listening?, 74 S. CAL. L. REV. 1133, 1146-47 (2001) (discussing the unjust result in *Hochstein* as just one example of overreaching in defining responsible persons).

73. *Slodov*, 436 U.S. at 254; *see* discussion *infra* Part III.A.

74. *See* Logal v. United States, 195 F.3d 229, 232 (5th Cir. 1999) (noting the responsibility element is to be construed broadly); Lyle, *supra* note 72, at 1145. To illustrate this point, compare Internal Revenue Code section 6672 with section 7202. Section 7202 is a criminal felony provision that uses the exact language as section 6672, requiring responsibility and willfulness, and imposes a penalty of up to five years in prison and/or a $10,000 fine. I.R.C. §§ 6672, 7202. Since the sanctions are criminal, courts have more narrowly construed the definition of willfulness under section 7202 even though the 100 percent penalty of section 6672 may impose a much greater monetary penalty than a $10,000 fine. *See infra* note 89.

75. *See, e.g.*, Mazo v. United States, 591 F.2d 1151, 1156 (5th Cir. 1979). Status, by itself, is not important because courts generally have stated that mere technical authority or titular designation alone is not an indication of responsibility, though it is a factor. Fiataruolo v. United States, 8 F.3d 930, 939 (3d Cir. 1993). Likewise, while share ownership is a factor in determining responsibility, generally for close corporations, share ownership alone is not dispositive. Vinick v. United States, 205 F.3d 1, 8 (1st Cir. 2000). Duty generally involves the degree of control over and involvement in the business, such as whether the person has an active management role in daily operations or the ability to hire and fire employees. *See, e.g.*, *id.* at 8-9; Mahler v. United States, 121 F. Supp. 2d 179, 184 (D. Conn. 2000).

76. The Third Circuit's test is representative: In determining responsibility, courts consider the following (nondispositive) factors: "(1) contents of the corporate bylaws, (2) ability to sign checks on the company's bank account, (3) signature on the employer's federal quarterly and other tax returns, (4) payment of other creditors in lieu of the United States, (5) identity of officers, directors, and principal shareholders of the firm, (6) identity of individuals in charge of hiring and discharging employees, and (7) identity of individuals in charge of the firm's financial affairs." Brounstein v. United States, 979 F.2d 952, 954-55 (3d Cir. 1992).

77. Gephart v. United States, 818 F.2d 469, 473 (6th Cir. 1987) (stating that it is well established that the test for responsibility focuses "upon the degree of influence and control which the person exercised over the financial affairs of the corporation and, specifically, disbursements of funds and the priority of payments to creditors").

78. Courts have rejected the "final word" or "ultimate control" test, which finds responsibility only if the person has the final word or ultimate control over which bills are paid, including taxes. Bedikan, *supra* note 68, at 238 (citing Adams v. United States, 504 F.2d 73 (7th Cir. 1974)).

79. *Brounstein*, 979 F.2d at 954; Morgan v. United States, 937 F.2d 281, 284 (5th Cir. 1991). Factors suggesting significant control include (1) decision-making authority concerning which, when, and in what order creditors are paid, (2) control over the company's bank accounts, (3)

dispositive, authority over disbursements, including the determination of which creditors get paid, and the authority to write checks appear to be highly significant, at least when they both exist at the same time.[80]

The broad application of this significant control test[81] is often criticized by commentators, who complain that the courts have greatly expanded liability beyond the officials who are actually responsible for the nonpayment of the trust fund taxes.[82] Courts, for example, have found employees responsible even though they were under explicit orders from their superiors not to pay taxes,[83] or had little more than technical check-writing authority.[84]

Recognizing the often inequitable imposition of responsibility, the IRS changed its policy in the early 1990s in an attempt to focus collection only on those persons truly responsible for the employer's

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signatures on the company's federal quarterly and other tax returns, and (4) the ability to sign checks. *See Vinick*, 205 F.3d at 9-10; *Brounstein*, 979 F.2d at 954-55; *Mahler*, 121 F. Supp. 2d at 184.

80. SHAFIROFF, *supra* note 2, at 9-8 to 9-9 & n.14.3, 9-11 n.14.13 (arguing that check writing authority is the crucial factor in the cases); James C. Seiffert & W. Bryan Hudson, *IRS's New Approach to Determining "Responsible" Persons for the 100 Percent Penalty*, 79 J. TAX'N 144, 145 (1993) (stating that the definition of responsibility "presumably lead the courts to the individuals who have the 'final word' as to the payment of taxes"); *see Vinick*, 205 F.3d at 10 (noting that technical check-writing ability without the ability to determine who is paid is a weak pillar on which to base liability).

81. *See* Gustin v. United States, 876 F.2d 485, 491 (5th Cir. 1989) (noting that the Fifth Circuit takes a broad view of who qualifies as a responsible person).

82. *See, e.g.*, Bedikan, *supra* note 68, at 238-39.

83. *See, e.g.*, Roth v. United States, 779 F.2d 1567, 1572 (11th Cir. 1986); Howard v. United States, 711 F.2d 729, 734-35 (5th Cir. 1983). In *Howard*, the Fifth Circuit, while "appreciating the difficulty" of his position, nevertheless held that Howard was responsible even though he might have been fired for paying the taxes. *See Howard*, 711 F.2d at 735 ("Howard had a choice. He could have paid the taxes, accepted the consequences, and thus avoided the penalty."). This rule also has been extended to willfulness, where most courts find that following a superior's orders does not negate willfulness. *See, e.g.*, Gephart v. United States, 818 F.2d 469, 475 (6th Cir. 1987). This defense often is called the "Nuremberg defense." Jay v. United States, 865 F.2d 1175, 1177 n.3 (10th Cir. 1989).

84. For example, in *Hochstein v. United States*, an officer of a corporation was held to be a responsible person even though control over the company was in the hands of a financing company. 900 F.2d 543, 548 (2d Cir. 1990). The officer, Hochstein, repeatedly requested funds to pay the trust fund taxes, but the financing company gave him only enough to pay net wages. *Id.* at 546. The court, analogizing the financing company to the superior in *Howard*, found that Hochstein's check-writing authority and position in the corporation made him a responsible person, notwithstanding the fact that the financing company could have been held fully liable for the taxes, since they were in control. *See id.* at 546-47; Lyle, *supra* note 72, at 1146 (discussing *Hochstein* and noting that he merely signed checks for the financing company that controlled the corporation); Howard L. Sosnick, *Even Third Parties Can Be Hit with Payroll Tax Responsibility*, 23 TAX'N FOR LAW. 218, 219-20 (discussing Alsheskie v. United States, 31 F.3d 837 (9th Cir. 1994)). In *Alsheskie*, the Ninth Circuit distinguished *Hochstein*, stating that there was no evidence that Hochstein did not have authority to pay taxes, while Alsheskie was limited by the financing agreement. *Alsheskie*, 31 F.3d at 839.

decisions regarding payment of the trust fund taxes.[85] It exempted those employees that performed purely "ministerial" acts, which apparently exempts only lower level employees.[86] It remains to be seen whether this shift will solve the recognized problems of the past, considering that the policy appears quite limited and that the courts will likely continue to apply a broad definition of responsibility.

III. WILLFULNESS AND REASONABLE CAUSE

Even where a person is deemed responsible, personal liability is not imposed unless that person willfully failed to pay the trust fund taxes to the government. Generally, in the course of interpreting the willfulness element, a recklessness standard has evolved.[87] This Part examines the willfulness element under the trust fund recovery penalty, and the effects of willfulness jurisprudence on the reasonable cause exceptions of the failure-to-pay penalties with regards to the misappropriation problem.

A. The Definition of Willfulness Under the Trust Fund Recovery Penalty

1. General Principles

Willfulness is established where a responsible person (1) makes a voluntary, conscious, and intentional, decision to use the withheld funds to pay other creditors in preference to the government, usually called a deliberate choice or (2) recklessly disregards a known or obvious risk that the taxes may not be remitted to the government.[88] Importantly, the civil definition of willfulness is not dependent upon a showing of a bad motive or an intent to defraud or deprive the government of the taxes.[89] Willfulness does, however, require personal fault beyond negligence.[90]

85. Seiffert & Hudson, *supra* note 80, at 144.

86. *See* IRS, *supra* note 14, § 5.7.3.3.1.2(3). In its view, the " 'full scope of authority and responsibility would be contingent upon whether the person had the ability to exercise independent judgment with respect to the business's financial affairs.' " SHAFIROFF, *supra* note 2, at 9-9 (quoting IRS, *supra* note 14, § 5.7.3.3.5). Thus, non-owner employees, who act solely under the dominion and control of others, should not be subject to the penalty. *See* IRS, *supra* note 14, § 1.2.1.5.14(4).

87. *See* Morgan v. United States, 937 F.2d 281, 286 (5th Cir. 1991) (noting that "[m]ere negligence does not establish willfulness"); *infra* Part III.A.

88. *See, e.g.,* Cook v. United States, 52 Fed. Cl. 62, 69 (2002).

89. *Id.; see supra* note 74. *Compare* Monday v. United States, 421 F.2d 1210, 1216 (7th Cir. 1970) (holding section 6672 "[l]iability does not depend upon the presence of bad motive or the

The courts have considered two factual paradigms to constitute a deliberate choice to misappropriate withheld funds as a matter of law. The first paradigm is where the responsible person elects to pay business creditors with funds that he knows are needed to pay the trust fund taxes.[91] This includes the payment of net wages to employees with knowledge that there are insufficient funds to pay employment taxes.[92] The second is where the responsible person has knowledge of the withholding tax delinquency, yet permits the payment of other creditors before the government.[93] If a responsible person becomes aware of a trust fund tax delinquency after the fact, he has an affirmative duty to use all existing and after-acquired unencumbered funds to satisfy the tax obligation.[94]

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specific intent to defraud the Government or deprive it of revenue"), *with* Cheek v. United States, 498 U.S. 192, 201 (1991) (defining willfulness in the context of criminal tax statutes as "a voluntary, intentional violation of a known legal duty") *and* United States v. Morrison, No. 01-4336, 2002 U.S. App. LEXIS 1948, at *5-6 (4th Cir. Feb. 7, 2002) (noting *Cheek*'s definition of willful incorporates the had purpose or evil motive requirement of *Bishop v. United States*, 412 U.S. 346, 361 (1973)).

90. *See* Slodov v. United States, 436 U.S. 238, 254 (1978); *Cook*, 52 Fed. Cl. at 69.

91. *See, e.g.*, Collins v. United States, 848 F.2d 740, 742 (6th Cir. 1987); Godfrey v. United States, 748 F.2d 1568, 1577 (Fed. Cir. 1984); Howard v. United States, 711 F.2d 729, 736 (5th Cir. 1983); Parr v. United States, 203 F. Supp. 2d 726, 735 (S.D. Tex. 2002).

92. *Cook*, 52 Fed. Cl. at 69-70 (citing Sorenson v. United States, 521 F.2d 325, 328 (9th Cir. 1975)). The preference of any claim, including wage claims, over the government's claim to the withheld funds is willful, and if there are insufficient funds, the employer must prorate the available funds between the government and the employees, even if the employees threaten to quit. *Sorenson*, 521 F.2d at 328; *see* Hochstein v. United States, 900 F.2d 543, 548 (2d Cir. 1990) ("For purposes of determining willfulness, an employee to whom the corporate employer owes wages is simply another creditor.").

93. *See, e.g.*, Gephart v. United States, 818 F.2d 469, 475 (6th Cir. 1987) ("Plaintiff admitted that he was aware of the unpaid federal withholding tax liability ... and that, notwithstanding such knowledge, he continued to sign checks in payment of other corporate obligations. This action constitutes willfulness ...."); Frey v. United States, No. 3:99-CV-0831-D, 2001 U.S. Dist. LEXIS 5786, at *21 (N.D. Tex. May 4, 2001) ("Once Frey became aware of the tax liability, [she] had a duty to ensure that the taxes were paid before any payments were made to other creditors." (internal quotation marks omitted)).

94. *E.g.*, Davis v. United States, 961 F.2d 867, 876 (9th Cir. 1992). "Unencumbered funds" are defined as funds "[w]here the taxpayer's discretion in the use of funds is subject to restrictions imposed by a creditor holding a security interest in the funds which is superior to any interest claimed by the IRS, [and] the funds are regarded as encumbered if those restrictions preclude the taxpayer from using the funds to pay the trust fund taxes." Honey v. United States, 963 F.2d 1083, 1090 (8th Cir. 1992). The *Davis/Honey* rule is modified if (1) the responsible person acquires a company with a prior trust fund tax delinquency, or (2) the person was not a responsible person when the delinquency accrued, but later became responsible. In the first case, if the person assumes control of the company when there are no funds with which to satisfy the tax obligation, and the after-acquired funds are not directly traceable to the withheld funds, the use of after-acquired funds to pay other creditors is not willful. *Slodov*, 436 U.S. at 259-60; *see* Mazo v. United States, 591 F.2d 1151, 1154 (5th Cir. 1979) (limiting *Slodov* to instances where there was a change in control of the company). In the second case, the liability of the responsible person is generally limited to the amount of the unencumbered funds available at the time that

The adoption of the recklessness standard greatly expanded the scope of the willfulness requirement because it encompasses instances where there is no actual knowledge of the misappropriation.[95] The courts continue to stress, however, that ordinary negligence does not constitute willfulness,[96] though they often equate willfulness with gross negligence.[97] Therefore, absent circumstances that create an obvious risk that the trust fund taxes are not being paid, the responsible person's lack of knowledge as to his or her nonpayment constitutes simple negligence and absolves the responsible person from liability.[98]

Courts consider the following factual paradigms to be recklessness as a matter of law: where the responsible person (1) relies upon assurances from a person, whom the responsible person knows to be unreliable, that the taxes have been paid;[99] (2) fails to investigate or correct mismanagement after the responsible person has notice of nonpayment;[100] and (3) knows that the business is in

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person became responsible, and does not extend to after-acquired funds. Michaud v. United States, 40 Fed. Cl. 1, 26-27 (1997). For a comparison of the after-acquired funds doctrine and the existing funds doctrine, see *id.* at 24-28.

95. *See, e.g.,* Vinick v. Comm'r, 110 F.3d 168, 173 (1st Cir. 1997) ("[A]n individual who acts with a 'reckless disregard' of a known or obvious risk of nonpayment acts willfully."); *Cook*, 52 Fed. Cl. at 69.

96. Phillips v. IRS, 73 F.3d 939, 942 (9th Cir. 1996).

97. An oft-cited rule finds willfulness if the responsible party clearly ought to have known there was a grave risk that the withholding taxes were not being paid, and the person was in a position to easily verify the nonpayment. Wright v. United States, 809 F.2d 425, 427 (7th Cir. 1987); *see Cook*, 52 Fed. Cl. at 70 (holding "a responsible person is reckless if he knew or should have known of a risk that the taxes were not being paid, had a reasonable opportunity to discover and remedy the problem and yet failed to undertake reasonable efforts to ensure payment"). The *Wright* court reasoned, "if a high degree of recklessness were required the purpose of the statute would be thwarted, just by compartmentalizing responsibilities within a business (however small) and adopting a 'hear no evil—see no evil' policy . . . ." 809 F.2d at 427.

98. *See* United States v. Running, 7 F.3d 1293, 1300 (7th Cir. 1993) (finding of willfulness as a matter of law was reversed when the evidence showed that the responsible person knew the company was in financial distress, but was unaware of any tax delinquencies); *In re* Macagnone, 253 B.R. 99, 102 (M.D. Fla. 2000) (during a period of financial distress, failure to inquire into the payment of the withheld taxes was not reckless where there was no history of delinquencies).

99. *See* Denbo v. United States, 988 F.2d 1029, 1034 (10th Cir. 1993) (holding that plaintiff "willfully failed to remit federal payroll taxes because he was aware that the corporation had defaulted in its payment of employment taxes but nevertheless disregarded a known risk by relying on the assurances of [another] instead of doing more"); Gold v. United States, 506 F. Supp. 473, 480 (E.D.N.Y. 1981); *see also* Bedikan, *supra* note 68, at 267 (discussing *Gold*).

100. The duty to correct mismanagement, however, is similar to the duty to apply all business funds to the trust fund tax obligation when the responsible person becomes aware that it is not being paid, because both duties do not arise until there is actual knowledge of the misappropriation. *See supra* note 94. It is only when the responsible person is notified that the trust fund taxes have not been paid does a duty arise to investigate and correct that failure, and a failure to do so constitutes recklessness. *See* Godfrey v. United States, 748 F.2d 1568, 1578

financial trouble yet continues to pay other creditors without reasonable inquiry as to the payment of the taxes.[101] Further, delegation of the responsibility to pay trust fund taxes may be reckless if the person to whom the job is delegated has failed to pay the government in the past, and the responsible person fails to take reasonable steps to ensure payment.[102]

The factual paradigms have greatly reduced the role of the jury, which in theory should determine willfulness.[103] The development of the paradigms is largely due to the traditional lack of a reasonable cause exception to willfulness.[104] Also, as discussed below, the perceived inequity of the rigid paradigms has lead to the relaxing of the traditional rule in some circumstances.[105]

2. Financial Difficulties and Reasonable Cause

As a general rule, the fact that a business is in financial distress is irrelevant to the willfulness determination, even if use of

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(Fed. Cir. 1984) ("The case law requires . . . at least actual notice of the current delinquency to establish an affirmative duty to act.").

101. Vinick v. Comm'r, 110 F.3d 168, 173 (1st Cir. 1997); IRS v. Blais, 612 F. Supp. 700, 711 (D. Mass. 1985). *But see Running*, 7 F.3d at 1299 (stating that "knowledge of financial distress, without more, does not equate to knowledge that the facility was not meeting its tax obligations").

102. *See* Phillips v. IRS, 73 F.3d 939, 942 (9th Cir. 1996) ("[W]here a chief executive officer . . . left cosigned checks with his controller to pay the bills . . . when he knew that the controller had once failed in the past to pay over the withholding taxes, and the chief executive did nothing to prevent a recurrence, tbat was willfulness as a matter of law."); *see also Vinick*, 110 F.3d at 173. In *Vinick*, the court found the willfulness prong met when the plaintiff (in a refund action) knew that the person in charge of paying the trust fund taxes was unreliable, yet the plaintiff relied on that person's promises to pay in the future without further investigation. *Id.* at 174; *see also* Thomsen v. United States, 887 F.2d 12, 19-20 (1st Cir. 1989) ("[I]t is uncontested that [the treasurer] learned . . . that [the vice president] had failed to pay the withholding taxes for the past three quarters. . . . Uncontested likewise is the fact that [the treasurer] thereafter delegated to [the vice president] the responsibility for collecting the accounts receivable and paying the taxes from monies collected.").

103. *See, e.g.*, Honey v. United States, 963 F.2d 1083, 1087 (8th Cir. 1992); Mardousian v. United States, No. DKC 97-555, 1998 U.S. Dist. LEXIS 12035, at *10-11 (D. Md. July 1, 1998) (holding that when the manager chooses to pay wages and expenses instead of the IRS, that action is by definition willful, and there is no role for a jury determination).

104. *See infra* Part III.A.2.

105. *See* Finley v. United States, 123 F.3d 1342, 1345 (10th Cir. 1997) (en banc) ("[T]he better way to protect government revenue and preserve a role for the jury in this case and others without undermining existing precedent is to continue to apply the established paradigms to identify willful conduct as a matter or law, yet expressly recognize a reasonable cause exception to the application of those paradigms."). Indeed, these paradigms greatly reduce litigation costs by avoiding trials and allowing for summary judgment, or allowing for judgments as a matter of law that void the jury finding as to willfulness. *See, e.g.*, Collins v. United States, 848 F.2d 740 (6th Cir. 1988) (judgment as a matter of law, notwithstanding the jury's verdict); *Mardousian*, 1998 U.S. Dist. LEXIS 12035, at *13 (summary judgment for the IRS).

the taxes is absolutely necessary to keep the business operating.[106] As the Sixth Circuit noted, "the government cannot be made an unwilling partner in a floundering business."[107] Similarly, willfulness is not negated by a good faith belief that sufficient funds will be available to pay the government when the trust fund taxes become due.[108] Thus, employers are not allowed to subject the withheld taxes to the risks of business.[109]

Most circuits adhere to a bright line rule, holding that there is no reasonable cause exception to the willfulness element of the trust fund recovery penalty.[110] These courts find no "justifiable excuse" for a responsible person to knowingly misappropriate trust fund taxes.[111] A number of reasons have been offered for this bright line rule. First, unlike other penalty sections, no reasonable cause exception is provided for in the statute.[112] Second, a liability standard that does not incorporate reasonable cause is most consistent with the primary purpose of the statute, to protect government revenue.[113] Third, a reasonable cause exception would inject notions of bad motive or

106. *See, e.g.*, Hochstein v. United States, 900 F.2d 543, 548 (2d Cir. 1990).

107. *Collins*, 848 F.2d at 741-42.

108. Thibodeau v. United States, 828 F.2d 1499, 1505-06 (11th Cir. 1987); *see* Bowen v. United States, 836 F.2d 965, 968 (5th Cir. 1988) (holding that the expectation of a loan to cover the employment taxes does not negate willfulness).

109. *Thibodeau*, 828 F.2d at 1506. Likewise, courts generally hold that willfulness is not negated if the responsible person was under orders from a superior to pay the trust fund taxes to a creditor and not to the government. *See, e.g.*, Gephart v. United States, 818 F.2d 469, 475 (6th Cir. 1987) (noting "it is generally held that one who is a responsible person follows the directions of a superior not to pay withholding taxes to the government at his peril"); Howard v. United States, 711 F.2d 729, 735-36 (5th Cir. 1983) (holding that following a superior's orders does not make the responsible person's actions involuntary).

110. *See, e.g.*, Brewery, Inc. v. United States, 33 F.3d 589, 593 (6th Cir. 1994) (noting "section 6672(a) does not have a reasonable cause exception"); Olsen v. United States, 952 F.2d 236, 241 (8th Cir. 1991) ("This court has held that reasonable cause is no part of the definition of willfulness." (citation omitted)); Sorenson v. United States, 521 F.2d 325, 329 (9th Cir. 1975) ("'[R]easonable cause' . . . [is a] defense which has been specifically rejected by this court."); Harrington v. United States, 504 F.2d 1306, 1316 (1st Cir. 1974) ("[A] 'reasonable cause' or 'justifiable excuse' element has no part in . . . [the definition of 'willful'].''); Monday v. United States, 421 F.2d 1210, 1216 (7th Cir. 1970) ("The standard of willfulness should not be construed to include lack of 'reasonable cause' or justifiable excuse."); *In re* Treacy, 255 B.R. 656, 665 (E.D. Pa. 2000) (noting recent decisions of the Third Circuit do not include a reasonable cause exception).

111. *See Monday*, 421 F.2d at 1216 (" '[J]ustifiable excuse' [is] 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.").

112. *Harrington*, 504 F.2d at 1316 ("We cannot assume that Congress has made an oversight in this regard. If any inference is to be drawn, it is that Congress intended lack of 'reasonable cause' to be an element in certain sections of the statute, and not in others.").

113. *Id*; *Monday*, 421 F.2d at 1216.

specific intent into the civil definition of willfulness.[114] Fourth, reasonable cause analysis invites "consideration of such misleading and improper factors as the financial condition of the business or the demands of creditors."[115] Finally, this Note argues that a reasonable cause exception is wholly inconsistent with the duty of loyalty applicable to trustees and fiduciaries.[116]

Other circuits that recognize a reasonable cause defense adopt very limited exceptions. The Fifth Circuit conceptually allows the defense, but specifically precludes a responsible person who knowingly pays or allows creditors to be paid with the taxes.[117] The Second Circuit recognizes a so-called reasonable cause defense, holding that if the responsible person reasonably believed that the taxes were being paid, the failure to cause the payment of the taxes is not willful.[118] This rule is not a true exception to willfulness; instead, it simply recognizes that reasonable or even negligent mistakes that stop short of gross negligence are not willful. This standard, like that of the Fifth Circuit, does not negate willfulness where misappropriation occurs because of financial difficulties.[119]

Only one circuit has adopted a reasonable cause exception broad enough to allow misappropriation because of financial difficulties. In *Finley v. United States*, the Tenth Circuit rejected the factual paradigm approach, which it perceived as creating a strict liability standard for willfulness,[120] in favor of a jury determination of

114. *Monday*, 421 F.2d at 1216; *see supra* note 89 and accompanying text.

115. *Monday*, 421 F.2d at 1216; *see supra* note 106 and accompanying text.

116. *See infra* Part IV.B.3.

117. *See* Logal v. United States, 195 F.3d 229, 233 (5th Cir. 1999). This exception originated in *Newsome v. United States*, 431 F.2d 742, 747 (5th Cir. 1970), but the Fifth Circuit has never used it to negate a finding of willfulness as a matter of law. *Logal*, 195 F.3d at 233 (noting "no taxpayer has yet carried that pail up the hill" (quoting Bowen v. United States, 836 F.2d 965, 968 (5th Cir. 1988))); *cf.* Thosteson v. United States, 331 F.3d 1294, 1301 (11th Cir. 2003) (declining to decide whether a reasonahle cause exception exists, but noting that even if one did, it would not apply to cases where the plaintiff consciously paid other creditors with knowledge that the trust fund taxes had not heen paid); Bell v. United States, No. I:99CV2102, 2002 U.S. Dist. LEXIS 6866, at *11 (N.D. Ohio Feb. 12, 2002) (holding that even if a reasonable cause defense were viable, it would have no place where the trust fund tax obligation was accorded second class status to the bills).

118. Winter v. United States, 196 F.3d 339, 345 (2d Cir. 1999).

119. *See* Powers v. United States, No. 00-6229, 2001 U.S. App. LEXIS 5538, at *6-7 (2d Cir. Mar. 19, 2001) ("[Plaintiff] directed that funds . . . be used to pay the . . . payroll, rather than the back taxes, and . . . was aware that [his company] would have insufficient funds to cover the taxes owed . . . . [Plaintiff's] conduct is therefore willful as a matter of law."); *In re* Treacy, 255 B.R. 656, 665 (E.D. Pa. 2000) (standard not met where "Treacy was admittedly aware that employment taxes were owed to the government at times when he wrote and issued checks to other creditors, and took no steps to rectify the situation").

120. By creating a strict liability standard for willfulness, the broad, as-a-matter-of-law, factual paradigms displace the jury in what is a quintessential jury issue. United States v.

willfulness based upon the totality of the circumstances.[121] The taxpayer must be given an opportunity to "meaningfully distinguish his case before a jury based on the relative degree of willfulness or the presence of extenuating circumstances."[122]

To this end, the court fashioned a reasonable cause exception to the application of the established factual paradigms.[123] Based on the nature of the trust recovery penalty, however, a broad exception based merely on the exercise of ordinary business care and prudence by the responsible person, similar to the reasonable cause exceptions of the failure-to-pay penalties,[124] was inappropriate.[125] Instead, the court limited the exception to circumstances where the responsible person made reasonable efforts to protect the trust funds, but those efforts were frustrated by circumstances outside his control.[126] To date, only two as-a-matter-of-law holdings have been reversed on appeal in the Tenth Circuit and, in both cases, the company's assets had been seized by third parties.[127] Thus, the scope of the reasonable cause exception may be quite limited.[128] Of course, *Finley* remains the minority view, and whether it is the start of a trend in the law remains to be seen.

Finley, 123 F.3d 1342, 1346-47 (10th Cir. 1997) (en banc). Any curtailment of the jury function must be "carefully scrutinized," and the factual paradigms fail this scrutiny because the jury is stopped from fully evaluating the totality of the circumstances in determining whether the responsible person acted willfully. *See id.* The court suggests that a finding to the contrary would be against the reasonable expectations of Congress in enacting section 6672. *See id.* at 1347 n.4.

121. *See id.* at 1347.

122. *Id.* at 1346.

123. *Id.* at 1348. Thus, the as-a-matter-of-law rulings still are possible in the Tenth Circuit.

124. *See infra* Part III.B.

125. Specifically, "[s]ince § 6672 does not raise a concern regarding the protection of a taxpayer from harsh, additional penalties imposed for purposes of punishment and deterrence, it would be inappropriate to adopt a lenient reasonable cause exception like that applied to income tax penalties, i.e. ordinary business care and prudence." *Finley*, 123 F.3d at 1348.

126. *Id.* After a jury verdict of not willful, the lower court in *Finley* directed a verdict for the government based on a showing of a failure to investigate and correct mismanagement after the responsible person received notice of the tax deficiency. *Id.* at 1344. Because of the new reasonable cause exception, this ruling, based on an as-a-matter-of-law factual paradigm, was reversed and remanded for a new trial. *Id.* at 1350.

127. In *Finley*, the accounts of the employer were frozen by their bank, and when the responsible person deposited sufficient funds to cover the tax obligation, the bank instead applied the deposit to the outstanding deht of the corporation. *Id.* at 1343-44. Similarly, in *Howell v. United States*, while the responsible person made a voluntary decision to prefer business creditors, the corporation's assets soon were seized by insurance underwriters. 164 F.3d 523, 524, 526-27 (10th Cir. 1999). A question of fact concerning reasonable efforts existed where evidence showed that the responsible person historically left a cushion within the company's escrow accounts with which to pay the trust fund taxes, and the IRS had cooperated with this past practice. *Id.* at 527.

128. In cases where the company's assets are not out of the responsible person's control, as-a-matter-of-law holdings will likely withstand review, though the Tenth Circuit has not limited the control element to circumstances where the responsible person actually loses control of the

B. Importation of Willfulness Principles into the Failure-To-Pay and Deposit Penalty Provisions' Reasonable Cause Exceptions

Unlike the reasonable cause exception of the trust fund recovery penalty, the reasonable cause exceptions of the failure-to-pay penalties are explicitly provided by statute.[129] A broader view of reasonable cause is generally warranted for the failure-to-pay penalties, based on the purpose of the provisions. Any judicially created reasonable cause exception to the trust fund recovery penalty must be admittedly narrow to further the purposes of the statute.[130] Unlike normal penalty provisions, the trust fund recovery "penalty" serves a broader purpose because it allows collection of the tax from someone who is not the primary obligor.[131] Thus, it protects government revenue that would otherwise be lost, which is something other penalty provisions cannot ensure.[132] This broader purpose makes the trust fund recovery penalty more important to tax

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company's assets. *See* Mardousian v. United States, No. DKC 97-555, 1998 U.S. Dist. LEXIS 12035, at *9-10 (D. Md. July 1, 1998) (finding *Finley* inapplicable where the plaintiff never lacked control over the company's assets); *see also In re* Treacy, 255 B.R. 656, 665 (E.D. Pa. 2000) (holding *Finley* inapplicable where the responsible person paid creditors knowing the employment taxes were owed); Stauffer v. United States, No. 97-M-1566, 1998 U.S. Dist. LEXIS 14213, at *10-11 (D. Colo. Aug. 27, 1998) (granting summary judgment for government under similar circumstances despite *Finley*). The *Finley* court noted that because of the limited scope of the exception, most cases that fit into the factual paradigms still would qualify for as-a-matter-of-law holdings. *Finley*, 123 F.3d at 1349 (applying the standard that "no reasonable jury" could find reasonable cause); *see Stauffer*, 1998 U.S. Dist. LEXIS 14213, at *10 (holding *Finley* does not apply as a matter of law where the responsible person claims he relied on the IRS, which had told him that he needed only stay current on the tax and "that they would worry about the past-due taxes later").

129. *See* I.R.C. §§ 6651(a)(2)-(3), 6656(a) (2000) ("[D]ue to reasonable cause and not due to willful neglect"). Willful neglect is interpreted by the Supreme Court to mean a refusal to pay taxes. United States v. Boyle, 469 U.S. 241, 245 n.3 (1985). Although it is necessary to show both elements, a showing of reasonable cause rules out willful neglect; therefore, the cases, and this Note, focus only on the reasonable cause element. *See, e.g.*, Joyce L. Sugawara et al., *Defining Reasonableness Before the Internal Revenue Service*, L.A. LAW., May 2000, at 23, 23, WL 23-May LALAW 23.

130. *See Finley*, 123 F.3d at 1348 ("By so limiting the elements of reasonable cause . . . we . . . maintain the ability to zealously protect government revenue via the application of certain factual paradigms widely-recognized and accepted as 'willful conduct.' ").

131. Most penalty provisions serve both a deterrence purpose, in that they encourage voluntary compliance with the law, and a punishment purpose, in that they impose fines if the law is broken. So, while they are collection devices in the sense that they help ensure payment, they cannot help the government recover if the taxpayer is wholly unable to pay. *See supra* note 14; *cf. Finley*, 123 F.3d at 1348 (distinguishing section 6672 from penalties that impose fines for purposes of deterrence and punishment). The trust fund recovery penalty, however, does allow the government to recover even if the taxpayer is unable to pay.

132. *See Finley,* 123 F.3d at 1348 (noting section 6672 is only a means of insuring tax payment); *see also supra* note 66.

collection, and therefore calls for a more narrowly defined reasonable cause exception.

In addition, a broader reasonable cause exception is warranted for the failure-to-pay penalties due to their scope. Because they also apply to direct tax obligations, it is logical that a more lenient reasonable cause exception would apply than in the case of the trust fund recovery penalty.[133] This does not mean, however, that reasonable cause should be given the same meaning in the trust fund and the direct tax contexts.[134] When determining reasonable cause, courts must note this crucial distinction and take care not to apply trust fund misappropriation principles to direct taxes.

1. General Principles

Under the Treasury Regulations, the lack of sufficient funds to pay direct taxes constitutes reasonable cause only if the taxpayer can show that he exercised ordinary business care and prudence in providing for payment, but would have suffered an undue hardship if timely payment was made.[135] "Undue hardship" requires more than simply an inconvenience to the taxpayer. Instead, the taxpayer must show that he would have suffered a substantial financial loss if he had paid the taxes on time.[136] The Regulations provide that, in making this determination, "all the facts and circumstances of the taxpayer's financial condition" must be considered.[137] Importantly, the Regulations also provide that the nature of the tax is also relevant. Thus, what may constitute reasonable cause for the nonpayment of direct taxes may not constitute reasonable cause for the nonpayment of trust fund taxes.[138] The combined effect of these two regulatory directives is the crux of the division in authority as to whether financial conditions are relevant in the trust fund tax context.[139]

In determining whether the failure to pay direct taxes is reasonable, consideration of a business's financial condition is entirely consistent with the policy underlying the failure-to-pay penalty

133. The failure-to-pay penalty applies to trust fund and direct taxes, including the income, estate, and gift taxes. *See* Alan J. Tarr & Carol F. Burger, *Civil Tax Penalties* 634 Tax Mgt. A-9 (BNA) (2002).

134. *See infra* notes 138, 146, 228-229 and accompanying text.

135. Treas. Reg. § 301.6651-1(c)(1) (as amended in 2000).

136. Treas. Reg. § 1.6161-1(b) (as amended in 1973).

137. Treas. Reg. § 301.6651-1(c)(1).

138. *Id.* § 301.6651-1(c)(2).

139. *See infra* Part III.B.2-.3.

provisions.[140] The failure to pay trust fund taxes, however, involves entirely different policy considerations and an entirely different type of obligation. In the trust fund recovery penalty context, courts almost universally refuse to excuse employees from misappropriation because of financial difficulties.[141] Federal courts are split as to whether the same situation excuses the employer from the failure-to-pay penalties. Because of the similarities between the two situations, willfulness jurisprudence influences how the courts approach this issue.

2. The Sixth Circuit: No Excuse for Misappropriation

The Sixth Circuit was the first to address whether the failure-to-pay penalty would apply to misappropriation without exception.[142] In *Brewery*, a restaurant owner properly withheld employment taxes for two years, yet failed to pay them to the government, opting instead to use the funds to finance his struggling business.[143] Upon financial recovery, and subsequent payment of the taxes, the taxpayer sought and was denied a refund of the failure-to-pay penalties assessed.[144]

The court adopted a per se rule, holding that "financial difficulties can never constitute reasonable cause to excuse the penalties for nonpayment of withholding taxes by an employer."[145] The court expressed two bases for this rule. First, the court read the regulations as providing for heightened scrutiny in the trust fund tax context, requiring "particularly compelling facts and circumstances" to

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140. *See, e.g.,* United States v. Finley, 123 F.3d 1342, 1348 (10th Cir. 1997) (explaining that the exception may protect the taxpayer from the imposition of "harsh, additional penalties imposed for purposes of punishment and deterrence").

141. *See supra* notes 106-128 and accompanying text.

142. Brewery, Inc. v. United States, 33 F.3d 589, 592-93 (6th Cir. 1994).

143. In *Brewery*, two events caused the taxpayer's restaurant's financial difficulties. *See id.* at 591. First, during a remodeling project, the taxpayer and several adjoining property owners agreed to share the cost of a new sewer system; however, when one of the property owners went bankrupt, the taxpayer's actual project cost was much higher than expected. *Id.* Second, when the city decided to renovate a bridge directly in front of the taxpayer, its main access point was blocked, resulting in a major loss in business. *Id.* With operating losses, the restaurant was forced to pick and choose whom it would pay, and the taxpayer "considered the IRS one of those creditors." *Id.*

144. *Id.*

145. *Id.* at 592; *see In re* McTyre Trucking Co., 223 B.R. 588, 593 (Bankr. M.D. Fla. 1998); *In re* Uptown Printing Co., 186 B.R. 904, 906-07 (Bankr. E.D. La. 1995); *In re* Sykes & Sons, Inc., 188 B.R. 507, 513 (Bankr. E.D. Pa. 1995); *In re* Frederick Savage, Inc., 179 B.R. 342, 348 (Bankr. S.D. Fla. 1995). This rule is in line with the majority of the lower federal courts that addressed this issue prior to *Brewery*. *See, e.g.,* C.J. Rogers, Inc. v. United States, No. 89-70209, 1990 U.S. Dist. LEXIS 18031, at *5-6 (E.D. Mich. Sept. 17, 1990); Wolfe v. United States, 612 F. Supp. 605, 608 (D. Mont. 1985).

find reasonable cause, a standard that cannot be met when the employer misappropriates trust fund taxes.[146]

Second, and more important, the court found the reasoning of its willfulness jurisprudence to be persuasive in this context.[147] The fact that the trust fund recovery penalty is levied against employees, while the failure-to-pay penalties are levied against the employer, is an irrelevant distinction.[148] The nature of the taxes, being held in trust, binds the two rules together: misappropriation of government property to pay business expenses is not justifiable, even if it is absolutely necessary to keep the business operating.[149]

3. The Second, Third, and Ninth Circuits: Excusing Misappropriation

Other circuits that have addressed this issue reject the per se rule of *Brewery*, holding that financial difficulties can be considered in the determination of reasonable cause for the nonpayment of trust fund taxes.[150] The leading case for the majority rule, *Fran Corp. v. United States*, did not address the conceptual differences between

146. *See Brewery*, 33 F.3d at 592 ("[T]he facts and circumstances required to establish reasonable cause must be particularly compelling."); *see also In re McTyre*, 223 B.R. at 593 ("[T]he test for 'reasonable cause' is more stringent when trust fund taxes are at issue."); *C.J. Rogers*, 1990 U.S. Dist. LEXIS 18031, at *4-5 (noting court decisions that did not adopt the per se rule ignored this language in the Regulations).

147. *Brewery*, 33 F.3d at 592-93 (citing Collins v. United States, 848 F.2d 740 (6th Cir. 1988), which is a willfulness case).

148. *See id.* at 593.

149. *Id.* at 593; *see* Norwalk Liquidating, Inc. v. United States, 159 F. Supp. 2d 684, 690-92 (N.D. Ohio 2001) (concluding that using trust funds to sustain a company during a downward spiral is not reasonable cause as a matter of law); *Wolfe*, 612 F. Supp. at 608 ("Almost every non-willful failure to pay taxes is the result of financial difficulties."); *In re McTyre*, 223 B.R. at 593 ("[T]he need for capital, even capital necessary to keep the business operating, is not reasonable cause."). To hold otherwise would make the government "an unwilling partner in a floundering business" and would allow taxpayers to "self-execute a government loan" by using government funds penalty free. *Brewery*, 33 F.3d at 593 (citing *Collins*, 848 F.2d at 742); *see also In re* Frederick Savage, Inc., 179 B.R. at 348 ("If every taxpayer's cash flow problems were sufficient to justify delay in payment of taxes, such an exception would swallow the rule."). Moreover, allowing businesses to postpone paying tax obligations until economic conditions improve would restrict severely the ability of the government to raise revenue. *Wolfe*, 612 F. Supp. at 608. The *Brewery* court also extended its per se rule to the nontrust fund employment taxes as well, holding that the employer's share of FICA is more closely analogous to trust fund taxes than direct income tax obligations. 33 F.3d at 593-94. This Note argues that courts should clearly distinguish between trust fund and nontrust fund taxes in applying reasonable cause. Whether the *Brewery* court's application of the per se rule to nontrust fund employment taxes is correct is outside the scope of this Note.

150. *See* Van Camp & Bennion v. United States, 251 F.3d 862, 868 (9th Cir. 2001); E. Wind Indus. v. United States, 196 F.3d 499, 500 (3d Cir. 1999); Fran Corp. v. United States, 164 F.3d 814, 818 (2d Cir. 1999); Q.E.D., Inc. v. United States, 55 Fed. Cl. 140, 145-47 (2003).

trust fund taxes and direct taxes, the focus of the *Brewery* decision.[151] Its holding was based entirely upon the fact that neither the statutes nor the regulations distinguish between trust fund and direct taxes, and neither specifically bars the consideration of financial difficulties in the case of latter but not the former.[152] Instead, the regulations specifically provide that the taxpayer's financial condition is a relevant consideration in determining ordinary care.[153] In addition, while the Regulations do call for "heightened scrutiny" with respect to trust fund taxes, this requires only that type of tax at issue is simply another factor considered in the ordinary care analysis, not that the type of tax alone justifies ignoring the financial difficulties of a business.[154] Finally, according to the court, if the per se rule were adopted, it would effectively read the reasonable cause exception out of the statute.[155]

Recognizing the danger of its rule, the court noted that financial difficulties would be a justifiable excuse only in "rare" cases.[156] The *Fran* case did not qualify as such because the taxpayer had failed to exercise ordinary business care by continuing to make payments that were not essential to the preservation of the business.[157] The court, in effect, adopted an essential creditor rule

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151. *See* 164 F.3d 814 (2d Cir. 1999). In *Fran*, the taxpayer, an electrical contractor, faced severe financial difficulties after the State of New York refused to pay progress and cost overrun payments it owed the taxpayer. *Id.* at 815. Additionally, a private college defaulted entirely on its obligations to the taxpayer. *Id.* The State eventually paid the taxpayer, hut in the intervening year, the taxpayer had insufficient cash to pay both its creditors and the government. *Id.* The taxpayer choose to pay its creditors with the employment taxes it withheld from its employees. *Id.*

152. *Id.* at 818. The Court found this most significant for the failure-to-deposit penalty, which specifically applies to employment taxes and yet neither requires a higher standard nor requires the courts not to consider financial difficulties. *Id.* As mentioned previously, however, not all employment taxes are trust fund taxes. *See supra* notes 46-47 and accompanying text.

153. Treas. Reg. § 301.6651-1(c)(1) (as amended in 2000). Moreover, since this language long has been a part of the regulations, it has the effect of law due to congressional silence on the issue. *Fran*, 164 F.3d at 818.

154. *Fran*, 164 F.3d at 819. More stringent standards are necessary, however, for trust fund taxes. *E. Wind*, 196 F.3d at 509.

155. *Fran*, 164 F.3d at 819; *see Van Camp & Bennion*, 251 F.3d at 868 ("If the potential ruin of a corporation is not relevant, then the reasonable cause exception is virtually meaningless."). This is not the case, since there are a number of situations that would constitute reasonable cause even for trust fund taxes. *See infra* notes 210, 228.

156. *Fran*, 164 F.3d at 819. The court recognized the *Brewery* concern that the government could be made an unwilling partner in a floundering business. *Id.*

157. *See id.* at 819-20. Specifically, the taxpayer paid rent to its president even though the president owed the taxpayer almost $150,000 from a loan, which under ordinary care would have been suspended. *Id.* at 819. The taxpayer continued to lease and repair cars that were not essential to the business, including a Porsche. *Id.* at 819-20. Finally, the taxpayer continued to pay for "lavish and extravagant" entertainment expenses, including events not necessary for its business. *Id.* at 820. The court concluded as follows: "Perhaps most important is Fran's failure to

which allows misappropriation if the taxes are used to pay only those creditors, including employees, necessary to keep the business operating.[158] It therefore allows for misappropriation if the need is great enough.

One of the rationales of *Brewery* was the notion that if the employer could use withheld funds in its business, the government would become an "unwilling partner" of the enterprise.[159] Other courts have since seized on this idea, finding that when the government is somehow a "willing partner" in the business or is the cause of the company's financial difficulties, the reasonable cause exception might be met.[160] In *East Wind Industries, Inc. v. United States*, the Third Circuit held that where the illegal conduct of a government employee directly caused the taxpayer's financial difficulties, the government had become a willing partner in the business such that the nonpayment of the taxes was excused.[161]

East Wind involved egregious facts and arguably can be limited to cases of illegal conduct by government officials. Courts appear willing, however, to read the willing partner rule more broadly, allowing for misappropriation where the employer can show some direct and substantial causal link between the actions of the government, illegal or legal, and the taxpayer's financial difficulties.[162]

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provide any evidence to show that it placed its obligations to the IRS before those to any and all creditors not directly related to the two projects that defaulted. Absent such a showing, Fran cannot demonstrate that it acted prudently in disregarding its legal obligations to pay and deposit the employment taxes." *Id.*; *see also* Synergy Staffing, Inc. v. IRS, 323 F.3d 1157, 1160 (9th Cir. 2003) (finding the taxpayer cannot prevail unless it shows how it spent its available funds in lieu of paying its taxes).

158. *See, e.g., E. Wind*, 196 F.3d at 509-10 (noting that the taxpayer only paid its essential creditors); PARCC Health Care, Inc. v. United States, 238 F. Supp. 2d 435, 444 (D. Conn. 2002) (stating that the taxpayer must show that payments were necessary to the survival of the business).

159. Brewery, Inc. v. United States, 33 F.3d 589, 592-93 (6th Cir. 1994).

160. *See E. Wind*, 196 F.3d at 507, 512-13; *PARCC*, 238 F. Supp. 2d at 444; *In re* Gordon Sel-Way, Inc., No. 88-04525, Chapter 7, 1995 Bankr. LEXIS 1109, at *18-19 (Bankr. E.D. Mich. July 24, 1995) (recognizing that this situation might be an exception to the *Brewery* per se rule, for "equity or estoppel" reasons).

161. *E. Wind*, 196 F.3d at 512-13. The taxpayer in that case was a government contractor whose contracts went through various agencies of the Department of Defense. *Id.* at 501. When employees of those agencies began soliciting bribes in exchange for contracts, the taxpayer initially refused, and as a result, lost over five million dollars due to retaliatory action by the corrupt employees. *Id.* at 501-02. Because of the financial difficulties this caused, the taxpayer accrued but did not pay employment taxes, and, importantly, the court found that all the payments it made were to essential creditors and employees. *Id.* at 508-09. The court concluded, "By its actions, the Government, through the Defense Agencies, became a willing partner in a floundering business." *Id.* at 512-13.

162. It appears that in order for the government to be a willing partner, it must have a sufficiently direct or substantial relationship to the financial difficulties of the taxpayer. *In re Gordon Sel-Way*, 1995 Bankr. LEXIS 1109, at *25 (finding the government's role in causing the

Both the willing partner rule and the essential creditor rule are inconsistent with the application of general trust principles to misappropriation of trust fund taxes.

IV. TRUST PRINCIPLES AND ENFORCING THE SECTION 7501 TRUST

Judicial interpretation of the penalty provisions combined with the existence and scope of any reasonable cause exceptions to the penalties determine the extent to which a Code trust will be enforced. Under reasonable cause exceptions, the essential creditor rule, the willing partner rule, and the *Finley* rule, the employer can justifiably raid the trust property that it holds in trust for the government in various circumstances.[163] To the extent that these exceptions allow for misappropriation, they are wholly inconsistent with the basic fiduciary principles that govern all trust relationships.

A Code trust and its accompanying taxes vary widely from the typical common law trust and trust property. First, a Code trust is created in an abstract amount, rather than in the actual dollars withheld, while common law trusts require the designation of specified property as trust property.[164] Second, the powers and duties of a Code trustee are different from those of a common law trustee.[165] For these reasons, it is impossible to apply wholesale common law trust principles to the Code trust context.

Still, the trustee's fiduciary duty of loyalty, which underlies all trust relationships, can and should be applied to a Code trust to limit the employer's discretion over the withheld taxes. Generally, a trustee is given broad discretion over the trust property, and for that reason, the common law trustee is held to a strict duty of loyalty.[166] A Code trustee likewise possesses broad discretion over the trust property until the date the taxes are required to be deposited or paid. Therefore, the employer should be held to the same duty of loyalty as a common law trustee. First, in using the term "trust," Congress intended to import this basic trust principle into the withholding

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financial problems to be "limited, distant, and not sufficiently directly related"); *cf. E. Wind*, 196 F.3d at 511 (finding that if the government had paid the taxpayer what it was owed, the taxpayer would not have experienced the financial difficulties); *PARCC*, 238 F. Supp. 2d at 444-45 (finding a material question of fact exists as to whether the government is a willing partner in the "highly regulated" nursing home business).

163. *See supra* Part III.A.2 (discussing *Finley*), Part III.B.3 (discussing essential creditor and willing partner rules).

164. Begier v. IRS, 496 U.S. 53, 62 (1990).

165. *See infra* Part IV.A-B.

166. *See, e.g,* Karen E. Boxx, *The Durable Power of Attorney's Place in the Family of Fiduciary Relationships*, 36 GA. L. REV. 1, 19 (2001).

context. Alternatively, if Congress's intent is unclear, the employer owes the government fiduciary loyalty by virtue of its control over its property.[167]

A. *The Nature of the Common Law Trust Compared to the Code Trust*

A trust is an equitable obligation that binds the trustee to exercise discretion over property in which he has control for the benefit of other persons, the beneficiaries.[168] This definition also fits a Code trust, where the employer exercises discretion over the taxes, which it holds for the benefit of the government until the taxes become due. However, the similarities between common law trusts and Code trusts end at this level of generality. A Code trust is not a common law trust.[169]

First, a common law trust cannot exist unless an ascertainable and transferable property interest is identified as the trust property.[170] A Code trust, in contrast, creates a trust in the abstract amount withheld, "a dollar figure not tied to any particular assets," and not in the actual dollars withheld.[171]

Second, the rights of a Code trustee with respect to the trust property are much more limited than those of a common law trustee. A common law trust is comprised of two estates: the equitable estate owned by the beneficiary and the legal estate owned by the trustee.[172] As legal owner of the trust property, the trustee has numerous property rights, including the right to possess and alienate the property.[173] Still, the beneficiary owns the right to benefit from the

167. *See infra* Part IV.B.1. Once establishing the basic duties of the employer as trustee, this Part uses basic trust principles to propose the proper course of interpreting and applying the section 7501 trust and its related penalties. The common law of trusts is extensive, and this Note does not attempt a comprehensive review of trusts; however, well-settled and general trust principles obviously influenced Congress in deciding to call the withheld amount "trust" funds. These principles, therefore, should influence the courts in approaching questions regarding trust fund taxes.

168. CHARLES E. ROUNDS, JR., LORING: A TRUSTEE'S HANDBOOK 4 (2002) (citing Martyn Frost, *Overview of Trusts in England and Wales, in* TRUST IN PRIME JURISDICTIONS 13 (Alon Kaplan ed., 2000)). The trustee may also be a beneficiary in common law trusts. *Id.* at 4 n.12.

169. *Id.* at 570.

170. *Begier*, 496 U.S. at 62.

171. *Id.* The lack of identifiable trust property leads to problems, however, especially in tracing the trust fund taxes in bankruptcy. *See id.* at 70 (Scalia, J., concurring) ("Section 7501 obviously intends to give the United States the advantages of a trust beneficiary with respect to collected and withheld taxes. Unfortunately, it does not always succeed in doing so. A trust without a res can no more be created by legislative decree than can a pink rock-candy mountain.").

172. ROUNDS, *supra* note 168, at 66.

173. *Id.* at 66, 69.

trust property, such that the trustee's creditors have no right to it.[174] A Code trustee, however, has no such legal estate in withheld taxes. According to most courts, the taxes are for the exclusive use of the government, and the employer is simply obligated to hold the taxes and not expose them to any business or investment risk.[175]

In most respects, a Code trust cannot truly be considered a trust at all, and Congress clearly did not intend to create the equivalent of a common law trust. Indeed, the primary goal was to give the government, as a trust beneficiary, preference over business creditors in bankruptcy.[176] This does not mean, however, that Congress did not intend to apply trust principles to the withheld amounts, since "the common law of trusts is not binding on Congress."[177] Congress' intent to treat employers as trustees and withheld taxes as trust property is evident in the legislative history of section 7501 which states that "under existing law the liability of the person collecting and withholding the taxes to pay over the amount is merely a debt, and *he cannot be treated as a trustee* or proceeded against by distraint."[178] By enacting the Code trust, Congress intended to treat the collection of withheld taxes differently from the collection of direct taxes, where the government is essentially a creditor.[179]

174. *Id.* at 396.

175. The amount withheld is entirely owned by the government (with the employee entitled to the excess) and is for the exclusive use of the government. Gephert v. United States, 818 F.2d 469, 472 (6th Cir. 1987). Any use of the trust funds for other purposes is a violation of the trust. *See, e.g., id.*; *see also infra* Part IV.B.1 (discussing the duty of care).

176. *See generally* Begier v. IRS, 496 U.S. 53 (1990); Rodney, *supra* note 41, at 454-60.

177. *Begier*, 496 U.S. at 62 n.4. The common law of trusts would not allow for the application of trust principles to withheld amounts because a Code trust cannot be considered a trust in the traditional sense. However, the common law of trust does not bind Congress's ability to apply trust principles to other arrangements. So, Congress can apply trust principles to situations, like the Code trust, in which the common law would not apply trust principles.

178. Slodov v. United States, 436 U.S. 238, 255 (1978) (quoting S. REP. NO. 73-558, at 53 (1934) (emphasis added)). Justice Scalia complains that the lack of identification of withheld funds creates enormous tracing problems. *Begier*, 496 U.S. at 71. However, such a question is unimportant for present purposes, because it does not affect the duty of loyalty of the employer/trustee not to use the trust funds for business expenses.

179. There can be no other interpretation of Congress's creation of section 7501. If the only thought was of bankruptcy preference, Congress could have simply amended the Bankruptcy Code to give the withholding taxes higher preference over other claims. By using the specific legal term "trust," Congress obviously intended to import the most basic trust concept—the fiduciary duty.

B. *The Fiduciary Duty of the Code Trustee*

A trust represents a "quintessential fiduciary relationship."[180] As such, the fiduciary duties of a trustee apply to an employer, considering the special nature of a Code trust. One may argue that the Code trust does not impose common law fiduciary duties on the employer, since it is admittedly not a common law trust. Even so, outside the trust concept, based on its relationship to the property and to the government, the employer is a fiduciary of the government.

1. The Employer as a Fiduciary

In all fiduciary relationships, the beneficiary entrusts the fiduciary with control over an asset.[181] Mere discretion over another's assets does not make one a fiduciary; instead, the fiduciary also acts on behalf of the beneficiary.[182] One commentator defines a fiduciary as one who "acts on behalf of another party . . . while exercising discretion with respect to a critical resource belonging to the beneficiary."[183] In this context, "discretion" is equated with opportunism, the power to use or work with the critical resource in a manner that exposes the beneficiary to harm that cannot reasonably be evaded through self-help.[184]

The withholding system creates such a relationship. The employer acts as the agent of the government by collecting taxes under the authority granted to it by the government. This agency relationship clearly satisfies the "on behalf of" requirement.[185] After collection, the employer has unlimited discretion over the government's property. While discretion is not to be equated with mere access to the critical resource,[186] the Code permits the use of the

180. D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1452 (2002).

181. Cooter & Freedman, *supra* note 5, at 1046.

182. Smith, *supra* note 180, at 1438. A person acts on behalf of another party when they act primarily for the benefit of that party. *See id.* at 1439.

183. *Id.* at 1402 (emphasis omitted). Two classic definitions state that one is a fiduciary if "the law demands of one party an unusually high standard of ethical or moral conduct with reference to another," or where there is a duty "on the part of the fiduciary to act for the benefit of the other party to the relation as to matters within the scope of the relation." Boxx, *supra* note 166, at 15-16. Neither definition, however, identifies when the relationship usually arises. *Id.* at 16.

184. Smith, *supra* note 180, at 1444, 1449. "Where self-help protection of the critical resource is strong, the case for judicial protection . . . is weak, and vice versa." *Id.* at 1443.

185. *See id.* at 1438-39. In fact, the employer is called a "withholding agent." *See* I.R.C. § 7701(16) (2000).

186. *See* Smith, *supra* note 180, at 1448-49.

withheld taxes by the employer[187] in a manner that exposes the government to harm in the form of late payment or nonpayment.[188] In sum, like the common law trustee, the employer occupies the position of a fiduciary.

The common law fiduciary relationship exposes the beneficiary to two harms: misappropriation and negligent management of assets.[189] In response, the fiduciary has two distinct duties: care and loyalty.[190] The duty of loyalty combats the first potential harm by prohibiting the trustee from entering into self-interested transactions, self-dealing, or otherwise misappropriating the trust property.[191] The duty of care combats the second potential harm by requiring the fiduciary to make productive use of the trust property and to act prudently in all dealings with the property.[192]

The duty of care of the Code trustee, due to the special nature of the trust, is virtually nonexistent, insofar as it would require the employer to make productive use of the withheld funds. However, the special nature of the Code trust does not affect the duty of loyalty. If the trust fund taxes are used in such a way that no funds are available to satisfy the tax obligations when due, the employer breaches its duty of loyalty by entering into self-regarding transactions that misappropriate the taxes for its own use.[193] The penalty provisions can only deter this misappropriation, not avoid it. When misappropriation is excused under the doctrine of reasonable cause, courts depart sharply from this principle.

187. *See infra* Part IV.B.2.

188. *See* Smith, *supra* note 180, at 1449 (discretion "connotes the power to use or work with the" asset). The cases throughout this Note illustrate just how much discretion the employers have over the withheld funds, and they clearly have the power to use the funds in a way that potentially harms the government by exposing the funds to the business risks of troubled or failing companies. Whether the harm is late or nonpayment of the taxes, the harm is directly caused by the discretion the employer has over the withheld funds.

189. Cooter & Freedman, *supra* note 5, at 1047.

190. *See, e.g.*, Boxx, *supra* note 166, at 17.

191. *See* Boxx, *supra* note 166, at 17-18; Cooter & Freedman, *supra* note 5, at 1047. According to Gordon Smith, the duty of loyalty is the duty "to refrain from self-interested behavior that constitutes a wrong to the beneficiary as a result of the fiduciary exercising discretion with respect to the beneficiary's critical resources." Smith, *supra* note 180, at 1407.

192. *See* Boxx, *supra* note 166, at 18; Cooter & Freedman, *supra* note 5, at 1047.

193. A "self-regarding" transaction is a breach of the duty of loyalty in that it benefits the fiduciary at the beneficiary's expense. Cooter & Freedman, *supra* note 5, at 1048. Because the fiduciary is obligated to place the interests of the beneficiary before her own, she is obligated only to undertake "other-regarding" acts. *Id.*

2. The Modified Duty of Care

The common law duty of care requires the trustee to make the trust property productive, usually requiring the trustee to invest the property.[194] Under the prudent investor rule, so long as the trustee acts reasonably in investing, the duty of care is satisfied.[195] This simply recognizes that there is no such thing as a risk free investment, and the trustee is not the insurer of the trust property.[196]

By contrast, Code trusts do not require an employer to make the withheld fund productive. In fact, employers are discouraged from investing the withheld funds in their business or otherwise. Courts routinely say that the funds are for the "exclusive use of the government"[197] and that an employer cannot subject the withheld funds to business or investment risks.[198] This is the ideal view from the government's perspective, but it is not the reality of the Code trust. Because the Code does not impress a trust in the actual dollars withheld, does not penalize the mere use of the trust fund taxes, and does not require segregation,[199] the employer is, in fact, free to use the withheld funds in its business so long as it has sufficient funds to pay

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194. ROUNDS, *supra* note 168, at 261.

195. *Id.* at 199.

196. *Id.* at 261. The prudent investor rule originally was stated as follows: "All that can be required of a trustee to invest, is, that he shall conduct himself faithfully and exercise a sound discretion. He is to observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested." Harvard Coll. v. Amory, 26 Mass. 446, 461 (1830).

197. *See, e.g.*, Brewery, Inc. v. United States, 33 F.3d 589, 593 (6th Cir. 1994) ("[T]hese trust fund taxes are for the exclusive use of the government . . . .").

198. *See, e.g.*, Thibodeau v. United States, 828 F.2d 1499, 1505-06 (11th Cir. 1987).

199. *See supra* notes 34-35 and accompanying text. A common law trustee is required to keep the trust property segregated from the trustee's property. *See* ROUNDS, *supra* note 168, at 250. Commingling of trust funds with personal funds constitutes a breach of trust and, in some states, is a criminal act. *See id.* In contrast, Code trustees are not required to segregate the withheld taxes from general funds, but as mentioned, segregation may be required of certain repeat offenders, upon notice, and under threat of criminal penalty. *See supra* note 35. A universal segregation requirement could have two positive effects. First, it could lessen, but definitely would not eliminate, the misappropriation problem. One commentator suggests that imposing a duty to segregate tax funds when payroll is processed would help solve the misappropriation problem without causing administrative burdens. *See* Bedikan, *supra* note 68, at 270. Employers could implement such a system by creating special payroll bank accounts which are funded prior to pay day with the full amount of gross wages. When paychecks are cashed with the net wage amounts withdrawn from the account, the balance of the account after all the checks are cashed represents the trust fund tax amounts. These trust fund tax amounts stay in the bank account until paid to the government. Second, the proposed system would substantially benefit the government in reaching trust funds taxes in bankruptcy. *See supra* note 41. A segregation requirement, however, would most definitely create serious administrative burdens for all employers, and a full examination of segregation is outside the scope of this Note.

the government when the taxes are due. An employer can legally satisfy the tax obligation with any funds from its general account, including funds that have been "used" by the employer for business purposes, such as by earning interest.[200]

This does not mean that any liability for losing the withheld funds is predicated on a duty of care. If the employer does decide to invest the withheld funds, Code trusts contain no safe harbor prudent investor rule; even reasonable investments that result in a failure to make the tax payments result in liability.[201] In this sense, the employer as trustee acts as the *insurer* of the trust funds, at least to the extent reasonable cause is not recognized, and, if the trustee himself cannot pay, then the responsible persons become the insurers of the trust.

3. The Duty of Loyalty

The most basic concept underlying the fiduciary relationship is the duty of undivided loyalty, which requires the trustee to act in the beneficiary's sole interest in matters involving the trust property.[202] The duty of loyalty prohibits self-dealing with and misappropriation of the trust property, in addition to transactions in which the trustee has a conflict of interest.[203] Apart from the common law right to reasonable compensation, the trustee cannot benefit economically, either directly or indirectly, from the trust property.[204] This includes an absolute bar on the borrowing of trust funds, which is treated no differently than misappropriation.[205]

The duty of loyalty applies equally to Code trusts. The employer breaches the fiduciary duty of loyalty if its use of withheld funds results in having insufficient funds to satisfy its tax obligation.

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200. Thus, to the extent the "exclusive use principle" implies that the business cannot use funds withheld from employment paychecks, it is wrong. Because no actual dollar is withheld and no actual dollar is held in trust, there is no actual dollar whose use hy the employer is verboten.

201. From this perspective, the employer may subject the withheld funds to business risk, and unlike the common law trustee, it can pocket the profits. lt, however, cannot avoid responsibility for the losses.

202. ROUNDS, *supra* note 168, at 202.

203. *See* Karen E. Boxx, *Of Punctilios and Paybacks: The Duty of Loyalty Under the Uniform Trust Code*, 67 MO. L. REV. 279, 281 (2002); Cooter & Freedman, *supra* note 5, at 1047.

204. ROUNDS, *supra* note 168, at 204.

205. *See* Charles Bryan Baron, *Self-Dealing Trustees and the Exoneration Clause: Can Trustees Ever Profit from Transactions Involving Trust Property*, 72 ST. JOHN'S L. REV. 43, 45-46 (1998). Charles Rounds says it nicely: "Nothing good can come of a trustee's borrowing from the trust estate no matter how competitive the interest rate may be and no matter how complete the paper trail . . . . The thief when caught asserts it is only a loan." ROUNDS, *supra* note 168, at 206.

In contrast to common law trusts, the mere use of the withheld funds is not a misappropriation of the trust property.[206] Misappropriation occurs only where the employer uses its available funds in such a way that it is unable to pay the taxes when due. Misappropriation does not and, indeed, cannot occur until a payment is due.[207]

Under the common law "no further inquiry rule," once self-dealing is discovered, the court makes no further inquiry into the reasonableness of the decision to use the trust property, refusing "to deal with the question of abstract justice in the particular case."[208] Reasonable cause exceptions that excuse the misappropriation of trust fund taxes are inconsistent with this rule—no reason, no matter how great, justifies the use of the withheld funds by the employer.[209] In sum, the special nature of the Code trust in no way affects the application of the common law duty of loyalty to the Code trustee. Once misappropriation is established, the employer must be held liable.[210]

4. Liability for Misappropriation

The legal rules surrounding the common law duty of loyalty recognize that to act in the best interest of another is wholly inconsistent with the tenet of economics that all persons act in their own best interest.[211] The duty of loyalty for both common law and Code trusts must therefore serve both a corrective and deterrent function; creating an incentive structure that brings these two competing interests together by making disloyalty so prejudicial to the trustee that it is in his best interest not to breach the trust.[212]

206. *See supra* notes 199-200 and accompanying text.

207. This conclusion is true even if one considers the employer as "borrowing" the withheld funds, with the intent to pay back tbe government. *See supra* note 205 and accompanying text.

208. Baron, *supra* note 205, at 53-55.

209. "This [no further inquiry] rule sounds almost unreasonably harsh, but it is required because of the demonstrated fallibility of humanity. There are no exceptions, although there are limits." ROUNDS, *supra* note 168, at 205-06. The principle should be no different with respect to Code trusts.

210. Every instance of an employer failing to pay the trust fund taxes on time will not constitute misappropriation. *See infra* note 228. The "no further inquiry" rule applies only if misappropriation causes the failure to remit the taxes.

211. Cooter & Freedman, *supra* note 5, at 1074.

212. Baron, *supra* note 205, at 52; Cooter & Freedman, *supra* note 5, at 1074. From this perspective, therefore, the rule against misappropriation must serve not only a corrective function, ensuring the government receives the full amount of the tax funds owed, but also a deterrent function, ensuring the punishment is severe enough that employers will avoid using the tax funds to pay their business creditors or employees.

At common law, the traditional remedy for breach of loyalty was disgorgement, which requires the trustee to make the beneficiary whole for any losses and to give up all the profits obtained through the misuse of the trust funds.[213] Disgorgement is an imperfect remedy if it simply places the trustee in the position that he would have occupied absent the misappropriation: "Just as a thief cannot be deterred simply by requiring her to return the stolen goods whenever she is caught, an agent cannot be deterred from appropriating a principal's asset" by simply returning the ill-gotten gain.[214]

Similarly, an employer in financial need will not be deterred from using the withheld funds if it is simply required to pay the amount of taxes due at a later date, with no penalty. It is necessary to punish the trustee in order to create adequate incentives to comply with the duty of loyalty.[215] Both common law disgorgement and the Code must therefore deter misappropriations by making the expected benefit less then the expected sanction.[216] The penalty provisions provided for in the Code serve this purpose. The failure-to-pay penalties punish the employer by making noncompliance with the tax law more costly then compliance. The trust fund recovery penalty punishes those responsible for noncompliance by holding them personally liable. To the extent that noncompliance is excused through reasonable cause exceptions, such as when the employer pays only its essential creditors, the Code will fail to prevent misappropriation.

In sum, to the extent that the reasonable cause exceptions of the penalty provisions allow for justifiable misappropriation, they are entirely inconsistent with the duty of loyalty. First, under traditional trust principles, the "no further inquiry" rule, misappropriation is never justifiable. Second, the duty of loyalty must include a liability provision that adequately deters misappropriation. Currently, some courts apply the Code's penalty provisions in ways that allow noncompliance and, thus, fail to deter misappropriation.

C. *Policy Suggestions*

A faithful application of duty of loyalty principles to the Code trust has implications for the rules surrounding both the trust fund recovery penalty and the failure-to-pay penalties. First, the majority rule rejecting a reasonable cause exception to the definition of

213. Boxx, *supra* note 166, at 18.

214. *See* Cooter & Freedman, *supra* note 5, at 1053; *supra* note 14.

215. Cooter & Freedman, *supra* note 5, at 1069.

216. To be a successful deterrent, the expected sanction must equal or exceed the gain from wrongdoing. *Id.* at 1052.

willfulness is proper, though this does not mean that the *Finley* court's insights should be ignored. Second, the minority rule rejecting consideration of financial difficulties in determining reasonable cause under the failure-to-pay penalties is proper. The essential creditor and willing partner rules should be rejected.

1. The Trust Fund Recovery Penalty

The *Finley* rule excuses the responsible person if he made reasonable efforts to protect the withheld funds but was frustrated by circumstances outside of his control.[217] Such an inquiry will allow for misappropriation, especially if the "outside the responsible person's control" prong is read broadly.[218] Under the duty of loyalty, this rule must be rejected to the extent it allows for misappropriation.

This does not mean that the central insight of *Finley*—that it is unfair to hold a person liable if the company's assets have been seized by a third party—should be rejected as well. In fact, this insight is theoretically sound as applied to the responsibility element of the trust fund recovery penalty. A narrower reading of this element alone should limit the statute's reach to those truly responsible for the misappropriation; they should be held liable for breach of their duty of loyalty.[219]

The fundamentals of the fiduciary relationship support a narrow reading of the responsibility element. The duty of loyalty applies only to persons with actual discretion over the trust property.[220] Therefore, only those agents of the employer with fiduciary discretion over the trust fund taxes are truly responsible for nonpayment.[221] Focusing on those with the ultimate authority is the best means by which to ensure that the target of the penalty truly had

217. *See supra* note 126 and accompanying text.

218. It is unclear whether, to be "outside the responsible person's control," the employer's assets have to be seized by a third party, as in *Finley*, or whether financial difficulties caused by circumstances outside the taxpayer's control is sufficient (because of, for instance, a natural disaster or the bankruptcy of its biggest customer). The use of the word "circumstances" suggests the latter reading.

219. Bedikan, *supra* note 68, at 269-70.

220. *See supra* notes 181-184 and accompanying text.

221. When the employer is a corporation, it acts only through its agents; thus, the corporation itself does not misappropriate, its agents do. *See* SHAFIROFF, *supra* note 2, at 9-5. In other business forms, there is no need for the responsible person statute because the IRS can rely on state law. For example, a general partner is fully liable for the partnership employment taxes under the general fiduciary duty of partners. *See, e.g,* Remington v. United States, 210 F.3d 281, 283-84 (5th Cir. 2000). Also, sole proprietors are personally responsible for all business debts under state law, including withheld taxes, without regard to section 6672. Schmehl & Fox, *supra* note 25, at A-10.

fiduciary discretion.[222] Of course, if individual discretion is removed, such as when a superior orders an employee not to pay the taxes or the employer's assets are seized by a third party, responsibility is removed as well.[223] Those with actual discretion have a duty to ensure the payment of the taxes, such that intentional borrowing of the withheld funds for the employer's behalf exposes the borrowers to personal liability.[224] With a narrower reading of responsibility, the onerous reach of the statute is substantially lessened.

A further problem identified by *Finley* is the widespread use of as-a-matter-of-law factual paradigms, which the court believes imposes virtual strict liability for willfulness.[225] The *Finley* court's concern for the proper role of the jury can be heeded in a more limited way than the adoption of a reasonable cause exception. One solution is to adopt a rule that a finding of recklessness without actual knowledge requires a jury to determine whether the lack of knowledge was reckless, negligent, or even reasonable.[226]

At the same time, as-a-matter-of-law holdings remain appropriate in cases involving actual knowledge of the misappropriation.[227] If the responsible person is actually aware of the nonpayment, the action or inaction of the person is, by definition, willful. Limiting as-a-matter-of-law holdings to cases in which the responsible person had actual knowledge will both preserve the role of the jury and ensure that liability is not imposed without personal fault.

2. The Failure-To-Pay Penalties

Ultimately, the *Brewery* court's per se rule is most consistent with the employer's duty of loyalty implicit in the Code trust. First, it categorically rejects justifiable misappropriation, which is consistent with the common law "no further inquiry" rule. Second, it preserves the reasonable cause exception for circumstances that do not involve

222. *But see supra* note 78 (noting that courts generally reject the ultimate authority test).

223. *See supra* notes 83-84, 127 and accompanying text.

224. If the employer is a corporation, the responsible persons are agents of the trustee, and they may be held liable if they knowingly participated in a breach of trust. ROUNDS, *supra* note 168, at 180-81.

225. *See supra* note 120 and accompanying text.

226. Thus, the jury would have to determine if the responsible person acted recklessly in relying on a certain person to pay the taxes or if the failure to make inquiry into the payment of the taxes during times of financial difficulties was in fact reckless. *See supra* notes 99, 101.

227. Thus, the jury does not have a role in the deliberate choice paradigms or when recklessness is based on the failure to correct mismanagement after notice of nonpayment. *See supra* notes 91-94, 100.

disloyalty, yet it does not eliminate the reasonable cause exception for trust fund taxes.[228] The language of the Regulations clearly intends the scope of reasonable cause for trust fund taxes to be narrower than for direct taxes.[229] Finally, it is an effective deterrent against misappropriation because it punishes the employer rather than simply requiring that the government be made whole.

Adoption of the per se rule recognizes the special nature of withheld taxes as being held in trust. It does not affect the circumstances that constitute reasonable cause for direct taxes, in which financial difficulties remain a legitimate factor.[230] It is no greater burden on the courts to require them to clearly differentiate between the two in applying the exception.[231]

The duty of loyalty bars misappropriation for any reason.[232] Thus, the essential creditor rule must be rejected since it allows misappropriation in order to pay essential creditors and employees.[233] In addition, the "willing partner" rule must be rejected because misappropriation is never justified, even if the beneficiary is somehow the cause of the trustee's financial difficulties.[234]

V. CONCLUSION

Misappropriation of trust fund taxes by an employer should be treated as the equivalent of misappropriation of trust property by a common law trustee. Both involve the violation of the most basic trust principle, the duty of loyalty, and both must be punished without exception. In describing this requirement, Charles Rounds aptly stated that,

> The no further inquiry rule should continue to apply to unauthorized trustee borrowings, and the courts should resist the temptation to recognize "fairness" and

228. *See* Sarah S. Brieden, Case Note, *The Ninth Circuit Holds that an Employer's Financial Difficulties Can Constitute Reasonable Cause for Failure to Pay Employment Taxes*—Van Camp & Bennison, P.S. v. United States, 56 SMU L. Rev. 749, 752-53 (2003). Reasonable cause will excuse late payment of trust fund taxes in the following circumstances, among others: (1) death or serious injury of agent having sole authority to pay; (2) unavoidable absence of the agent; (3) destruction by casualty of the employer's records; (4) employer unable to determine amount of payment because he could not access his records because of circumstances beyond its control. *See* IRS, *supra* note 14, § 1.2.1.3.3; *cf. In re* Frederick Savage, Inc., 179 B.R. 342, 348 (Bankr. M.D. Fla. 1995) ("If every taxpayer's cash flow problems were sufficient to justify delay in payment of taxes, such an exception would swallow the rule.")

229. *See supra* note 138 and accompanying text.

230. *See supra* notes 137, 140 and accompanying text.

231. *See* Brieden, *supra* note 228, at 753-54.

232. *See supra* notes 208-209 and accompanying text.

233. *See supra* notes 157-158 and accompanying text

234. *See supra* notes 160-161 and accompanying text.

> "benign intentions" as legitimate defenses to such activity. To do otherwise is to tempt the honest and afford avenues of escape to the dishonest. The law should be absolutely unambiguous in this regard and ignorance of it should never be a judicially recognized excuse.[235]

To the extent that they excuse misappropriation, the reasonable cause exceptions recognized by some courts are all examples of the "fairness" defense that Rounds cautions courts to avoid. The law should be absolutely unambiguous in prohibiting the misappropriation of trust property, even if the beneficiary is the IRS and the trust property is taxes. This rule simply holds employers and their agents accountable for the choices that they make.

P. Prestin Weidner[*]

235. ROUNDS, *supra* note 168, at 208.

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