Paying the Taxman[1] in Trust Fund Cases:

Bankruptcy and Non-Bankruptcy Alternatives

Morris N. Robinson, CPA, Esq., LLM

Businesses are required to withhold income and Social Security taxes. Businesses are also required to collect sales, meals and use taxes from their customers. These taxes are sometimes called "trust fund taxes," since the business holds these funds in trust for the government. Unpaid trust fund taxes remain the financial responsibility of the business and become the financial responsibility of business managers who are sometimes called "responsible parties."

Eventually, the taxman demands payment of unpaid trust fund taxes. Bankruptcy may be the only viable option where a business also owes many trade creditors. But, if the business does not owe trade creditors — or owes only a few major trade creditors — non-bankruptcy alternatives may produce a better financial result.

Compromising Trust Fund Taxes

Trust fund taxes can never be discharged in bankruptcy. Trust fund taxes, however, may be compromised with an offer in compromise ("offer") if the business is not currently involved in a bankruptcy proceeding. As a matter of policy, the IRS and the Massachusetts Department of Revenue will only compromise the *amount* of trust fund taxes if the business has died and the jobs it once supported are lost irretrievably. This shortsighted policy encourages the demise of troubled businesses and the jobs they support.

Securing "Breathing Room"

Financially troubled businesses typically need time to develop a successful business model and to obtain additional capital. The filing of a non-frivolous offer can provide this "breathing room." The filed offer suspends trust fund collection efforts, which can extend for two years or more as the offer makes its tortuous way towards resolution. All that is necessary is that the business remains current on its post-offer tax filings and tax payments. Bankruptcy generally does not produce as much "breathing room."

Achieving Workouts with Unsecured Trade Creditors

Troubled businesses typically seek to reduce the amount of their business debt and to extend the time to pay it. They also seek to renegotiate or to cancel unprofitable executory contracts such as leases. If the business does not choose bankruptcy, it must achieve a voluntary workout agreement with each of its major trade creditors. As the number of major trade creditors increases, voluntary workouts become increasingly difficult to negotiate. Thus, in many cases, a bankruptcy filing may be the only practical alternative since a confirmed bankruptcy plan binds all intransigent creditors.

Excluding Discharge of Indebtedness Income

Internal Revenue Code Section 108 excludes income arising from the discharge of indebtedness in bankruptcy. Section 108 similarly excludes income arising from the reduction of indebtedness in a workout transaction. In workouts, the amount of excluded income is limited to the excess of the taxpayer's liabilities over the fair market value of the taxpayer's assets. Both are measured just before the workout transaction.

Extending the Time to Pay Trust Fund Taxes

In an offer in compromise, the business may offer to make monthly tax payments over the remaining period of the 10-year statute of limitations on tax collections. Under IRS formulae, however, a debtor's overall tax payments are often minimized if payment is completed within 60 months or less. Moreover, IRS personnel evaluating the offer may push for even shorter payout periods. In bankruptcy filings under Chapters 11 and 13, the debtor must complete payment of unpaid trust fund taxes in no more than five years from the date of the bankruptcy filing.

Pre-Petition Interest on Trust Fund Taxes

Accrued interest on trust fund taxes is often a significant percentage of the total amount owed by the business to the taxing authorities. In an offer in compromise, interest accrues on trust fund taxes until IRS accepts the offer. Thus, when negotiating an offer, a debtor must affirmatively request the partial or complete abatement of interest based on "doubt as to collectability." Where doubt as to collectability exists, the IRS will compromise or completely excuse the accrued interest on trust fund taxes.

However, in bankruptcy filings under Chapters 11 and 13, pre-petition interest cannot be discharged and is treated as a part of the underlying tax claim. Thus, the business must pay pre-petition interest on unsecured trust fund claims over five years from the date of the bankruptcy filing (pre-petition interest represents interest accrued up to the date of the bankruptcy filing on trust fund taxes).

> “Trust fund taxes can never be discharged in bankruptcy.”
>
> ~Adam J. Ruttenberg, Boston Bankruptcy Attorney

In contrast to businesses, responsible party managers are never responsible for interest owed by businesses to the U.S. Treasury on trust fund taxes. They are, however, responsible for interest that accrues on their personal obligation to pay trust fund taxes after the IRS designates them as responsible parties and demands payment from them. Responsible parties are also responsible for interest owed by their businesses to the Commonwealth of Massachusetts on trust fund taxes.

Post-Petition Interest on Trust Fund Taxes

After an offer in compromise is accepted, additional interest will not accrue unless the taxpayer defaults. After a bankruptcy filing, the debtor’s continuing obligation to pay interest on unsecured trust fund claims — so-called post-petition interest — depends on the type of filing.

- **(a) In a Chapter 13 filing,** a debtor is not required to pay post-petition interest on unsecured trust fund claims.
- **(b) In a Chapter 11 filing,** however, a debtor must pay post-petition interest on unsecured trust fund claims.

Tax Penalties on Trust Fund Taxes

Penalties on trust fund taxes and accrued interest thereon may be a significant percentage of the total amount due the taxing authorities. In bankruptcy, unsecured penalties for failure to timely file, failure to timely pay, and failure to timely deposit are treated as general unsecured obligations of the debtor and may be discharged in bankruptcy. Under an offer in compromise, however, these unsecured penalties are not automatically excused. Therefore, when negotiating an offer in compromise, the debtor’s representative should ask that penalties be excused to facilitate the recovery of the business and to protect the jobs the business supports. Where doubt as to collectability exists, the IRS will compromise or completely excuse the penalties assessed on trust fund taxes.

Responsible party managers are responsible for penalties owed by their businesses to the Commonwealth of Massachusetts on trust fund taxes.

Negotiating Offers in Compromise

Negotiating offers in compromise is not easy. Sometimes IRS personnel will reject offers out-of-hand for trivial technical reasons. It also is not unusual for IRS personnel to claim to “lose or misfile” an offer in compromise. Meanwhile, we have to devote more time than we would like to making sure that the IRS does not levy on our clients’ assets while a “lost or misfiled” offer is found or an erroneously rejected offer is reinstated.

We have two important tools to assist us in achieving offers in compromise:

1. *Taxpayer Advocate Service***.** The U.S. Taxpayer Advocate Service (TAS) for Massachusetts is an independent organization within the IRS that assists taxpayers who have not been able to resolve disputes with the IRS through normal channels or who believe that the IRS procedures are not working properly. Under the direction of **Betsy J. Fallacaro**, the Taxpayer Advocate for Boston, TAS personnel are well-trained, responsive and highly effective at serving taxpayers. They defuse emergencies that threaten the existence of a business, such as an unexpected seizure of cash that prevents a business from paying its employees. They also help make a dysfunctional IRS “work” by

cont. on page 8

requiring the IRS Appeals Office to hear cases within a reasonable amount of time.

In highly exceptional cases, a business can obtain a Taxpayer Assistance Order (TAO) from the TAS, enjoining the IRS from levying on the assets of a business. The business must demonstrate that a levy will cause irreparable harm to the reputation and ongoing operations of the business. Several years ago, for example, our office won a TAO requiring the IRS to release an attempted levy of a travel agency's customer deposits. We proved irreparable harm to the reputation of the travel agency if the customer deposits were seized, and the customers were not able to take the trips and vacations they had paid for.

2 *Collection Due Process Appeals.* The business may appeal for cause a Notice of Intent to File a Federal Tax Lien or a Notice of Intent to Levy. Normally, collection action is suspended while either of these appeals is pending. The business can also appeal the denial of an offer in compromise. Again, collection action is suspended while the appeal is pending. In our experience, the hearing officers are tough, aggressive, experienced and practical. We obtain reasonable results at these hearings by understanding our client's financial situation in detail, by presenting their financial situation forcefully, and by standing our ground.

Delinquent Tax Returns

Troubled businesses are often delinquent on their income, payroll and sales tax filings. The IRS will reject an offer in compromise if the business has unfiled payroll or income taxes. Bankruptcy has similar rules.

(a) **In a Chapter 13 filing,** all tax returns for the four most recent tax years must be filed at or shortly after the bankruptcy filing.

(b) **In a Chapter 11 filing,** the failure to file tax returns typically leads to estimated tax liabilities that are substantially higher than the actual tax due.

Therefore, troubled businesses and their owners must begin the process of financial rehabilitation by preparing and filing all delinquent income, payroll and sales tax returns. Then, sometimes for the first time, business managers will understand the full extent of their business' trust fund liabilities and of their own personal responsibility. This is often the beginning of the turnaround.

Protecting Responsible Parties

The liability of a responsible party to pay trust fund taxes is derivative — the manager owes the tax only if the business owes the tax. Therefore, managers have avoided trust fund taxes successfully by having the business pay in the trust funds just before the bankruptcy filing. The courts have allowed this preference over the objections of creditors. The courts reason that the trust fund taxes represent a priority claim that must be paid before any amounts can be distributed to the unsecured creditors. Thus, reason the courts, unsecured creditors are not harmed.

In addition, not all payroll taxes owed by the business to the U.S. Treasury are trust fund taxes. Therefore, businesses will attempt to earmark payments against the trust fund portion of the various payroll taxes the business owes. Understandably, tax collection officers resist these attempts to earmark payments in the strongest terms.

Optimizing Client Options

In trust fund cases, non-bankruptcy solutions often produce excellent results while avoiding the stigma and expense of bankruptcy. Thus, a financially troubled business and its CPAs should consult with a tax collection expert and a bankruptcy expert before deciding upon a course of action. Ideally, both experts should be present at the strategy session. The combined insights of these experts will help your financially troubled client optimize its options.

[1] The term "taxman" is part of the idiom. I mean no disrespect to the many capable women who serve our taxing authorities as commissioners of revenue and in other capacities.

Morris N. Robinson, CPA, Esq., LLM, is managing shareholder of M. Robinson & Company PC, a law firm specializing in resolving the business and tax problems of businesses and individuals. Attorney Robinson gratefully acknowledges the assistance of **Betsy J. Fallacaro**, the IRS Taxpayer Advocate for Boston and of Boston Bankruptcy Attorney **Adam J. Ruttenberg** of Looney & Grossman LLP.