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FEATURE

Ignore Trust Fund Taxes, Get IRS/DOR Attention

By Laura Brown

Your focus at this time of year naturally turns to income tax returns, but as a business owner, you should be paying attention to "trust fund" taxes year-round – unless you want the Internal Revenue Service (IRS) and the Massachusetts Department of Revenue (DOR) to be your worst nightmare and cause you many sleepless nights.

What are trust fund taxes? Trust fund taxes include the federal and state withholding amounts taken from your employees' paychecks. They also include the state sales and meals taxes added to customers' invoices.

These taxes are referred to as trust fund taxes because the business is supposed to hold the funds "in trust" for prompt turnover to the IRS/DOR along with a tax return illustrating how the amount was calculated.

Prompt payment can be weekly or monthly. In other words, the IRS and DOR are trusting you to take money from someone and turn it over to the government quickly.

Here's how things can go wrong. In the real world, you experience cash flow problems and economic downturns. Nevertheless, payroll liabilities can remain constant and your regular customers pay within 90 or 120 days, instead of 30 or 60.

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The employees want their paycheck or they will quit; suppliers and vendors need to get paid now or else they won't ship; the bank and leasing companies must get their monthly payment or they will close your line of credit or repossess your equipment.

You continually prioritize the monthly payments, and guess what – it seems that the only ones that are not hassling you are the DOR and the IRS! So you pay the employees, the suppliers and the bank to keep your business going, and when that "big check" comes in from your tardy customer, you'll take the whole thing to pay the IRS and DOR.

You make a note of it in your schedule, even write it down on a stickie and put it on your computer monitor, and you may even tell your bookkeeper, so you know that's the plan and it's going to happen. Well, the big check comes, and again, something urgent is paid instead.

It has been my experience that the IRS/DOR become very aggressive very fast and will come knocking within several months for their trust fund taxes, as opposed to a year or so for income taxes. My clients constantly ask, "I'm doing the best I can, why can't they wait a little for their money, and why are they so mean?"

Well, because the IRS/DOR view the trust fund taxes as their money, which you have embezzled. In my opinion, trust fund taxes are the worst taxes to pay in a tardy fashion. Of course, you should not miss any taxes that you owe. But the consequences for not paying the "trust fund" tax are very serious.

What you need to know: The fact that your business is incorporated or that your company and/or you file for bankruptcy does not matter, as trust fund taxes are nondischargeable in bankruptcy.

If not paid by the business, the trust fund taxes become the personal liability of the person (or persons) who the IRS/DOR determine has the status, duty and control over the finances, known as the "Responsible Party."

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And then the fun begins – in trust fund tax land, there is no "innocent until proven guilty" because YOU have the burden of proving that you are NOT the Responsible Party.

In addition, the more individuals designated as the Responsible Party, the better for the IRS/DOR because they can go after the person with the deepest pockets. You will see what I mean as I tell you more.

Together, the individuals are jointly and severally liable, meaning that the IRS/DOR can recover the entire amount from one person (which may or may not be you) or a bit from everyone.

In your situation, if you and others own the business, are officers of the company and can all write checks (or delegate to a bookkeeper and, sometimes, you need more than one signature for a large amount), the IRS/DOR may determine that several people are Responsible Parties, including you.

Or the absolute worst can happen. At home the party continues as you explain to your spouse (if you file a joint tax return) why the IRS/DOR took "his" refund that his tax situation generated.

While you are at it, you can explain why there is a federal tax lien filed against your (jointly held) home at the public registry of deeds, which lien was also published in last week's Banker and Tradesmen. How mortifying!

And what about when your husband asks, "Honey, did you know that the bank froze our home equity loan so we can't pay the contractor to finish the kitchen and bath currently under construction? And what is this levy against our checking account? The mortgage payment is going to bounce."

Why isn't the IRS going after one of the other owners? After all, didn't they handle the office while you were traveling?

So, what are you to do? This can and has happened to my clients. You are especially vulnerable if you are busy or lack good financial oversight. In these situations, dealing with the IRS/DOR can seem like a full-time job, diverting your focus from your business.

The IRS/DOR will demand a lot of information and documents, including a list of your accounts receivable. Those people may be contacted. I personally have received a notice from the IRS ordering me to pay them instead of my subcontractor who neglected to pay his trust fund tax.

Many clients have come to me after they have tried unsuccessfully to negotiate with the very aggressive folks at the IRS/DOR. The key is to get the situation under control and avoid the personal liability by proving that you are not the Responsible Party even though you fit the profile.

This is not easy. The term "Responsible Party" is not a defined term that may be easy to disprove, but is a factual inquiry decided upon a case-by-case basis.

The moral of my story is a warning that a wise woman should monitor her and her company's tax situation all year long.

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