SEVENTH ANNUAL
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THE IRS IS AT IT AGAIN! PERSONAL LIABILITY OF THE SURETY AND SURETY'S COUNSEL FOR UNPAID WITHHOLDING ON PRINCIPAL'S PAYROLL!

PRESENTED BY:

STEVEN G. SCHEMBER
SHUMAKER, LOOP & KENDRICK
101 EAST KENNEDY BOULEVARD
SUITE 2500
TAMPA, FLORIDA 33602

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I. FACTUAL SCENARIO

Submitted for your approval is the following not untypical scenario:

Wonderful People Surety, Inc., "Wonderful Surety" issues payment and performance bonds on behalf of its principal, Slipshod General Contractors, Inc., "Slipshod", on various public and private bonded projects throughout the Southeastern United States. Slipshod has a "portfolio" of non-bonded jobs also situated at various locations in the Southeastern United States.

Unfortunately for Slipshod and Wonderful Surety, Slipshod has spread itself too thin and has gotten itself involved in several unprofitable projects, both bonded and unbonded. The inevitable flow of Notices of Non-Payment from subcontractors and materialmen start pouring across the desk of Wonderful Surety's claims representative, Harriet Hassled. Not long thereafter, the inevitable demand letters from Wonderful Surety's obligees start coming in, followed by requests for pre-default meetings and ultimately Notices of Termination or Default.

Ms. Hassled retains the services of Wonderful Surety's usual consultant, Aft-Pro, Inc., to investigate the status of Slipshod's operations. As she has learned from having attended previous Southern Surety & Fidelity Claims Conferences, Ms. Hassled does not hesitate to bring outside counsel, Kandu, Well, and Cheepley, P.A., (a co-sponsor of the Conference) into the matter at an early stage of Slipshod's downward spiral. Aft-Pro selects its most expert consultant, Mr. Moore Salt, who promptly conducts a thorough investigation into the entire state of Slipshod's affairs, and surprisingly enough, concludes that, given better supervision on the job sites, better financial management in the home office, and some temporary infusions of cash to alleviate cash flow shortages, Slipshod is in a position to complete its projects profitably and with minimal loss to Wonderful Surety. Aft-Pro, through Mr. Salt, therefore recommends that Wonderful Surety provide financial assistance to Slipshod to enable it to complete its contracts.

Amazingly enough, all of Slipshod's owner-obligees agree to allow Slipshod to complete the various bonded projects, with managerial and financial assistance being provided by Wonderful Surety. In order to implement the financing by Wonderful Surety of Slipshod's completion of the bonded projects, Slipshod executes agreements assigning all contract proceeds on the bonded projects to Wonderful Surety. In addition, a joint trust checking account is set up into which are deposited the contract proceeds on the bonded contracts, as well as funds supplied by Wonderful Surety. Two signatures are required to draw funds on the joint trust account. One of the required signatures is that of Mr. Slimeball, President and Owner of Slipshod. The other required signature can be either that of Mr. Well, Ms. Hassled or Mr. Salt.

The following procedure is then implemented in order to fund the completion of Slipshod's bonded contracts. Slipshod, through its President, Mr. Slimeball, compiles a list of all

expenses payable on the jobs bonded by Wonderful Surety, including materials and labor and expenses on the bonded projects, as well as expenses for office overhead, insurance premiums and administrative salaries attributable to the bonded projects. This list is then submitted to the consultant, Mr. Salt, who reviews the list to insure that the expenses being submitted for payment are, in fact, related to the bonded projects. Mr. Salt then submits the list of expenses he has approved for payment to Mr. Well and Ms. Hassled for their review and approval. Thereafter, either Mr. Salt, Mr. Well or Ms. Hassled, depending on their availability, signs a check payable to Slipshod in the amount of the approved expenditures. This check is then co-signed by Slimeball and deposited into Slipshod's general operating account. Thereafter, under the supervision of Mr. Salt, checks are cut from this account to pay the various approved expenses.

The system described above appears to work well, and during the last three quarters of calendar year 1995, Slipshod proceeds to complete, or nearly complete, all of its projects which were bonded by Wonderful Surety. At first, the funds used to pay Slipshod's expenses are provided by Wonderful Surety. However, as the projects commence and contract proceeds are received, more and more of these expenses are able to be paid from contract proceeds rather than from the funds of Wonderful Surety.

At the end of each of the last three quarters of 1995, Slipshod provides Salt, Hassled and Well with copies of IRS Form 941, Quarterly Tax Returns, signed by Slimeball, indicating that withholding has been paid on all payroll and salary taxes with respect to the bonded jobs. Copies of the checks sent to the IRS with these quarterly returns are not included with the Form 941s. Copies of the cancelled quarterly withholding checks are also not provided to Wonderful Surety, its attorneys or consultants.

By February, 1996, the projects bonded by Wonderful Surety have been completed by Slipshod. The contract proceeds from the bonded projects are nearly enough to reimburse Wonderful Surety for its initial out-of-pocket cash expenditures. Fortunately, Wonderful Surety also holds a letter of credit from Slipshod and Slimeball which it draws down to reimburse its out-of-pocket expenses not covered by the contract proceeds.

Slipshod, through Slimeball, requests that Wonderful Surety provide additional bonding for it on new projects, which Wonderful Surety declines to do. In March, 1996, Slipshod, citing large losses on its unbonded projects, as well as its inability to obtain bonding for new projects, files Chapter 7 bankruptcy, listing assets of $10,000 and liabilities of $10,000,000. Well, Hassled and Salt breathe a collective sigh of relief that Wonderful Surety has managed to escape with no losses. They congratulate themselves on their decision not to provide further bonding to Slipshod. Hassled closes her claims file, and Well and Salt send their final statements for services rendered to Wonderful Surety and close their files.

In June, 1996, Hassled receives a phone call from Mr. A. Whole of the Internal Revenue Service requesting a meeting to discuss unpaid payroll taxes by Slipshod. Hassled immediately calls Well and Salt and a meeting with all three and the IRS Agent is arranged shortly thereafter. At the meeting, the IRS Agent, Whole, informs Hassled, Well and Salt that Slipshod has failed to pay any withholding on any of its labor payroll or administration salaries

paid during 1995. The money paid to Slipshod by Wonderful Surety for payment of these taxes has mysteriously disappeared.

Whole further advises Hassled, Well and Salt that Slimeball has signed a sworn affidavit stating that Slipshod had made an agreement with Wonderful Surety that Wonderful Surety would pay these taxes. Whole then advises Hassled, Well and Salt that they could be held individually liable for the unpaid withholding of $500,000, plus a 100% penalty making a total liability of $1,000,000.00, since they were persons "responsible" for the payment of these taxes.

The now stunned and astonished Hassled, Well and Salt deny any liability for the payment of the taxes and state that the funds given to Slipshod to meet payroll and salaries included sufficient funds for payment of the taxes. They also produce the copies of the IRS Form 941s signed by Slimeball indicating that the taxes had been paid. Whole responds by saying that it is Slimeball's testimony that he sent the signed Form 941s to Hassled, Well and Salt so that they could file them along with the check for the withholding taxes that were to be paid by them. At this juncture, the meeting deteriorates into a shouting match with Hassled, Well and Salt angrily denying any liability and denouncing Slimeball as a liar, and Whole threatening to personally assess the unpaid taxes and 100% penalty against them.

In September, 1996, Hassled, Well, and Salt receive a letter from the IRS, a copy of which is attached to this paper. The letter says in pertinent part:

> The law provides that individuals who were required to collect, account for, and pay taxes for the business may be personally liable for a penalty if the business doesn't pay the taxes. These taxes, which consist of employment taxes you withheld or should have withheld from employee's wages and didn't pay or excise taxes you collected or should have collected from patrons and didn't pay, are commonly referred to as trust fund taxes.

We plan to charge you an amount equal to the unpaid trust fund taxes which the business still owes the government. This personal liability is called the trust fund recovery penalty. We will assess and collect the penalty as though it were a tax you owed.

Hassled, Well and Salt retain counsel and respond to the IRS letter. A copy of this response is attached to this paper. Unfortunately, Hassled, Well & Salt are unable to convince the IRS not to assess the tax penalty, despite the assistance of their counsel. They are instead forced to pay the taxes and penalty under protest and file a suit in Federal Court to obtain a refund. When the suit is filed, the IRS answers with a counterclaim against Hassled, Well and Salt seeking to impose even more tax liabilities against them.

II. **COULD THIS REALLY BE HAPPENING?**

If the above scenario seems like a bad dream or something out of a Kafka novel that could not really happen, think again. The factual scenario set forth above is based upon an actual

pending case. (With some literary license taken as to the facts, and the names being changed to protect the innocent.) As we all know, the IRS occasionally goes on "kicks" where it attempts to find new sources of revenue. By all appearances, it looks as if the IRS may be on such a "kick", attempting to hold attorneys and consultants employed by sureties personally liable for unpaid taxes of the sureties' principals.

III. **HOW COULD THE LAW POSSIBLY BE SO TERRIBLE?**

There are two sections of the Internal Revenue Code upon which the IRS primarily relies in attempting to hold third parties, not employed by the taxpaying employer, liable for withholding taxes which have not been paid by such employer.

> Section 6672 of the Internal Revenue Code provides:
>
> Sec. 6672 [1986 Code]. (a) GENERAL RULE -- Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.
>
> Section 3505(b) of the Internal Revenue Code provides:
>
> (b) PERSONAL LIABILITY WHERE FUNDS ARE SUPPLIED -- If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.

As can be seen, Section 6672 provides for liability for the entire amount of any unpaid tax, plus an additional 100% penalty, with interest from the date of the assessment against the responsible person. The IRS has magnanimously adopted a policy, however, of not collecting both the unpaid tax and the 100% penalty. Rather, the IRS only collects the unpaid tax once, with interest from the date of the assessment.

Under Section 6672, the IRS can simply assess the penalty against the taxpayer, placing the onus on the taxpayer to file a suit to get a refund of the penalty so assessed.

Conversely, liability under Section 3505(b) can only be found after the IRS brings a lawsuit against the taxpayer and obtains a judgment against him. While the amount paid by the taxpayer under Section 3505(b) is limited to 25% of any amounts paid to the employer, the IRS can recover pre-judgment interest on any recovery under Section 3505(b). Accordingly, the IRS normally attempts to assess both a Section 6672 and Section 3505(b) penalty against a taxpayer. In so doing, it can immediately assess the tax against the taxpayer as allowed by Section 6672 and collect post-assessment interest while at the same time filing suit against the taxpayer using the 25% penalty provided for in Section 3505(b) to apply to pre-judgment interest not otherwise collectible under Section 6672.

Furthermore, as is the case in the factual scenario set forth above, the IRS often will use the possibility of a counterclaim for additional penalties under Section 3505(b) as a deterrent to the taxpayer's filing of a suit for a refund of taxes assessed pursuant to Section 6672.

A. Individual Liability Under Section 6672

There are two elements to a claim for liability under Section 6672:

1. The individual against whom the penalty has been assessed must be a person responsible for collecting and paying the tax; and

2. The "responsible person" must "willfully" fail to pay to the government the amount of taxes otherwise due.

1. Responsible Person:

Numerous cases have discussed who is and who is not a "responsible person" within the meaning of Section 6672. From these cases, a series of factual tests have evolved which are succinctly summarized in Jorgenson v. U.S., 99-2 USTC 85,934 (N.D.Ind 1992) at Page 85,936:

> The key to liability under Section 6672 is control of finances within the employer corporation: The power to control the decision-making process by which the employer corporation allocates funds to other creditors in preference to its withholding tax obligations ... (citations omitted) ... The "person" who is responsible for the payment of corporate taxes within the meaning of Section 6672 is that individual who has the final word as to what bills should or should not be paid, and when ... (citations omitted) ... [T]he word "final" means significant rather than exclusive control over the disbursal of funds.
>
> [S]ection 6672 is broad enough to reach an entity which assumes the function of determining whether or not the employer will pay over taxes withheld from its employees.

Banks[1], finance companies[2], secured creditors[3], prospective purchasers of an ongoing business[4], and accountants[5], have all been determined to be "responsible persons" under Section 6672, even though they were not employees, officers or directors of the tax paying employer, under circumstances when such persons or entities assume direct responsibility for payment of payroll and other expenses of the employer corporation.

In addition, sureties have also been found to be "responsible persons" within the meaning of Section 6672 when these sureties exercise sufficient control over the finances of their principals.[6]

As might be expected, the determination as to whether or not a particular individual or entity is a "responsible person" within the meaning of Section 6672 is a fact-intensive, case by case, determination. The Pacific National and F & D cases cited on page 11, in which each of the respective sureties were held to be "responsible persons", involved instances where the sureties took assignments of contract balances from their principals and set up joint checking accounts which enabled the sureties to essentially control the financial affairs and operations of the principal.

Critical to the holdings in both Pacific National and F & D was the fact that in each case the trial court specifically found that the surety knew that the principal had no other funds with which to pay withholding other than the funds contained in the joint accounts controlled by the sureties. Also critical was the fact that the sureties in both of these cases were only paying net wages out of the joint accounts controlled by them rather than paying gross wages, including funds for withholding.
The courts in both Pacific National and F & D concluded that the principals had turned over all of their funds to the sureties and had effectively placed themselves at the mercy of the sureties with respect to payment of their financial obligations. The courts in both Pacific National and F & D found that it was "inconceivable" that the principals would have voluntarily put themselves in such a position if they had known that the surety would refuse to co-sign checks for withholding taxes and leave the principals and their officers and directors subject to criminal sanctions for failure to pay same. The courts in both Pacific National and F & D, therefore, had no difficulty in holding both sureties to be "responsible persons" liable for the penalties provided by Section 6672.

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[1] Mercantile Bank of Kansas City v. U.S., 856 F.Supp. 1355 (W. D. Mo. 1994)

[2] U.S. v. Vaccarella, 735 F.Supp. 1421 (S.D.Ind. 1990)

[3] Causey v. U.S. , 683 F.Supp. 605 (M.D. Ga. 1988)

[4] Caterino v. U.S., 794 F.2d 1 (1st Cir. 1986)

[5] Quattrone Accountants, Inc. v. IRS, 895 F.2d 921 (3rd Cir. 1990)

[6] Pacific National Insurance v. United States, 422 F.2d 26 (1970); Peterson v. Fidelity and Deposit Company of Maryland, 330 F.Supp. 424 (D.D.C. 1971)

2. Willfulness:

The second test for determining whether or not a third-party non-employer who is determined to be a "responsible person" is liable under Section 6672 is whether or not that person "willfully" failed to pay the taxes due. The cases are fairly uniform in setting forth the test for "willfulness" in the context of a Section 6672 proceeding:

Willfulness in this context is the voluntary, conscious, and intentional decision to prefer other creditors to the United States ...(citations omitted)... Any responsible person who knows the taxes are not paid and allows the business to pay other creditors acts willfully ... (citations omitted)... Evil motive and specific intent are not necessary elements ... (citations omitted) ... Mere knowledge or reckless disregard for known risks is sufficient. Caterino v. United States, 794 F.2d 1 (1st Cir. 1986).

A general review of the cases addressing the "willfulness" requirement of Section 6672 reveals that the courts have had little trouble finding that the failure to pay taxes was "willful" if, in fact, the courts have previously found that the person not paying the taxes was a "responsible person" within the meaning of Section 6672.

In Houston v. United States, 492 F.Supp. 574 (C.D. Ca. 1980), Houston, a general contractor, agreed to provide financing for one of its sub-contractors which was having financial difficulties. A joint bank account was established for the purpose of paying the sub-contractor's "payroll checks, union benefit checks and government checks". Id. at 575. The general contractor advised the owner of the project that he was going to " 'do everything possible' to insure that the funds (in the joint account) were used for those purposes." Id. at 575. The court found that the general contractor knew that the sub-contractor had no other funds to pay any of these costs other than the joint account.

Thereafter, funds were drawn out of the joint account for the purpose of paying wages to the sub-contractor's employees, but no checks were ever drawn to pay taxes. The Court found that the failure of the general contractor to pay taxes under the foregoing, rather skimpy, circumstances was "willful" within the meaning of Section 6672 and imposed liability on the general contractor for failing to pay the taxes.
Houston is a fairly typical holding. If a "responsible person" has knowledge of, or a reasonable basis to believe, the fact that taxes are not being paid, his failure to require payment will be held to be "willful".

The "bottom line", therefore, with respect to liability under Section 6672 is that if an individual or entity fits the definition of a "responsible person" within the meaning of the rules, regulations and cases set forth above, the failure of such "responsible person" to require payment of the taxes will, in the absence of clear circumstances showing true ignorance of such non-payment, usually be considered "willful" within the meaning of Section 6672.

B. **Individual Liability under Section 3505(b)**

As set forth above, persons and entities outside the formal structure of a taxpayer business have been held to be "responsible persons" if they otherwise fit the criteria for classification as such under Section 6672.

As a general rule, however, prior to 1966, only "employers" were liable for withholding taxes. As a result, there were widespread problems, especially in the construction industry, wherein third parties, i.e. banks, sureties, general contractors and other financiers, were supplying funds to employers to pay net payroll to their employees but were not paying the withholding taxes due on such payrolls. The employees received their withholding credit even though the withholding had not been paid. Although the employer remained liable for the payment of withholding, often it was broke and unable to pay, which is why it needed to borrow in the first place.

Thus, prior to 1966, unless the lender or surety applying funds to the borrower exercised sufficient control over the borrower's finances so as to be classified as a "responsible person" within the meaning of Section 6672, payment of withholding taxes was avoided on a widespread basis. U.S. v. Arnold, 400 F.Supp. 1118 (N.D.Cal. 1975). Indeed, in the Pacific National and F & D cases, supra, both sureties argued to the court that withholding taxes were specifically not expenses payable under the terms of the surety bonds.

The IRS, in order to correct these problems, brought about the enactment in 1966 of Section 3505(b) which provides that lenders, sureties and others who specifically finance payroll but do not pay employees directly, can be liable for withholding taxes under the circumstances set forth in the Section.

As is the case with Section 6672, there are two elements which must be satisfied in order to find lenders, sureties, or others who finance payrolls liable:

1. The lender, surety, or other person must supply funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer; and
2. The lender, surety, or other person must have actual notice or knowledge that such employer does not intend to or will not be able to make timely payment or deposits of the withholding taxes.

As can be seen, Section 3505(b) eliminates any requirement that the third-party financier of payroll be a "responsible person" having control over the employer's ability to pay the withholding taxes. It is enough to satisfy the first requirement of Section 3505(b) that the third-party financier supply funds to the employer which it knows are to be used to make payroll for the employer's employees. On the other hand, the third-party financier must have actual knowledge or must, in essence, recklessly disregard facts which would place it on notice that the taxes are not being paid in order for liability to be imposed under Section 3505(b).

Furthermore, the penalty under Section 3505(b) is limited to 25% of the amount paid by the financier to the employer for payroll as opposed to the 100% penalty set forth in Section 6672.

There is unquestionably some overlap between the coverage of Section 6672 and Section 3505(b) since the "responsible person" element of Section 6672 is much more stringent than the requirements of Section 3505(b). As a general rule, it can be stated that any third-party financier who would be liable for the 100% penalty provided in Section 6672 would also be liable under Section 3505(b). The converse is not true, however, since it is apparent that a third-party financier could fall within the coverage of Section 3505(b) without also being a "responsible person" under Section 6672.

1. The "specific purpose of paying wages of the employees of the employer" element.

In most instances involving sureties who elect to finance their principals, there will usually be little doubt that some or all of the funds being advanced by the sureties to the principals will be used for payroll in some form or another. In other contexts, however, issues of fact have been created as to whether or not a third-party financier was supplying funds for the specific purposes of paying employees' wages. Under the unique circumstances presented in those cases, banks or lenders honoring overdrafts on a regular basis [7], and banks or lenders allowing their borrowers to exceed a previously established line-of-credit[8] have been found, under the particular circumstances of those cases, to have been supplying funds for the accounts of their borrowers for the specific purpose of paying wages even though the funds being supplied by the bank were originally set up as loans to enable the borrowers to meet general operating expenses.

2. The "actual notice or knowledge" element.

Section 3505(b) provides that if the third-party financier has actual notice that taxes are not or will not be paid, then it is liable for the taxes. More troublesome, however, is the rule that "knowledge" (within the meaning of Internal Revenue Code, Section 6323[i][1]) will also impose liability on the third-party financier. Section 6323(i)(1) provides:

> For purposes of this sub-chapter, an organization shall be deemed for purposes of a particular transaction to have actual notice or knowledge of any fact from the time such fact is brought to the attention of the individual conducting such transaction, and in any event from the time such fact would have been brought to such individual's attention if the organization had exercised due diligence. An organization exercises due diligence if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there was reasonable compliance with the routine. Due diligence does not require an individual acting for the organization to communicate information unless such communication is part of his regular duties or unless he has reason

[7] United States v. First National Bank of Circle, 652 F.2d 882 (9th Cir. 1981) and United States v. North Side Deposit Bank, 569 F.Supp. 948 (D.PA.)

[8] Fidelity Bank, N.A. v. United States, 616 F.2d 1181 (10th Cir. 1980)

to know of the transaction and that the transaction would be materially affected by the information.

A particularly interesting case applying this so-called "due diligence rule" is United States v. Metro Construction Company, Inc., 439 F.Supp. 308 (C.D. Ca. 1977). In that case, Metro, the general contractor, advanced sums to Wanka, its subcontractor, admittedly for the specific purpose of paying wages of Wanka's employees. Metro knew that Wanka had no source of funds other than those funds which it supplied to Wanka to fund the projects involved. Wanka would submit requests for labor draws on a weekly basis to Metro. The draw requests did not indicate whether they were for net payroll amounts or gross payroll amounts which would include withholding. It turned out that the labor draw requests were for net payroll, not including withholding, and that withholding was not paid. Thus, IRS brought suit against Metro to collect the tax under Section 3505(b).

Metro argued that it should not be assessed for the withholding because it did not know that the withholding was not being paid. The court found that because of Metro's experience as a general contractor, and because of Metro's ability to estimate what reasonable gross labor costs would be for the projects in question, Metro should have been on notice that the labor draws being requested by Wanka were for net payroll and not gross payroll.

The court specifically found, at 310:

> This Court concludes that, if Metro, in the instant case, had information constituting "suspicious circumstances" which would lead a reasonable person to suspect that employment taxes could not or would not be paid by Wanka, due diligence would require an investigation of the situation by Metro.

The court went on to hold, at 311-312, that Metro had not exercised "due diligence" within the meaning of Section 6323(i)(1), because: (A) a difference of approaching 50% between gross payroll costs and net payroll should have been a flag to (Metro) that (Wanka) was billing for only net pay and that (Wanka) was not receiving from (Metro) the payroll taxes, union benefits, and so forth."

The court concluded, at p.312:

> Even under the "due diligence" of (Section 6323(i)(1)), the Court concludes that, having in mind the very suspicious circumstances referred to above, the actual notice or knowledge of the pertinent facts would have been brought to Metro's attention by minimal investigation, on its part, made during the first quarter of 1972. It does not appear that Metro maintained reasonable routines for communicating significant information to the person conducting the transaction.

Metro Construction demonstrates that a knowledgeable third-party financier will be held to have had "knowledge" within the meaning of the Internal Revenue Code if it was placed upon reasonable inquiry as to whether or not the taxes were being paid.

Another extremely interesting case involving elements of both Section 6672 and Section 3505(b) is Mellencamp v. United States, (S.D.Ind. 1991) 91-2 USTC 50,325 (S.D.Ind. 1991). Mellencamp involved facts very similar to the hypothetical factual scenario set forth in this paper.

Mellencamp was the Vice President of Robbins Electric Company, an electrical contractor which obtained bonding from Indiana Insurance Company on ten construction projects. Robbins ran into financial difficulty on the projects and Indiana agreed to provide financing to enable Robbins to complete the projects, taking a typical assignment of contract proceeds on the bonded projects and setting up a typical joint signature account for disbursement of funds to meet Robbins' operating expenses, including Robbins' payroll.

The particular arrangement between Robbins and Indiana in Mellencamp was that an employee of Robbins, one Ahlbrand, who did not have check signing authority for Robbins, would bring an itemization of unpaid bills and payroll to the offices of Indiana. Ahlbrand would also bring with him an itemization of the withholding taxes due and payable on such payroll. Ahlbrand would further bring with him checks payable from the Robbins-Indiana joint checking account already made out to the various creditors and employees, as well as to the depository agent for the withholding taxes. Indiana would review the various bills from creditors, payroll records and tax records, and then would co-sign the checks, total them, and draw an Indiana check for deposit into the Robbins-Indiana joint account in the exact amount of that total.

Ahlbrand was then supposed to take the checks payable to the various creditors, employees, and depository agent, and send them to those respective recipients. In fact, Ahlbrand paid the creditors and paid the employees, but took the withholding tax checks and stuck them in his desk drawer, never sending them to the government.

The result was that over the months, a surplus of approximately $344,000 was accumulated in the Robbins-Indiana joint account. The government eventually seized this amount, but it was apparently still not enough to pay all the taxes owed. Therefore, the IRS assessed the unpaid taxes against Mellencamp and others under Section 6672 and sued Indiana for the taxes under Section 3505(b). The court found that under the specific facts of that case Indiana did not have the requisite knowledge that the withholding taxes were not being paid since it had no reason to believe that Ahlbrand was not taking the checks payable for the withholding taxes and sending them to the appropriate depository.

Despite this holding, however, this writer believes that a strong argument might have been made by the government, using the rationale of Metro Construction, supra, that Indiana failed to use "due diligence" to follow up to see that Ahlbrand in fact paid the checks to the appropriate depository rather than simply sticking them in his desk drawer.

Furthermore, although not mentioned by the court in Mellencamp, certainly Indiana must have received and reviewed the bank statements on the Robbins-Indiana joint account. Such review certainly would have shown the increasing surplus in the account each month and would have placed Indiana "on inquiry" as to which checks were not being paid from the account. In the view of this writer, Indiana was lucky to escape liability.

In any event, Mellencamp is an interesting case involving both Section 6672 issues and Section 3505(b) issues.

A question of even more paramount interest, however, is whether or not Mr. Mellencamp, the plaintiff in this Southern District of Indiana case, is in any way related to the famous John "Cougar" Mellencamp, who is a native of the same area of Indiana. The answer to such inquiry must be left for a subsequent paper, however. (The above sentences are inserted at this juncture of the paper to see whether anyone has actually read it this far!)

3. Other issues pertaining to liability under Section 6672 and Section 3505(b).

Usually, the IRS is required to give a taxpayer notice and a demand for payment before bringing a civil suit to collect alleged taxes payable by a taxpayer. However, the United States Supreme Court has held that notice is not required to a third-party financier within the meaning of Section 3505(b) before suit can be brought against such third-party financier. Jersey Shore State Bank v. United States, 479 U.S. 422, 107 S.Ct. 782, 93 L.Ed. 2d 800 (1987).

Several cases have also held that a person charged with liability under either Section 6672 or Section 3505(b) cannot sue either the taxpaying employer or any of its officers, directors, or other "responsible persons" for contribution or indemnification from any liability for taxes under these Sections. In short, each responsible person or third-party financier liable under Section 6672 or Section 3505(b) has no right to indemnity or contribution from any other persons who might also be liable under these Sections. Continental Illinois National Bank v. United States, (N.D.Il.) (1987) 87-2 USBC 9942 (N.D.Il. 1987). In Re. Windsor Communications Group, Inc., 45 B.R. 770 (E.D. Pa.)(Bkrtcy. 1985)

IV. **LIKELY HOLDINGS BASED UPON THE FACTUAL SCENARIO IN THIS PAPER**.

As can be seen from the cases cited above, more often than not, corporate banks, sureties and other financing entities, as opposed to individual employees of such entities, have been targeted by the IRS for tax assessments or suits under Section 6672 and Section 3505(b). Obviously, the reason for this is that, more often than not, the banks, sureties and other corporate entities have "deeper pockets" than do any individual employees of such entities.

However, the foregoing cases also demonstrate that the IRS will not hesitate to attempt to hold an individual taxpayer liable for the taxes if it appears that the individual falls within the definition of either of the above Sections.

Under the hypothetical factual scenario set forth in this paper, it is at least arguable that Ms. Hassled and Messrs. Well and Salt are "responsible persons" within the meaning of Section

6672, since they had, in combination, the "final word" over payment of funds out of the joint trust account with Slipshod.

It is also unquestioned based upon the factual scenario that Hassled, Well and Salt knew that some or all of the funds from the joint account were being used to pay payroll. Indeed, Hassled, Well and Salt had specific notice that funds coming from the joint account were supposed to be utilized by Slipshod specifically for the purpose of paying the withholding taxes.

On the other hand, under the factual scenario, Slipshod had other unbonded projects and therefore, presumably had funds and cash flow coming in from sources other than the joint checking account. Hassled, Well and Salt thus may not be "responsible persons" and might not necessarily be on notice that the withholding taxes were not being paid.

Furthermore, under the factual scenario, since the checks for paying withholding taxes were given to Slipshod, and since Slipshod's President, Slimeball, falsely signed tax returns indicating the taxes had been paid, a good argument could be made that Hassled, Well and Salt did not "willfully" fail to pay the taxes, nor did they have actual notice or constructive knowledge that the taxes were not being paid.

Conversely, one might argue that Hassled, Well and Salt, had they exercised "due diligence", should have known that the taxes were not being paid, particularly in view of the fact that the false tax forms given them by Slipshod and Slimeball did not contain copies of the checks payable to the IRS, nor were copies of the cancelled checks received back from the IRS ever provided to them.

In the factual scenario, as well as in many of the actual cases cited in this paper, both the principal and its controlling officers and directors are also liable to the IRS for failure to pay withholding taxes. It is therefore to be expected that the principal and its controlling officers and directors, Slipshod and Slimeball in the factual scenario, would not hesitate to attempt to "cut a deal" with the IRS and testify that Wonderful Surety and Hassled, Well and Salt agreed that they would assume responsibility for payment of these withholding taxes.

In the factual scenario, as well as in most real life cases, the relationship between the surety and the principal has deteriorated to the point that there is no "love lost" between them. Undoubtedly, the surety is claiming indemnification and collateralization from the principal and its indemnitors and has ceased writing bonds for them. There is, therefore, every incentive for desperate principals and their controlling officers and directors to attempt to shift liability for payment of withholding taxes onto the surety to avoid their own civil and criminal liability for those taxes.

The short answer then, to the question of whether Hassled, Well and Salt are liable under either Section 6672 or Section 3505(b) is: "Who Knows?" Hopefully, none of us will ever be personally in a position to have to find out.

V. **<u>PRACTICAL HINTS TO AVOID LIABILITY UNDER SECTION 6672 AND SECTION 3505(b)</u>**.

The surety and its claims representatives, attorneys and consultants are placed in somewhat of a dilemma by the provisions of Section 6672 and Section 3505(b) in those cases when the surety elects to finance its principal and disburse funds for payment of wages of the principal's employees. Obviously, the surety does not wish to simply throw money at its principal with no strings attached. On the other hand, if the surety exercises tight control over the disbursements of its funds utilized to finance the principal, it will, in all likelihood, be deemed to be a "responsible person" under Section 6672. In any event, the surety is liable under Section 3505(b) if it knows or should have known that withholding taxes are not being paid.

There does not appear to be any clear cut solution to this dilemma. Certainly, language should be inserted in any agreement for the assignment of contract proceeds and setting up of the joint trust account setting forth that it is the principal's responsibility for payment of all withholding and pointing out that funds being disbursed by the surety include monies for such purpose.

Even if such language is included in the agreement, however, sureties and their representatives, attorneys, and consultants could still remain exposed to liability under Section 6672 and Section 3505(b) if they become aware that, despite such language, taxes are still not being paid.

Sureties are not in the business of becoming corporate controllers for their principals, nor do they have the resources to do so in any event. Sureties who have, in essence, taken over the operations of their principals have been subjected to all sorts of liability as "alter egos" of the principals, not just liability for unpaid taxes. Section 6672 and Section 3505(b) can impose liability on a surety which exercises too much control over its principals, financiers, and conversely can impose liability if the surety does <u>not</u> exercise sufficient control.

About the only solution to this dilemma that can be posed is not a very satisfactory one: In those cases where the surety decides to finance its principal, the surety and its claims representatives, attorneys and consultants should exercise their best judgment under all the facts and circumstances presented in the particular case and implement reasonable procedures to insure that the principal properly computes and pays the appropriate withholding taxes. Once these reasonable procedures have been implemented, the surety should then have some reasonable means of "follow-up" to check to make sure that the withholding taxes get paid. These "follow-up" procedures would also have to be determined based upon the best judgment of the surety and its representatives, attorneys and consultants under all the facts and circumstances then and there existing.