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**AVOIDING IRS PITFALLS WHEN FINANCING THE
PRINCIPAL**

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INTRODUCTION¹

A principal's financial inability to complete a bonded project portends a likely default termination and demand by the obligee for completion under the surety's performance bond as well as subcontractor and supplier claims under the payment bond. Faced with such prospects, the surety may decide that financing a particular principal under certain circumstances will permit it to discharge its bond obligations at the least cost. For example, the principal may have demonstrated its expertise and capability to perform the work, but cash flow problems prevent it from bringing the project to conclusion. The surety may be able to avoid the delays and increased costs which can result from replacing the principal with a new contractor by directly or indirectly providing the necessary funds to the principal.²

It is obvious that a principal in need of funding is in financial trouble. For that very reason, among others, it is just as obvious that the financing surety has an interest in controlling the use of payments from bonded contracts. The surety's fundamental objective is to ensure that contract funds are used to pay obligations which would otherwise be liabilities of the surety under its bonds.³ Therefore, whatever the reason for opting to finance the principal and whatever method of doing so is selected, a financing arrangement should contain some mechanism – such as joint control trust or escrow accounts – by which the surety can make sure that contract funds are used effectively to maintain the progress of bonded projects and to pay valid payment bond claims, rather than being diverted for other purposes.⁴ In short, the surety's control over the receipt and disposition of bonded contract funds is essential to any financing arrangement. Without that control, it would make no sense for the surety even to consider financing the principal.

It is precisely such control, however, and the knowledge of the principal's financial affairs which comes with it, that exposes the financing surety to liability for certain of the principal's tax obligations, primarily the payment of federal withholding taxes associated with the salaries and wages of the principal's employees. While there may be ways of advancing funds which might reduce the risk or scope of that liability for other lenders, the degree of control over the principal's funds which the surety needs probably makes such liability inevitable. In the end, the best way of avoiding IRS pitfalls when financing the principal is to accept the fact of federal tax liability and to make provision in the financing arrangements for satisfying it.⁵

¹ The author wishes to acknowledge the substantial assistance in preparing this article provided by Andrew S. Kent, an associate at Wolff & Samson.

² For a good discussion of the advantages and disadvantages of financing the principal and of the various methods of doing so, see George S. Bachrach, *Ch. 4, Financing The Principal*, in BOND DEFAULT MANUAL, 119, 129-32, 136-42 (Duncan L. Clore, ed., 2d ed. 1995).

³ *Id.* at 163.

⁴ See *generally id.* at 143-57.

⁵ *Id.* At 166; see also Thomas A. Joyce and William F. Haug, *Ch. 2, Financing The Contractor*, in BOND DEFAULT MANUAL, 21, 26-27 (Richard S. Wisner, ed., 1st ed. 1987).

I. FEDERAL WITHHOLDING – THE BASICS⁶

The Internal Revenue Code (“Code”)⁷ imposes a number of taxes related to employment, often referred to as payroll taxes,⁸ including federal income tax withheld from an employee’s wages and the social security tax (FICA).⁹ The employer is required to withhold from an employee’s wages the employee’s federal income tax¹⁰ and the employee’s FICA contribution.¹¹ Whenever an employer pays wages, the employer incurs liability for the payment of such payroll taxes whether or not the employer has withheld them.¹² If the employer has withheld payroll taxes, the government must credit the withheld amounts against the employee’s tax liability even if the employer never pays the withheld amounts to the government.¹³ Under section 7501 of the Code, taxes withheld from the employee by the employer “shall be held to be a special fund in trust for the United States,¹⁴ and are “commonly referred to as ‘trust fund taxes.’”¹⁵

The employer shares the burden of social security, as the Code imposes FICA taxes on the employer as well as the employee.¹⁶ Thus, in addition to the obligation to pay the income tax and FICA taxes withheld from the employee, the employer is required to pay its own FICA taxes.¹⁷

Although the employer is required to withhold payroll taxes from the employee as wages are paid, the employer is required to pay the withheld amounts to the government only quarterly.¹⁸ As a result, “the funds accumulated during the quarter can be a tempting source of ready cash to a failing corporation beleaguered by creditors.”¹⁹ The Code seeks to encourage employers not to yield to that temptation.²⁰ Because of the statutory trust imposed on withheld payroll taxes, the employer becomes liable for the withheld taxes as if those taxes had been imposed directly on it.²¹ Thus, the employer is subject to the full panoply of summary collection methods for failing to pay withheld payroll taxes including administrative assessment, notice and demand; and thereafter, a lien may be imposed on the employer’s property which

⁶ For an excellent discussion of the federal statutory withholding scheme and of issues relating to a lender’s liability thereunder for the borrower’s withholding obligations, see Larry A. Makel & James C. Chadwick, *Lender Liability For A Borrower’s Unpaid Payroll Taxes*, 43 Bus. Law. 507 (1988).

⁷ I.R.C. §§ 1-9833.

⁸ See, e.g., Makel & Chadwick, *supra* note 6.

⁹ *Jersey Shore State Bank v. United States*, 479 U.S. 442, 443 (1987). Social security taxes are imposed by Chapter 21 of Subtitle C of the Internal Revenue Code, I.R.C. §§ 3101-28, which is titled, Federal Insurance Contribution Act; hence, the acronym “FICA.”

¹⁰ I.R.C. § 3402(a)

¹¹ *Id.* § 3102(a).

¹² *Id.* § 3403 (liability for employee income taxes). *Id.* § 3102(b) (liability for employee’s share of FICA). Makel & Chadwick, *supra* note 6, at 507 n. 2.

¹³ Makel & Chadwick, *supra* note 6, at 507 n. 2.

¹⁴ I.R.C. § 7501.

¹⁵ *Slodov v. United States*, 436 U.S. 238, 243 (1978).

¹⁶ I.R.C. §§ 3111.

¹⁷ *Jersey Shore State Bank v. United States*, 479 U.S. 442, 443-44 (1987).

¹⁸ *Slodov*, 436 U.S. at 243.

¹⁹ *Id.*

²⁰ See generally *id.* at 243-45.

²¹ “The amount of such [trust] fund 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.

may then be levied upon, distrained and sold.²² Moreover, interest and a penalty of up to fifteen percent on the unpaid amount may be imposed.²³ Finally, criminal penalties are available for an employer's failure to comply with its obligations regarding trust fund taxes.²⁴

The withholding system enables the government to collect payroll taxes at their source, and generally there has been high degree of voluntary compliance.²⁵ Nevertheless, whether of not an employer fighting for survival resists the temptation to divert trust funds, distressed employers often fail leaving their payroll taxes unpaid.²⁶ When that happens, the government's formidable array of collection remedies will be useless. Because it has already credited the withheld payroll taxes to the employee's tax liability, the government will lose those taxes when the employer fails²⁷ – unless there is some third party which can be made responsible for the employer's payroll withholding obligations.

There are such third parties, and the surety can be one of them. When a third party has assumed full control of the payment of the employer's employees, the third party may come within the definition of "employer" under section 3401(d).²⁸ If so, the third party will be liable as if it were the employer.²⁹ Alternatively, the third party may be deemed under section 6672³⁰ to be a "person" responsible for withholding and paying payroll taxes. If a responsible person "willfully" fails to withhold and pay, it will be liable for the full amount owed by the employer.³¹ For various reasons, a third party may pay an employer's employees directly or provide funds to the employer for its payroll. In either case, under section 3505,³² if the third party does not withhold payroll taxes or advance funds sufficient to cover payroll taxes, it will have some degree of liability for the employer's withholding obligation.³³

All of those provisions have been applied to a financing surety with the result that the surety was held liable for at least part of the payroll taxes arising from wages paid to the principal's employees. The surety, however, need not be financing the principal to find itself liable for such taxes. Under section 270a(d) of the Miller Act,³⁴ the surety is directly liable under

²² See *Slodov*, 436 U.S. at 244 and Code provisions cited therein.

²³ *Id.* For a discussion of collection and enforcement procedures in the context of the construction industry, see Mary Jensen Hobson & David B. Young, *Taxation of the Construction Industry: The Internal Revenue Service and Copnstruction Projects*, 59 UMKC L. REV. 271, 279-89 (1991).

²⁴ *Slodov*, 436 U.S. at 244.

²⁵ Makel & Chadwick, *supra* note 6, at 507.

²⁶ *Id.*

²⁷ Unless the employer's bankruptcy estate has assets which produce dividends for creditors, the government's loss will be complete. For a discussion of the government's claim for withholding taxes against the employer's bankruptcy trustee, see *Otte v. United States*, 419 U.S. 43 (1974). The Court's conclusion as to the priority of such a claim was later revised by statute. *In re Baldwin-United Corp.*, 43 B.R. 443, 452 n. 12 (S.D. Ohio 1984); *In re Chief Freight Lines Co.*, 146 B.R. 291, 293 (N.D. Okla. 1992).

²⁸ I.R.C. § 3402(d) defines "employer" for the purposes of the employer's obligation to withhold employees' federal income tax.

²⁹ The surety's liability as an "employer" under sec. 3401(d) is discussed *infra* Part II.

³⁰ I.R.C. § 6672.

³¹ The surety's liability as a responsible person is discussed *infra* Part III.

³² I.R.C. 3505(a). That provision addresses the third party's payment of wages directly to the employees, and its impact is discussed *infra* Part IV,A I.R.C. § 3505(b) addresses "net payroll financing," and its affect on the surety is discussed *infra* Part IV,B.

³³ A chart summarizing a comparison of liability under these provisions is attached hereto as Appendix A.

³⁴ 40 U.S.C.A. 270a(d) (West 1986).

its performance bond for withholding taxes owed by the principal on the bonded project.³⁵ Payment of wage claims under a payment bond constitutes a direct payment of wages to an employee which gives rise to an obligation to withhold payroll taxes under section 3505(a).³⁶

II. SURETY'S LIABILITY AS "EMPLOYER" – SECTION 3401(d)(1)

Section 3401(d) of the Internal Revenue Code defines "employer" as "the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person."³⁷ Subsection (1) of section 3401(d) makes an exception "if the person for whom the individual performs or performed the services does not have control of the payment of wages for such services,"³⁸ and provides, in that case, that "employer" means "the person having control of the payment of such wages."³⁹

The question whether a surety that established a joint control account with the principal, from which the principal's employees were paid, had "control of the payment of wages" to the principal's employees arose in a 1963 Ninth Circuit case, *Century Indemnity Company v. Riddell*.⁴⁰ The joint control account was apparently a condition of issuing the bond and was established at that time.⁴¹ Progress payments from the bonded job were paid into the joint account, and all checks on the account had to be signed by the principal and countersigned by a representative of the surety. Although the surety paid certain creditors which the principal could not pay, the surety never advanced its own funds to meet the principal's payroll. The principal compiled a weekly report computing gross and net wages due which was sent to the surety. The surety approved disbursements for the gross payroll amount for several months. At about the time that it was learned that the principal had underbid the job resulting in bond claims, the surety began approving checks for only the net payroll. Payroll taxes associated with those wages were not paid. The Internal Revenue Service ("IRS"), contending that the surety fell within the statutory definition of an "employer,"⁴² assessed the unpaid payroll taxes, including the principal's (employer's) share of FICA, against the surety.⁴³ Rejecting that contention, the Ninth Circuit held that the surety was not the "employer" of the principal's employees for purposes of payroll taxes.⁴⁴ After extensively reviewing the legislative history, the court formulated the following analysis of the issue:

³⁵ The surety's Miller Act liability is discussed *infra* Part V.

³⁶ The surety's liability for withholding taxes in connection with wage claims under the payment bond is discussed *infra* Part IV, A.

³⁷ I.R.C. § 3401(d).

³⁸ I.R.C. § 3401(d)(1).

³⁹ *Id.*

⁴⁰ 317 F.2d 681 (9th Cir. 1963).

⁴¹ One may infer that the surety had doubts about the principal from the outset, although the court's opinion does not give the reason for opening the account when the bond was issued. The court relates that some month's into the job, the principal found that it had underbid the project, *id.* at 685, and perhaps the surety's concern arose from an analysis of the bid spread.

⁴² The court construed I.R.C. § 1621(d)(1), the predecessor of I.R.C. § 3401(d)(1) with the identical operative language, see *Century Indemnity Co.*, 317 F.2d at 682 n. 1 and 2.

⁴³ Technically, § 3401(d)(1) defines "employer" for the purpose of identifying the person having the obligation to withhold income tax from an employee's wages. There is no definition of employer that applies to FICA withholding. However, as held by the Supreme Court, "[t]he fact that the FICA withholding provisions of the code do not define 'employer' is of no significance, for that term is not to be given a narrower construction for FICA withholding than for income tax withholding," *Otte v. United States*, 419 U.S. 43, 51 (1974).

⁴⁴ *Accord Arthur Venneri Co. v. United States*, 340 F.2d 337 (Ct. Cl. 1965); *General Ins. Co. of America v. Wiseman*, 64-1 U.S. Tax Cas. (CCH) ¶ 9166, 1963 WL 12705 (W.D. Okla. 1963).

Joint control of a trust account into which contract payments are required to be deposited, even from the inception of a contract job as in this case, which still leaves the common law employer in control of all the incidents of employment except the requirement of the concurrence of its bonding surety on checks for withdrawals from such account, does not have the dual effect required by Section 1621(d)(1) [the substantially identical predecessor of 3401(d)(1)] of establishing (1) that the contractor “does not have control of the payment of the wages”, and (2) that the surety, whose concurrence is required, does have such “control of the payment of such wages.” Here, neither has sole control, but neither is the subcontractor [the principal] without any such control...[B]oth criteria must be met.⁴⁵ Literally, the exception of Section 1621(d)(1) does not cover such a situation. If construction is called for, then it must be in accordance with the legislative intent above indicated, which calls for a narrow construction of the exception, and a broad construction of the general terms covering the common law employer’s responsibilities.⁴⁶

A decade later, the United States Supreme Court had occasion to address the definition of “employer” under section 3401(d)(1) in *Otte v. United States*.⁴⁷ There, the bankruptcy trustee sought to avoid the government’s claim for income and FICA taxes, which were due on account of wages earned by the bankrupt’s employees prior to bankruptcy but not paid until after filing, on the ground that he was not the employees’ employer and hence had no obligation to withhold and pay payroll taxes. The Court held that either the trustee or the bankrupt estate was the employer under the exception of subsection (1) of section 3401(d) which, the Court said, “obviously was intended to place responsibility for withholding at the point of control.”⁴⁸ Invoking that observation, the District Court for the District of Oregon in *Reliance Insurance Company v. United States*,⁴⁹ a 1998 opinion, found that a financing surety was the “employer” of the principal’s employees and therefore held that the surety was liable for the employer’s share of FICA taxes due on account of wages paid to those employees.⁵⁰ There, the surety sued the government for wrongfully levying on contract funds in the hands of the owner, and the government asserted the surety’s liability for the employer’s share of FICA taxes as a set-off. In that case, the principal voluntarily defaulted because cash flow difficulties prevented it

⁴⁵ Citing *Westover v. William Simpson Constr. Co.*, 209 F.2d 908 (9th Cir. 1954).

⁴⁶ *Century Indemnity Co.*, 317 F.2d at 691.

⁴⁷ 419 U.S. 43 (1974).

⁴⁸ *Id.* at 50.

⁴⁹ 1998 WL 718177 at *4, 82 A.F.T.R.2d (RIA) 5482, 98-2 U.S. Tax Cas. (CCH) ¶ 50,609 (D. Or. 1998).

⁵⁰ That court also held that the financing surety had a superior right to the contract funds paid by the owner pursuant to an IRS levy for unpaid payroll taxes. The court relied on I.R.C. § 6323(c) which accords priority to a bond as “an obligatory disbursement agreement” under certain circumstances. In response to the surety’s wrongful levy action, the government claimed a right to off set the employer’s share of the FICA taxes under *United States v. Munsey Trust Co.*, 332 U.S. 234 (1947). The employees’ income tax and their share of the FICA tax was unavailable for set-off because the court found that the surety’s responsibilities as a third-party wage-payer was governed by I.R.C. § 3505 which imposes liability on the basis of the third party’s failure to pay or fund the payment of payroll taxes to be withheld from the employee but does not transform the third party into an “employer.” *Reliance Ins. Co.*, 1998 WL 718177 at *5. Therefore, the government’s right of set-off, which applies only to the taxpayer, does not reach a third party which is liable only under § 3505.

from meeting its payroll. Thereupon, the surety financed completion by the principal including funding its payroll. At first, the surety provided cashier's checks to the principal for distribution to its workers. Soon thereafter, the parties established a joint control checking account upon which the checks to the employees were drawn. The employer's share of the FICA taxes due on account of the wage payments funded by the surety was not paid. The surety provided the payroll checks on the basis of payroll information compiled and provided by the principal. On that basis, the court concluded that the surety had "control the payment of wages" within the meaning of section 3401(d)(1) and was therefore the "employer" of the principal's workers and subject to the government's set-off in the amount of the employer's share of the FICA taxes.⁵¹

The *Reliance Insurance* court made no mention of the Ninth Circuit's decision in *Century Indemnity*, a case where a surety also had the right to approve wage payments from a joint control account on the basis of payroll information provided by the principal but was held not to be an "employer" under the predecessor of section 3401(d)(1) because such a joint control account was regarded as an arrangement for sharing control over the wages paid by the principal. Instead, the court in the *Reliance Insurance* case relied heavily on a later Ninth Circuit opinion, *Evans v. Internal Revenue Service (In re Southwest Restaurant Systems, Inc., Debtor)*.⁵² In that case, each of four corporations, which were commonly owned, operated a restaurant. The accounting functions and financial controls of the corporations were consolidated and handled by a single bookkeeper. Although each corporation had its own general expense bank account, the employees of all four entities were paid from one payroll account according to computation prepared by the bookkeeper. Form W-2 withholding reports for all employees were prepared in the name of one of the corporations, Southwest Restaurant Systems, Inc., and the quarterly tax returns reporting the withholding liabilities of all four entities were submitted in the name of that corporation. When that corporation filed for bankruptcy, its trustee opposed the IRS's claim for unpaid withholding taxes owed by the other three corporations on the ground that the debtor corporation was not the employer of their employees. In holding that the debtor was the "employer" of the employees of its sibling corporations within the meaning of section 3401(d)(1), the Ninth Circuit distinguished its earlier decision in *Century Indemnity* on the ground that "[h]ere, of course, there was no shared control; the debtor alone controlled."⁵³ It also noted that since *Century Indemnity* was decided, the Supreme Court had addressed section 3401(d)(1) in the *Otte* case. Taking *Otte*'s observation that the exception of subsection (1) was intended to place withholding "at the point of control"⁵⁴ as its point of departure, the Ninth Circuit reasoned as follows:

No one other than the person who has control of the payment of wages is in a position to make the proper accounting and payment to the United States. It matters little who hired the wage earner or what his duties were or how responsible he may have been to his common law employer. Neither is it important who fixed the rate of compensation. When it finally comes to the point of deducting from the wages earned that part which belongs to the United States and matching it with the employer's share of FICA taxes, the only

⁵¹ *Reliance Ins .Co.*, 1998 WL 718177 at *5.

⁵² 607 F.2d 1237 (9th Cir. 1979).

⁵³ *Id.* at 1240.

⁵⁴ 419 U.S. at 50.

person who can do that is the person who is in “control of the payment of such wages.”⁵⁵

Has the analysis of *Century Indemnity* that a joint control account gives rise to a shared control over the payment of wages which does not have the “dual effect” required by section 3401(d)(1)⁵⁶ survived *Otte* and *Southwest Restaurant*? Certainly it can be said that the facts of *Southwest Restaurant* show that for the purposes of wage payments at least, the four corporations were operated as a single business entity and each was for that purpose the alter ego of the other. Such an ongoing arrangement seems significantly different from the limited, *ad hoc* nature of the typical surety-principal joint control bank account. Yet, even though *Southwest Restaurant* acknowledged that difference in distinguishing *Century Indemnity* on the basis of the shared control found in that case,⁵⁷ its analysis of the function of the “control of wages” concept suggests, as did the observation in *Otte*, that there can be only one “employer” – that person or entity who has control for the purpose of making wage deductions and paying them and the employer’s FICA tax to the government.⁵⁸ Clearly, that seems to have been the attitude underpinning the *Reliance Insurance*⁵⁹ court’s use of *Southwest Restaurant* to find that the surety’s right to approve payments from a joint control account constituted “control of the payment of wages.”

The *Reliance Insurance* case also illustrates an important consequence of being found to be an “employer” under section 3401(d)(1). If a surety is so designated, it will be liable for the employer’s share of FICA taxes as well as for the payroll taxes which are required to be deducted from the employees. The liability of a surety as a third party under sections 6672 or 3505 is limited to the latter or some part thereof.⁶⁰ For the same reason – being stuffed into the shoes of the principal as taxpayer – a surety which is held to be an “employer” will be liable for penalties imposed on taxpayers for failing to file quarterly returns and failing to deposit withheld trust funds. Such penalties cannot be assessed when the surety is held liable only as a third party under sections 6672 or 3505.⁶¹

⁵⁵ 607 F.2d at 1240.

⁵⁶ *Century Indemnity Co.*, 317 F.2d at 691

⁵⁷ 607 F.2d at 1240.

⁵⁸ I.R.C. §6672 also uses control as a test. Under that statute, however, it is explicitly recognized that there can be more than one person responsible for collecting and paying payroll taxes. See discussion *infra* at Part III.A.

⁵⁹ *Reliance Ins. Co.*, 1998 WL 718177 at *4-*5.

⁶⁰ See John W. Schmehl & Richard L. Fox, *Responsible Person and Lender Liability for Trust Fund Taxes – §§6672 and 3505*, in TAX MANAGEMENT at A-1 (type of taxes to which §6672 applies) and A-30 (type of taxes to §3505 applies) (Tax Management Inc. Portfolio No. 639, 1996).

⁶¹ *Id.*

SURETY'S LIABILITY AS A "RESPONSIBLE PERSON" – SECTION 6672⁶²

Section 6672⁶³ provides in pertinent part as follows:

(a) General rule. – Any person required to collect, truthfully account for, and pay over any tax imposed by this title⁶⁴ 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 ... be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over.⁶⁵

This provision applies only to "third-party taxes," that is, taxes which are imposed on someone other than the person who is required to collect, account for and pay over the tax.⁶⁶ Although section 6672 extends to all third party taxes imposed by the Internal Revenue Code, it has traditionally been used as a mechanism for collecting payroll taxes which an employer is required to withhold from the wages of its employees.⁶⁷ It should be noted, however, that "[s]ection 6672 imposes a liability separate and distinct from the employer's liability for the withheld taxes and it imposes that liability upon persons other than the employer"⁶⁸ which is made directly liable for those taxes under other provisions of the Internal Revenue Code.⁶⁹ Moreover, under the language of the statute, a responsible person is not liable for the withheld taxes themselves but only for "a penalty" equal to the amount of the tax which was not withheld or paid over.⁷⁰ Despite the use of the term "penalty," section 6672 liability encompasses only the unpaid withholding taxes and does not extend to interest and penalties which can be assessed against the employer from whom the taxes are due.⁷¹ Though sometimes referred to as "the 100% penalty" (or "the trust fund recovery penalty" because withheld payroll taxes are trust funds under section 7501⁷²), section 6672 does not impose any additional liability over and above the principal amount of the unpaid taxes.⁷³

⁶² For a comprehensive technical analysis of §6672, see Schmehl & Fox, *supra* note 60, at A-1 – A-28. For a full discussion of lender liability issues under §6672, see Makel & Chadwick, *supra* note 6, at 511-519, 527-534, 539-543.

⁶³ I.R.C. §6672.

⁶⁴ United States Code, Title 26, Internal Revenue Code.

⁶⁵ I.R.C. §6672(a).

⁶⁶ See Schmehl & Fox, *supra* note 60, at A-6.

⁶⁷ *Id.* at A-1 – A-2.

⁶⁸ *Pacific Nat'l Insurance Co. v. United States*, 422 F.2d 26, 30 (9th Cir. 1970).

⁶⁹ See discussion *supra* Part I.

⁷⁰ Nevertheless, under I.R.C. 6671(a), the §6672 penalty may be assessed and collected as if it was a tax owed by the third party. See discussion *supra* Part II, C.

⁷¹ See Schmehl & Fox, *supra* note 60, at A-2, A-16. If a §6672 penalty is administratively assessed by the IRS against a responsible person, however, interest will run against that person as of the time of the assessment. *Id.*

⁷² See discussion *supra* Part I.

⁷³ See Schmehl & Fox, *supra* note 60, at A-2. There are, however, criminal sanctions for failing to comply with §6672. Under I.R.C. §7202, which tracks the language of §6672, a person who has the responsibility for collecting, truthfully accounting for and paying over a tax required by the Code and willfully fails to do so, shall be guilty of a felony and subject to 5 years imprisonment or up to a \$10,000 fine or both. §7702. See also *Slodov v. United States*, 436 U.S. 238, 245 (1978) (noting that a person violating §6672 is subject to the criminal penalties of §7202). Absent the criminal penalties, it might be tempting to risk violating §6672 because the civil the "penalty" imposed, if the IRS discovered the violation, would be no more than the tax which the responsible person would have had to pay in complying with the statute.

For a person to be held liable under the terms of section 6672, two conditions must be made to appear.⁷⁴ First, the person must, in fact, be a responsible person within the meaning of the statute; that is, the person must have been required to collect, account for or pay over payroll taxes. Second, the responsible person must have willfully failed to perform any one of those functions.⁷⁵

A. Responsible Person

Clearly, section 6672 was intended to impose personal liability upon officers, directors or employees of the employer who had the responsibility for causing the employer to collect and pay trust fund taxes but failed to discharge that duty.⁷⁶ A particular problem arose when a corporate employer filed for bankruptcy which left the government recourse to only such assets as the estate possessed. The individuals who controlled the corporation were shielded by the corporate veil from personal liability. Section 6672 was a direct response to that problem.⁷⁷ Responsibility is a matter of status, duty and authority, particularly whether the person has significant control over which creditors get paid.⁷⁸ When applying section 6672 to those directly associated with the employer, such as stockholders, directors, officers or employees, courts consider a wide variety of factors involving the distribution of corporate authority and functions.⁷⁹ Although the central factor of control remains the standard when section 6672 is invoked against “outsiders” or third parties such as sureties or construction lenders (and their employees), the issues arise in a different setting resulting in a separate set of problems.

In the beginning, sureties fared relatively well in fending off section 6672 liability. In *United States v. Hill*,⁸⁰ decided in November 1966, a financially distressed contractor entered into an agreement with its construction lender and surety whereby the lender bank, to which the contractor had assigned project receivables as collateral, agreed to loan an additional \$100,000 to the contractor, and the surety agreed to guarantee the loan. The parties also agreed that the loaned funds would be deposited into a special account which required the surety’s approval for all checks. When presented with a check for payroll taxes, the surety’s representative refused to approve it. When the Internal Revenue Service could not collect the unpaid payroll taxes from the corporate principal, it issued an assessment against the individual stockholders as responsible persons under section 6672. The stockholders sued for a refund, and the government, by way of a third party complaint, alleged that the bank and one of its officers and the surety and its claims representative were also responsible persons liable for the unpaid taxes under section 6672. Affirming judgments n.o.v., the Fifth Circuit held that none of the third party defendants was a responsible person under the statute. It observed that “the courts have indicated a strong preference to impose liability only within the corporate or other business structure” and noted that there was “strong evidence that Congress has not

⁷⁴ An IRS assessment under §6672 raises a rebuttable presumption that the assessment is correct, and the opposing party has the burden of proving otherwise. See *Brounstein v. United States*, 979 F.2d 952, 954 (3d Cir. 1992); *Kordopatis v. United States*, 949 F.Supp. 1217, 1225 (E.D. Pa. 1997).

⁷⁵ Although the obligations are phrased in the conjunctive in the statute, the Supreme Court has held that liability under §6672 is not limited to persons who are in a position to perform all three duties. *Slodov*, 436 U.S. at 246-50.

⁷⁶ *Id.* at 244-45.

⁷⁷ See *Makel & Chadwick*, *supra* note 6, at 511-512.

⁷⁸ See *Kordopatis*, 949 F.Supp. at 1225-26. There can be more than one responsible person for a given employer. *Id.*

⁷⁹ *Id.*

⁸⁰ 368 F.2d 617 (5th Cir. 1966).

heretofore intended that Section 6672 should apply to one advancing payroll monies to an employer.”⁸¹ The court acknowledged that the surety never refused to approve a check for liabilities covered by its bond obligations⁸² and that it exercised its control over the bank account in accordance with the condition of its guarantee that the loan proceeds be used exclusively for completion of the bonded projects. In the court’s view, however, the surety’s involvement did not amount to taking over the principal, and therefore the surety should prevail because no surety had ever been held liable for withholding taxes “if it did not run the day-to-day affairs” of the principal.⁸³ In effect, the court concluded that joint control over the principal’s checking account did not constitute the level of control required under section 6672.

About three years later in February, 1970, a surety’s invocation of *Hill* came to naught in *Pacific National Insurance Co. v. United States*.⁸⁴ The surety there, as in *Hill*, had bonded several projects of a contractor which was unable to complete without financial assistance. Through an intricate arrangement,⁸⁵ the surety advanced funds for the principal’s net payroll but refused to fund the principal’s request for funds to pay withholding taxes. In order to pay the principal’s non-payroll expenses, the surety arranged for a bank to loan to the principal the estimated amount of the progress payments to be earned under the bonded contracts. The surety guaranteed the loan, the proceeds of which were placed in a special account for each project. Although the progress payments were assigned to the bank, the surety retained the right to decide whether payments would be deposited into the special accounts or applied to reduce the principal’s indebtedness to the bank. The principal made requests to the surety for payments to creditors; the surety decided which would be paid. When it approved a payment, the surety transferred sufficient funds from the appropriate special account to the principal’s account.⁸⁶ The surety argued that it could not be held liable under section 6672 because it was not a person responsible for collecting and paying over to the government the taxes withheld from the employees’ wages. Relying on *Hill*, the surety contended that only the employer or its officers or other employees could be responsible persons under the statute. The Ninth Circuit flatly rejected that position. It held first that the applicable definition of “person” as used in section 6672⁸⁷ was broad enough to include artificial entities as well as natural beings and was not limited to those directly affiliated with the employer such as its officers or employees.⁸⁸ The court then formulated the scope of the definition of responsible person for the purposes of section 6672 as follows:

⁸¹ *Id.* at 622.

⁸² The court pointed out that “[l]iability of a surety for wages under a contractor’s performance bond does not make the surety liable for withholding taxes.” *Id.* at 624. For an analysis of the surety’s bond liability for payroll taxes, see discussion *infra* Part Part V.

⁸³ *Id.*

⁸⁴ 422 F.2d 26 (9th Cir. 1970).

⁸⁵ The principal prepared payrolls showing for each employee gross pay, taxes withheld, and the resulting net wages. The principal drew checks to each employee in the net amount due. The surety’s representative examined the payroll, and had each employee endorse his check. The representative then carried the endorsed checks to the bank, deposited into the principal’s account funds of the surety sufficient to cover the checks (i.e., the amount of the total net payroll), cashed the employees’ checks and returned to the job site with the cash which was paid to the employees. *Id.* at 28-29.

⁸⁶ *Id.*

⁸⁷ I.R.C. §6671(b) (“the term ‘person’ ... includes 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 perform the act in respect of which the violation occurs.”).

⁸⁸ *Pacific Nat’l Ins. Co.*, 422 F.2d at 31.

“[T]he section [defining “person”] must be construed to include all those so connected with a corporation as to be responsible for the performance of the act in respect of which the violation occurred”;⁸⁹ it reaches those who have “the final word as to what bills should or should not be paid, and when.”⁹⁰

The Ninth Circuit affirmed the judgment below against the surety on its claim for a refund. Clearly, that court agreed with the district court’s conclusion that in refusing the principal’s request that the surety fund its payroll tax obligation and in approving or disapproving the payment of creditors from the special accounts, the surety “exercised complete dominion and control over funds belonging to Central States [the principal] and was the person who decided which creditors of Central States were to be paid and when.”⁹¹

Courts have generally adopted *Pacific National Insurance’s* functional test⁹² for determining whether a person or entity is a responsible person. There have been some glosses. For example, the Eighth Circuit in *Anderson v. United States*⁹³ said that “[i]t is not necessary that such control be exercised exclusively by the person; it may be exercised jointly with others.”⁹⁴ The Fifth Circuit in *Commonwealth National Bank v. United States*,⁹⁵ approved⁹⁶ jury instructions stating that “[f]inal’ means significant rather than exclusive control over the disbursement of corporate funds.”⁹⁷ Whatever the particular formulation, the touchstone is the ability to direct that creditors of the principal other than the government be paid and make it stick.

Control may not be sufficient, however, unless the third party has control over *all* of sources of funds which the employer could use to pay its trust fund obligation. In *Commonwealth National Bank of Dallas v. United States*,⁹⁸ for example, a construction lender took a security interest in all of the contractor’s account receivables to secure a loan and a line of credit. Payments to the contractor were made by checks drawn jointly to it and the bank. The bank also advanced funds by permitting the contractor to maintain overdrafts on its account. On a weekly basis, the contractor prepared and presented to the bank’s president or vice president checks to employees in the net amount due and tax deposit checks for the associated payroll taxes. The bank’s officers honored the checks for the employees but, pursuant to the contractor’s instructions, not the checks for payment of the trust fund taxes. The IRS assessed the 100% penalty under section 6672 against the contractor’s president, the bank and the bank’s president. All were found liable and appealed to the Fifth Circuit. The

⁸⁹ *Id.* at 31 (quoting *United States v. Graham*, 309 F.2d 210, 212 (9th Cir. 1962) which remanded a judgment in favor of a member of an employer’s board of directors for a refund of withholding taxes assessed under the predecessor of §6672).

⁹⁰ *Pacific Nat’l Ins. Co.*, 422 F.2d at 31, quoting *Wilson v. United States*, 250 F.2d 312, 316 (9th Cir. 1957) (reversing the criminal conviction of president of employer for failure to pay over withholding taxes in violation of the predecessor of §6672).

⁹¹ *Pacific Nat’l Ins.*, 422 F.2d at 29 (quoting the district court).

⁹² See *Commonwealth Nat’l Bank of Dallas v. United States*, 665 F.2d 743, 752 (5th Cir. 1982) (“[T]he test of liability under §6672 is indeed a functional one.”)

⁹³ 561 F.2d 162 (8th Cir. 1977).

⁹⁴ *Id.* at 165. *Accord Mercantile Bank v. United States*, 856 F.Supp. 1355, 1360 (W.D. Mo. 1994).

⁹⁵ 665 F.2d 743 (5th Cir. 1982).

⁹⁶ *Id.* at 755.

⁹⁷ *Id.* at 748 n. 4. *Accord Kordopatis v. United States*, 949 F.Supp. 1217, 1228 (E.D. Pa. 1997).

⁹⁸ 665 F.2d 743 (5th Cir. 1982).

bank and its president, arguing that their case was indistinguishable from the earlier Fifth Circuit decision in *United States v. Hill*,⁹⁹ asserted that a lending bank or officer thereof could not be held liable under section 6672. The court rejected the argument on the grounds that the lending bank in *Hill* did not have control over all of the contractor's funds. Even though the bank in *Hill* refused to permit its loaned funds to be used to pay the contractor's withholding taxes, the contractor's stockholders had deposited enough of their own funds to pay those taxes but used them to pay other creditors. In the *Commonwealth National Bank of Dallas* case then before it, the Fifth Circuit affirmed the liability of the bank and its president because the bank had a security interest in all of the contractor's receivables which were deposited into an account controlled by the bank. Unlike the situation in *Hill*, the contractor had no unencumbered funds in its account. The contractor's creditors including the government could be paid, if at all, only by extensions of credit by the bank. Since the bank's president and the contractor's president, together, decided which creditors would or would not be paid, the bank and its president had the necessary control to be liable under section 6672 for their decision not to pay the trust fund taxes owed by the contractor.¹⁰⁰ In so holding, the Fifth Circuit stressed that section 6672 liability does not, without more, arise from a lender's refusal to permit loaned funds over which it has control to be used to pay the employer's payroll tax liability *if* there are unencumbered funds available to the employer for that purpose.¹⁰¹ Apparently, the fact that the employer has access to funds with which to pay its withholding obligation means that a lender's control over other funds cannot be sufficient to subject it to liability under section 6672. Moreover, in shaping its view of section 6672 liability, the Fifth Circuit wished to

emphasize that the fact that a bank makes loans ... to a corporate employer that is failing to pay over withheld federal employment taxes to the United States will not, without more, subject the bank to §6672 liability. [citations omitted] What will subject the bank to liability for those taxes is the assumption of control over how the employer's funds are to be spent and over the process of deciding which creditors of the employer are to be paid and which are not, and when.¹⁰²

Possession of even such control, however, may not always be enough. In *Mercantile Bank of Kansas City v. United States*,¹⁰³ a bank extended a line of credit to a trucking company and took a security interest in the debtor's accounts receivable as collateral. Pursuant to the loan agreement, payments to the trucking company were mailed to a postal lock box controlled by the bank. During the period in question, the bank applied all deposits to pay down the loan but allowed the trucking company to draw further amounts against the line of credit by honoring checks when the debtor's account was overdrawn. If instructed by the trucking company, however, the bank would return particular checks for insufficient funds. The bank followed the debtor's direction as to the checks which were to be honored or returned. On those facts, the

⁹⁹ 368 F.2d 617 (5th Cir. 1966).

¹⁰⁰ *Commonwealth Nat'l Bank of Dallas*, 665 F.2d at 754-57.

¹⁰¹ *Id.* at 754. *Accord Merchants Nat'l Bank of Mobile v. United States*, 878 F.2d 1382, 1387-88 (11th Cir. 1989).

¹⁰² *Commonwealth Nat'l Bank of Dallas*, 665 F.2d at 757. If such a loan is made for the purpose of financing the employer's payroll, however, the lender's knowledge that the employer is not withholding or paying trust fund taxes will subject the lender to liability under I.R.C. §3505(b). See discussion *infra* Part IV,B.

¹⁰³ 856 F.Supp. 1355 (W.D. Mo. 1994).

court held that neither the bank nor its officers could be held liable under section 6672 for payroll taxes which the trucking company did not pay because section 6672 “requires the exercise of control over the employer’s funds. The mere existence of the power to control is not enough.”¹⁰⁴

The financing surety almost always has the required level of control, usually in the form of a joint control bank account, and would certainly use it. Indeed, there would be little point in the surety’s advancing its own funds unless it was able to assure itself that by doing so, it would realize a corresponding reduction in its bond liability. Moreover, it is not only the financing surety which is at risk under section 6672. A surety which wishes to avoid a crisis before it occurs may seek to control the principal’s use of contract funds by establishing a joint control account with the principal agreeing, for example, because of the obligee’s threat of default. Even if the surety advances no funds into such an account, its power to control disbursements will likely be sufficient.¹⁰⁵ It is not surprising, therefore, that since the *Pacific National Insurance* case, sureties which have established joint control accounts have generally be held to be responsible persons under 6672.¹⁰⁶ So pronounced is the trend that one court held that the president of the employer could not be held liable as a responsible person under section 6672 because the surety, through a joint control account, had taken control over the employer’s funds and the president, therefore, no longer had any control of them.¹⁰⁷ Another court went so far as to hold the surety liable to the president of the principal for the payments made by the president to the government under a section 6672 assessment because the surety, whose signature was required on a joint control account, refused to co-sign checks to pay withholding taxes.¹⁰⁸

One last bit of reasoning from the *Pacific National Insurance Co.* opinion is revealing. The surety argued that legislative history supported its assertion that section 6672 was not intended to apply to third parties which provided funds for net payroll because the third party is not the employer. The court answered thusly:

No reason has been suggested why Congress would have wished to exclude cases like the present from the coverage of the statute. The effect of exclusion would be to permit the surety to use tax money in discharging its obligations to complete performance of the contract by channeling funds for the work through the distressed contractor.¹⁰⁹

¹⁰⁴ *Id.* at 1361.

¹⁰⁵ The fact that individuals associated with lenders, such as the president in *Commonwealth Nat’l Bank of Dallas*, 665 F.2d at 754-57, demonstrates that liability under §6672 is based on control and does not require the responsible person to have supplied funds.

¹⁰⁶ See, e.g., *Anderson v. United States*, 561 F.2d 162 (1977); *United States v. Falino*, 441 F.Supp. 153 (E.D.N.Y. 1977); *Peterson v. Fidelity & Deposit Co. of Maryland*, 330 F.Supp. 424 (D.D.C. 1971)

¹⁰⁷ *Falino*, 441 F.Supp. at 156-57. The court noted that although the surety had violated §6672, the government had not pursued an action against it and was by then time-barred from doing so. *But see Commonwealth Nat’l Bank of Dallas v. United States*, 665 F.2d 743, 758 (5th Cir. 1982) (holding that the chairman of the board and president of the employer, a construction company, remained liable under §6672 even when the employer’s bank controlled the employer’s disbursements because he permitted the company to stay in business thereby allowing trust funds to be used to pay creditors other than the government.)

¹⁰⁸ *Peterson*, 330 F.Supp. at 427 (by agreeing to a joint control account, the principal “placed itself completely at the mercy of [the surety].”).

¹⁰⁹ *Id.* at 31.

Clearly, a surety would prefer that contract funds or its own loaned funds be used exclusively to complete bonded projects or otherwise to discharge obligations under its bonds. After all, contract funds are assigned to it under the indemnity agreement, and loaned funds come out of its own pocket. Still, unless the surety puts restrictions on the use of contract payments or loaned monies, the principal will be able to decide how they should be used subject, of course, to the government's statutory rights to payroll taxes. Withheld taxes are trust funds belonging to the government. The teaching of the section 6672 cases is that if the surety decides that it is in its interests to decide how funds, which would otherwise be under the principal's dominion, are to be spent, the surety will be held responsible for seeing to it that the government gets its money.

Willfulness

It is not enough to possess, or even to exercise, the power to cause the employer to prefer its obligations to other creditors over those it owes to the United States. Section 6672 does not impose even on responsible persons “an absolute duty” to pay trust fund taxes.¹¹⁰ The statute does not “impose liability without fault.”¹¹¹ It provides that the failure to withhold, account for, or pay over must be done “willfully.”¹¹² The bar has not been set high:

The term “willfully” means that the act of failing to collect, account for, and pay over the taxes was voluntary, consciously, and intentionally done, as opposed to accidental failure. [footnote omitted] It is not necessary that bad motive or evil designs be shown or that an intent to deprive the government of its taxes exists. [footnote omitted] Rather, the willfulness requirement is satisfied by showing that the responsible person made the deliberate choice to pay the withheld taxes to other creditors, instead of paying the government. [footnote omitted].

* * *

Evidence that a responsible person knew that payments were being made to other creditors, after he was aware of the failure to remit the taxes to the government, is proof of willfulness as a matter of law. [footnote omitted].¹¹³

That test was applied in *Anderson v. United States*¹¹⁴ to a completing surety held liable for the trust fund taxes which the principal failed to pay *before* the surety took over and completed the project. The surety paid all withholding obligations accruing after it took over. It appears, although it is not clear from the opinion, that the surety used the principal to finish the work and funded completion with contract payments, which were paid to it from that point onward, and its own funds. Although the surety knew about the unpaid taxes, it argued that it never came into possession of funds belonging to the principal which were “available” for paying the principal’s pre-existing tax liability. In effect, the surety argued that as of the time it took over, it was completing the contract for its own account and that, as the remaining contract funds were insufficient and it had to use its own funds, it sustained a loss in discharging its bond obligations. Although the court appeared to acknowledge the surety’s subrogation and assignment rights to the contract funds as of the default,¹¹⁵ it nevertheless concluded that jury could have disbelieved the testimony of the surety’s claims attorney and that therefore the surety failed to carry its burden of proving that it suffered at loss. If, as the court presumed the jury found, there was an excess, such funds were impressed with a trust for the payment of payroll taxes, and the surety’s failure to use those funds to pay the principal’s pre-existing withholding tax obligations constituted a willful violation of its duties

¹¹⁰ *Slodov v. United States*, 436 U.S. 238, 254 (1978).

¹¹¹ *Id.*

¹¹² I.R.C. §6672.

¹¹³ Schmehl & Fox, *supra* note 60, at A-9 – A-10.

¹¹⁴ 561 F.2d 162 (8th Cir. 1977).

¹¹⁵ *Id.* at 166 (“[I]t is the general rule that default operates to vest the interest in such [contract] funds in the surety to the exclusion of the principal.”).

under section 6672 since it was clear that the surety had complete control of the project and all project finances from the time that it took over.¹¹⁶

In reaching that conclusion, the Eighth Circuit in the *Anderson* case relied¹¹⁷ on the Sixth Circuit opinion in the *Slodov* case.¹¹⁸ A year later, however, the Supreme Court reversed the Sixth Circuit's decision in *Slodov*.¹¹⁹ As to the trust fund basis for holding a responsible person liable for the employer's pre-existing liability, the Court said:

[Section] 7501 does not impress a trust on after-acquired funds, and ... the responsible person consequently does not violate § 6672 by willfully using employer funds for purposes other than satisfaction of the trust-fund tax claims of the United States when at the time he assumed control there were no funds with which to satisfy the tax obligation and the funds thereafter generated are not directly traceable to collected taxes referred to by the statute.

C. Collection Procedures

Collection procedures and related issues have been discussed in detail and analyzed comprehensively in authorities specifically directed to the Internal Revenue Code,¹²⁰ and such publications should be consulted when facing collections issues. There are, however certain basic matters which deserve mention. For example, although the policy of the Internal Revenue Service is to collect payroll taxes only once from whatever source or sources are available, liability under section 6672 is joint and several. The IRS may choose to pursue collection against one responsible person for the entire amount due even if there are other responsible persons, and it is not required to allocate the amount of liability among them.¹²¹ The IRS has historically sought to collect payroll taxes first from the employer, but it is not required to do so.¹²²

Even though the trust fund penalty under section 6672 is not a tax on the responsible person, the penalty may be imposed by the same summary, administrative assessment and collection procedures by which a tax is recovered.¹²³ When trust fund taxes have not been paid, an IRS revenue officer is assigned to investigate and identify responsible persons. The revenue officer seeks to interview witnesses including potential responsible persons and to obtain pertinent documentation. Upon concluding the investigation, the revenue officer proposes an assessment. The responsible person is notified that an assessment has been proposed (Form 2751, Proposed Assessment of Trust Fund Recovery Penalty) and given the opportunity either to consent to the assessment or to appeal it.¹²⁴ The responsible person has

¹¹⁶ *Id.* at 166-67.

¹¹⁷ *Id.* at 166.

¹¹⁸ 552 F.2d 159, 164 (6th Cir. 1977).

¹¹⁹ 436 U.S. 238 (1978).

¹²⁰ See, e.g., Schmehl & Fox, *supra* note 60, at A-20 – A-28(2).

¹²¹ *Id.* at A-20.

¹²² *Id.* at A-21

¹²³ I.R.C. §6671(a) provides that assessable penalties including 100% penalty under §6672 “shall be assessed and collected in the same manner as taxes.”

¹²⁴ Schmehl & Fox, *supra* note 60, at A-27 – A-28.

60 days within which to file a written protest of the proposed assessment. If the responsible person does not do so within the 60 days, the IRS then issues assesses the penalty under section 6672 and issues a notice and demand for payment within 10 days. Unless payment is made, the responsible person, like a person deemed to be an employer, is subject to the full range of IRS collection methods.¹²⁵ If the responsible person does timely appeal the proposed assessment, the appeal is referred to the office of the District Director and ultimately to the Appeals office. If no agreement is made with the Appeals office and the Appeals office rejects the protest, the IRS proceeds to assess the penalty.¹²⁶ To contest an assessment, the responsible must pay the portion of the penalty attributable to one employee for one quarter, and seek a refund from the IRS. If a refund is denied or the IRS takes no action for six months, the responsible person may then institute a refund action against the United States in the appropriate federal district court or the Court of Federal Claims.¹²⁷

IV. SURETY'S LIABILITY AS NET PAYROLL LENDER – SECTION 3505¹²⁸

Cases such as *United States v. Hill*,¹²⁹ though reinterpreted by later cases in light of the enactment of section 3505 in 1966,¹³⁰ which virtually held that section 6672 liability could be imposed “only within the corporate or other business structure” of the employer and flatly stated that “[t]here is strong evidence that Congress has not heretofore intended that Section 6672 should apply to one advancing payroll monies to an employer,”¹³¹ illustrated the shortcomings of section 6672 as a device for collecting payroll taxes from third parties. Indeed, prior to 1966, “it was a common practice in some industries for a third party, such as a general contractor of a subcontracting employer, to furnish the employees with “net” wages and fail to pay ... the payroll taxes relating to such wages.”¹³² Thus, section 3505 was added to the government’s arsenal. The statute makes express reference to sureties, and sections (a) and (b) thereof provide as follows:

(a) Direct payment by third parties. – For purposes of sections 3102, 3202, and 3403, if a lender, surety, or other person, who is not an employer under such sections with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to

¹²⁵ See discussion *supra* Part I.

¹²⁶ The investigation, assessment and appeal procedures are discussed in detail in Schmehl & Fox, *supra* note 60, at A-27 – A-28.

¹²⁷ *Id.* at A-28(1) – A-28(2).

¹²⁸ For a comprehensive technical analysis of §3505, see Schmehl & Fox, *supra* note 60, at A-28 – A-39. For a full discussion of lender liability issues under §3505, see Makel & Chadwick, *supra* note 6, at 520-24, 534-39, 543-46.

¹²⁹ 368 F.2d 617 (5th 1966), discussed *supra* Part IIA.

¹³⁰ See, e.g., *Pacific Nat'l Ins. Co. v. United States*, 422 F.2d. 26, 27-28 (9th Cir. 1970) (quoting the entirety of §3505 at the outset of its opinion deciding that a surety could be a responsible person under §6672), discussed *supra* Part IIA.

¹³¹ *Hill*, 368 F.2d at 622.

¹³² Makel & Chadwick, *supra* note 6, at 520.

the taxes (together with interest) required to be deducted and withheld from such wages by such employer.¹³³

(b) Personal liability where funds are supplied. – If 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 6332(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.¹³⁴

Both subsection (a) and subsection (b) are directed the problem of “net payroll financing” which consists of a third party directly or indirectly paying an employer’s employees without also paying the associated payroll taxes. There are features common to both sections. For example, as is the case with section 6672, a third-party’s liability under either subsection of section 3505 extends only to taxes required to be withheld from employee wages and does not include the employer’s share of FICA.¹³⁵ Unlike section 6672, however, liability under either subsection (a) or (b) includes interest on the unpaid payroll taxes running from the time when they should have been paid.¹³⁶ Obvious differences between the subsections requires that each be addressed separately.

Section 3505(a)

Subsection (a) applies when the surety or other third party makes payments directly to the employer’s employees, while subsection (b) addresses indirect wage payments made through the employer. That difference is straight forward. Some third parties have tried to disguise direct payments as indirect funding by, for example, making checks payable jointly to a contractor and its employee, but courts have generally seen through such subterfuges and held the third parties liable under subsection (a).¹³⁷

No doubt such schemes were attempted because of the second major difference between the two provisions. By its terms, subsection (b) limits liability for withholding taxes (plus interest) to 25% of the amount advanced *for payroll*. Subsection (a) contains

¹³³ I.R.C. §3505(a).

¹³⁴ I.R.C. §3503(b).

¹³⁵ *Jersey Shore State Bank v. United States*, 479 U.S. 442, 446-47 (1987).

¹³⁶ *United States v. Security Pacific Bus. Credit, Inc.*, 956 F.2d 703, 705 (7th Cir. 1992).

¹³⁷ See Schmehl & Fox, *supra* note 60, at A-30 – A-31.

no such limitation; the third party is liable for 100% of the required payroll taxes (plus interest).

A third difference is that “liability under §3505(a) is absolute.”¹³⁸ Payment to employees without withholding and paying employment taxes to the government creates liability; nothing more need be shown. Unlike subsection (b), there is no requirement that third party have actual notice or knowledge that the employer will not or cannot pay the required withholding taxes.

Finally, payment need not be made during the employer’s payroll period or even while the employee still works for the employer.¹³⁹ The IRS construes section 3505(a) as imposing upon a surety, which pays a payment bond the wage claim of a worker, personal liability for withholding taxes associated with the payment, plus interest thereon from the due date of the employer’s return.¹⁴⁰ Compliance requires that the surety pay to the claimant only the net wages due on the claim and to pay the withholding taxes to the government. The IRS has fashioned Form 4219 (Statement of Liability of Lender, Surety, or Other Person for Withholding Taxes) which the surety must use for that purpose. By its terms, subsection (a) applies to wage payments to agents of the employee as well as to the employee himself. No doubt the IRS would regard payment to the claimant’s attorney as within the statute.

Section 3505(b)

Liability under section 3505(b) requires the surety or other third party to have supplied funds “for the specific purpose of paying wages of the employees of [the] employer.”¹⁴¹ Lenders often assert as a defense that the funds advanced constitute an ordinary working capital loan which is excepted from the purview of section 3505(b).¹⁴²

In *United States v. Intercontinental Industries, Inc.*,¹⁴³ for example, a holding company entered into an agreement with a builder of modular homes which was to be the first step in the builder eventually becoming a subsidiary of the holding company. The agreement called for the holding company to provide all of the operating funds which the builder could not obtain from other sources. On a weekly basis, the builder submitted to the holding company a request for operating funds required for designated purposes. The holding company then transferred the requested funds and received back from the builder daily expense reports verifying that the funds had been used for the requested purposes. A substantial portion of the funds provided by the holding company pursuant to that procedure were transferred into the builder’s payroll account. When the builder failed to pay payroll taxes for nine months and then went into bankruptcy, the IRS sued the holding company to recover the payroll taxes under

¹³⁸ *Id.* at A-30.

¹³⁹ *Id.*

¹⁴⁰ Treas. Reg. § 31.3505-1(i) (as amended in 1995).

¹⁴¹ I.R.C. §3505(a).

¹⁴² *United States v. Intercontinental Indus., Inc.*, 636 F.2d 1215, 1218-19 (6th Cir. 1980); *Fidelity Bank, N.A. v. United States*, 616 F.2d 1181, 1184 (10th Cir. 1980). For a general discussion of the ordinary working capital loan exception, see Schmehl & Fox, *supra* note 60, at A-33 – A-35; Makel & Chadwick, *supra* note 6, at 534-39.

¹⁴³ 635 F.2d 1215 (6th Cir. 1980).

section 3505(b). Although the holding company did not contest that it was aware of the builder's failure to pay withholding taxes, it argued that its advances were ordinary working capital loans which were not made for the specific purpose of paying the builder's wages. In rejecting the defense, the court said that the ordinary working capital loan exception "applies to the normal commercial setting where a business arranges an approved line of credit from a bank or other lender which could expect, in the ordinary course of business, that some of the funds supplied *might* be used for wages."¹⁴⁴ The court held that the holding company's arrangements with the builder were not within that definition because the holding company had received weekly and daily requests for funds, was told in great detail how the funds would be used, and exercised significant control over the funds including often specifying which bills the builder should or should not pay. Moreover, the court went on to hold that even if the loans were for ordinary working capital, the holding company would still be liable under section 3505(b) because it knew that the advanced funds were, in fact, being used to pay net wages as opposed to knowing that the funds might be so used:

Alternatively, even if we were convinced that the loans INI [the holding company] made were simply working capital loans, liability would attach under Treas. Reg. § 31.3505-1(b)(3), because INI had actual knowledge at the time the funds were advanced that a portion of the funds would be used for the specific purpose of paying net wages.¹⁴⁵

The knowledge required for showing that the third party advanced funds specifically for payroll purposes is to be distinguished from "the actual notice or knowledge"¹⁴⁶ that the employer would not or could not pay withholding taxes. That issue arose in *Fidelity Bank, N.A. v. United States*.¹⁴⁷ There, a bank had financed a construction company by, among other things, honoring overdrafts on the contractor's account. The contractor had assigned all of its contract receivables to the bank, so the bank had complete control over the contractor's finances. Among the overdraft checks approved by the bank were payroll checks which were identified as such. All payroll checks were, of course, for net wages; there were no checks for payroll taxes. The court held that the bank knew that some of the funds supplied through overdrafts were for the specific purposes of paying wages because the payroll checks were identified as such when they came to the bank officer who approved them. Moreover, the bank's control over all of the contractor's income through the assignment of receivables gave it the knowledge that the contractor was not paying withholding taxes. Because all creditors were paid from the contractor's account at the bank and because all of its sources of income

¹⁴⁴ *Id.* at 1218-19 (emphasis added).

¹⁴⁵ *Id.* at 1219. The court also held that it was not necessary for purposes establishing liability to prove that the lender knew in advance the exact amounts that were to be used for wages; all that need be shown is that the lender knew that some or all of the funds would be so used. *Id.* at 1220. In establishing the amount of liability, however the government had to prove the exact amount of the advanced funds which were used for net wages. *Id.* The court approved of the government's use of the last-in-first-out (LIFO) method of tracing the amount of funds used for net wages when the advanced funds had been commingled in an account with other funds. *Id.* at 1220-21.

¹⁴⁶ I.R.C. §3505(b) The statute specifies that notice or knowledge is as defined in I.R.C. §6323 (i)(1). Under that definition, actual notice or knowledge includes, effectively, constructive notice; that is, an organization is deemed to have that knowledge which it would have acquired through the exercise of due diligence. *Id.*

¹⁴⁷ 616 F.2d 1181 (1980).

were subject to the bank's control, "the bank had to know that without loans from it [through overdrafts] CDI [the contractor] would be unable to pay taxes due."¹⁴⁸ The IRS had also charged the bank with liability under section 6672. The court, however, affirmed a jury verdict for the bank because, although the evidence disclosed that the bank had the requisite control over the contractor's finances, it did not show that the bank made the decisions as to which of the contractor's creditors would be paid.¹⁴⁹

The latter holding illustrates the proposition that liability under section 6672 requires the third party to have more control over the employer's affairs and finances than need be shown under section 3505(b).¹⁵⁰ Nevertheless, the important point is that even under section 3505(b), which ostensibly rests liability on knowledge, control can become the key factor.

C. Collection and Enforcement Issues¹⁵¹

Neither subsection of section 3505 imposes a tax on a liable party. Both provide that such a party shall be liable "for a sum equal to the taxes"¹⁵² which should have been collected and paid. Thus, the statute simply creates a civil liability to the United States which the government may forcibly collect only by filing a civil suit.¹⁵³ Accordingly, the government may not resort to summary collection methods if a third party refuses a demand for payment under section 3505.¹⁵⁴ Instead, like any other plaintiff, the government must first prevail in a civil action; and if it does, it may then employ the remedies available to a judgment creditor.

By its terms, section 3505(b) limits the third party's liability to 25% of that portion of supplied funds which were provided for the purpose of funding payroll. Section 3505(b) imposes liability not only for payroll taxes but also for interest from when taxes should have been paid, and the government has argued that the 25% limitation applies only to the taxes owed and does not include interest even if the resulting total liability exceeds 25%.¹⁵⁵ The courts have rejected that position, holding that liability for taxes and interest together may not exceed the 25% limitation.¹⁵⁶

Courts have not been so kind to third parties who have been found liable both as responsible persons under section 6672 and net payroll lenders under section 3505(b). That was the position in which the third party lender found itself in *United States v. Security Pacific Business Credit, Inc.*¹⁵⁷ The IRS assessed the lender the full amount of the unpaid payroll taxes under the 100% penalty of section 6672 and sought interest on that amount up to 25% of the amount provided for payroll funding under 3505(b). When the lender complained that such a cumulation of remedies was just too much, the Seventh Circuit held for the government,

¹⁴⁸ *Id.* 1184.

¹⁴⁹ *Id.* at 1185-86.

¹⁵⁰ *Cf. United States v. Security Pacific Bus. Credit, Inc.*, 956 F.2d 703, 706 (7th Cir. 1992) ("[A]ny lender who so far controls his borrower's disbursements as to be adjudged a responsible person will almost certainly violate the net-payroll lender statute as well.").

¹⁵¹ For a detailed discussion of collection and procedural issues, see Schmehl & Fox, *supra* note 60, at A-38 – A-39.

¹⁵² §§3505(a) and (b).

¹⁵³ *Jersey Shore State Bank v. United States*, 479 U.S. 442, 447 (1987). Unlike I.R.C. 6672, there is no provision which makes §3505 liability assessable and collectible as a tax. See discussion *supra* Part IIIC.

¹⁵⁴ *Jersey Shore State Bank*, 479 U.S. at 447.

¹⁵⁵ See, e.g., *United States v. Intercontinental Indus., Inc.*, 635 F.2d 1215, 1221 (6th Cir. 1980).

¹⁵⁶ *Id.* at 1222. Accord *United States v. Hannan Co.*, 639 F.2d 284,285-86 (5th Cir. 1981).

¹⁵⁷ 956 F.2d 703 (7th Cir. 1992).

concluding that there was no reason to believe that Congress intended the 25% limit on a net payroll lender's liability to benefit a responsible person who had the control over the employer's finances to qualify as a responsible person under section 6672.¹⁵⁸

V. MILLER ACT PERFORMANCE BOND LIABILITY

Section 270a(d) of the Miller Act¹⁵⁹ provides that bonds required under that statute "shall specifically provide coverage for taxes imposed by the United States which are collected, deducted or withheld from wages paid by the contractor in carrying out the contract with respect to which the bond is furnished."¹⁶⁰ That provision also requires the government to give the surety written notice "with respect to any such unpaid taxes attributable to any period"¹⁶¹ within 90 days after the principal filed its tax return for that period, but that the government may not give such notice more than 180 days after the principal should have filed the return.¹⁶² The government may not bring suit on the Miller Act performance bond unless the required notice has been given, and it may not commence such a suit more than one year after giving notice.¹⁶³

It appears that, by its language, the statute imposes liability only for payroll taxes which the principal withheld from its employee's wages but not for the principal's share of FICA. It has been held, however:

that the Miller Act requires a surety to bear the burden of compensating the government for the interest and penalties incurred on unpaid taxes when, as here, that amount is liquidated and the applicable state law allows for such recovery.¹⁶⁴

Finally, only substantial compliance with the notice requirement is necessary. So long as notice is timely, failure to state accurately the precise amount of taxes owed or to detail each bond issued on behalf of the principal or the amount owed on each will not defeat the notice.¹⁶⁵

¹⁵⁸ *Id.* at 706-07.

¹⁵⁹ 40 U.S.C.A. §§270a-270f (West 1986 & Supp. 1999).

¹⁶⁰ 40 U.S.C.A. §270a(d). It should be noted that there is a line of authority permitting government taxing authorities to recover against sureties as "third-party beneficiaries" of performance bonds, where the bonded contract expressly includes a commitment to pay taxes, and where the bond does not expressly limit the right to bring a claim to the obligee or to a defined class of claimants. *United States v. Phoenix Indemnity Company*, 231 F.2d 573 (4th Cir. 1956); *United States v. Capitol Indemnity Corporation*, 1977 WL 1093, 39 A.F.T.R.2d (RIA) 77-1029, 77-1 U.S. Tax Cas. (CCH) ¶ 9268 (E.D.III. 1977).

¹⁶¹ *Id.*

¹⁶² *Id.*

¹⁶³ *Id.*

¹⁶⁴ *United States v. American Mfrs. Mut. Cas. Co.*, 901 F.2d 370, 373 (4th Cir. 1990).

¹⁶⁵ *Id.* at 374. *Accord United States v. Fidelity & Deposit Co. of Maryland*, 690 F.Supp. 905 (D. Haw. 1988).

VI. SUMMARY AND COMPARISONS.

As has been recognized, financing will inevitably lead to some level of control by the surety over the principal and its financial affairs.¹⁶⁶ A surety is not likely to loan funds to a financially distressed principal with no strings attached. It has also been concluded that liability to the surety for the principal's employment tax liability is likely unavoidable.¹⁶⁷ The conclusion as to liability follows from the recognized fact of control and should surprise no one. Even though the financing surety funds the work through the principal, the surety has undertaken the burden of completing the project. Functionally, it is the surety's crew out there at the site. For purposes of project finances at the very least (and often for wider purposes), the surety has supplanted the principal. The surety should no more expect to be permitted to use funds, which by statute belong to the government and constitute trust funds, "in discharging its obligations to complete performance of the contract"¹⁶⁸ than should the direct employer. Acknowledging this reality, sureties have been advised that financing documentation should provide mechanisms which assure that the principal's payroll taxes will be paid.¹⁶⁹

There are differing degrees of liability under the various statutes. Section 3505(b) has the 25% limitation, and the surety would obviously benefit if its liability could be confined to that section. One way of attempting to accomplish that might be by employing a technique which has been called "Back Door Financing."¹⁷⁰ Instead of directly funding the principal by advancing funds into a joint control account, for example, the surety could pay amounts owed to the principal's subcontractors and suppliers, leaving the principal with the responsibility of paying its employees. Amounts owed to subcontractors and suppliers are likely to end up as payment bond liabilities anyway, and the surety would not be supplying funds for the principal's payroll under section 3505(b) or directly paying the principal's employees under section 3505(a). In order for the surety to avoid section 6672 liability, however, the principal would have to have access to, and control over, funds sufficient to meet its payroll and withholding tax obligations. Unless the principal has access to outside funding, that would require allowing the principal to retain control over a substantial amount of the progress payments.

Such an arrangement demonstrates the basic trade off between payroll tax liability and control. More control is required to be held liable under section 6672 than under section 3505(b), and liability under the latter statute carries the benefit of the 25% limitation. It is not necessarily true, however, that more control is required to be deemed an employer than a responsible person. The nature of the control which makes a third party a responsible person – the authority to decide which of the employer's creditors should or should not get paid and when – has also been relied upon to hold the third party liable as an employer.¹⁷¹ Liability as an employer is a far harsher result than liability under either section 6672 or 3505. A third party which deemed to be an employer is liable for the employer's share of FICA taxes and for penalties for the employer's failure to file or deposit payroll taxes. So, control carries with it not only the risk of liability under section 6672 but the possibility of being held liable as the employer itself.

¹⁶⁶ See Bachrach, *supra* note 2, at 162-63.

¹⁶⁷ Joyce & Haug, *supra* note 5, at 26.

¹⁶⁸ *Pacific Nat'l Ins. Co. v. United States*, 422 F.2d 26, 31 (9th Cir. 1970).

¹⁶⁹ Bachrach, *supra* note 2, at 153 and Ex. 4.1 (presenting suggested provisions for that purpose).

¹⁷⁰ *Id.* at 131.

¹⁷¹ See discussion *supra* Part II.

CONCLUSION

In the end, the only way for a financing surety to avoid unpleasant encounters with the IRS is to recognize the virtual inevitability of payroll tax liability and pay the two dollars. That liability is simply one more factor to be considered in deciding whether or not to finance the principal. Indeed, it has been argued that potential payroll tax liability should be regarded “a neutral factor,” since the surety would probably pay the cost of those taxes indirectly as they will likely be included in the price of a relet contractor.¹⁷²

¹⁷² Joyce & Haug, *supra* note 5, at 26.