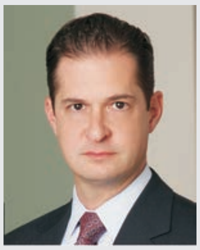
Jurisdictional Uncertainty in Trust Fund Recovery Penalty Cases

By Charles M. Ruchelman and Travis A. Greaves



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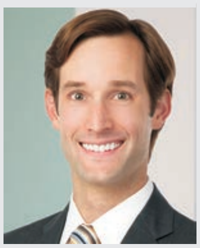

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This article summarizes the factual background and examines the legal analysis of a recent U.S. Court of Federal Claims opinion on the trust fund recovery penalty.

The taxpayer in *Kaplan v. United States* initiated an action in the U.S. Court of Federal Claims for a refund of three $100 payments made toward $86,902.76 in trust fund recovery penalties. The government argued, and the court agreed, that the taxpayer failed to satisfy the ''full payment rule,'' as modified by the divisible tax exception, by not providing sufficient proof that the three $100 payments accurately equaled the divisible amount for each of three quarters. The court dismissed the taxpayer's challenge for lack of subject matter jurisdiction under section 6672.[1]

The court's dismissal under that rationale should be of concern to tax practitioners. It may create unexpected challenges for taxpayers who contest the trust fund recovery penalty and could ultimately create judicial and litigant inefficiencies by requiring a taxpayer to restart the administrative refund process with the IRS, only to end up back before the same court.

Full Payment Rule

A fundamental principle of refund litigation is that the taxpayer must pay the full amount of taxes and penalties owed before bringing suit against the government. That principle is known commonly as the full payment rule.[2] When that rule has been satisfied, the government waives its sovereign immunity and allows taxpayers to bring suit in either the appropriate U.S. district court or the U.S. Court of Federal Claims.[3] If a taxpayer fails to allege full payment of tax in the complaint, the court may dismiss the case for lack of subject matter jurisdiction.[4] Courts have recognized a limited exception to the full payment rule in refund cases involving trust fund recovery penalty assessments under section 6672.[5]

The trust fund recovery penalty may be assessed when the IRS determines that an employer failed to pay its employees' employment taxes. To collect the unpaid ''trust fund'' portion of the withheld employment taxes, the IRS may assert a penalty equal to 100 percent of each employee's unpaid employment taxes against a ''responsible person'' who willfully failed to pay the employment taxes to the IRS.[6] The Tax Court lacks jurisdiction to hear trust fund recovery penalty cases; thus, to dispute the amount owed through the courts, the taxpayer must pay the taxes and file a refund suit.[7]

Often the trust fund recovery penalty is a very large sum, and the charged responsible person does not have the funds to pay the full amount to contest the determination. To alleviate that burden, courts have held that a taxpayer can satisfy the full payment rule by paying a divisible amount of the penalty attributable to a single employee's withheld taxes for one quarter.[8] For example, if an employer

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[1]113 Fed. Cl. 84 (2013) (motion for reconsideration pending).

[2]*Flora v. United States*, 362 U.S. 145 (1960) (interpreting 28 U.S.C. section 1346(a)(1)); *Tonasket v. United States*, 218 Ct. Cl. 709 (1978).

[3]28 U.S.C. section 1346(a)(1); 28 U.S.C. section 1491(a)(1).

[4]*See, e.g.*, *Douglas v. United States*, No. CIV-1-80-214, 1981 WL 1734 (E.D. Tenn. Jan. 19, 1981).

[5]*Steele v. United States*, 280 F.2d 89 (8th Cir. 1960); *Roseman v. United States*, No. 09-539T, 2013 WL 151716 (Fed. Cl. Jan. 3, 2013).

[6]Section 6672(a).

[7]*Medeiros v. Commissioner*, 77 T.C. 1255 (1981).

[8]*See Boynton v. United States*, 566 F.2d 50 (9th Cir. 1977) (the section 6672 assessment is a ''cumulation of separable assessments for each employee from whom taxes were withheld'');

(Footnote continued on next page.)

failed to pay $100,000 in employment taxes withheld equally among 100 employees in one employment quarter, the assessed person need only pay $1,000 to challenge the penalty. The government may then file a counterclaim for the remaining unpaid tax.

The IRS notice asserting the trust fund recovery penalty, however, ordinarily does not itemize the penalty attributable to each employee for each quarter, instead stating a cumulative amount. Still, in almost all trust fund recovery penalty cases, taxpayers invoke the jurisdiction of the courts by paying the divisible amount rather than the entire alleged liability. To do so, the taxpayer must usually estimate the divisible amount. Nonetheless, in practice, there have been few problems with that disconnect between the information the IRS provides and the information the taxpayer needs to make a divisible payment.

Summary of *Kaplan*

The jurisdictional issue in *Kaplan* was whether the taxpayer paid a divisible portion of the trust fund recovery penalty. Jonathan Kaplan owned an interest in Merchants Restaurants-SA LLC (Merchants), which operated a restaurant in San Antonio. He formed Merchants with his stepson and close friend in 2007. In December 2010 the IRS assessed trust fund recovery penalties against Kaplan for the first, second, and third quarters of 2008. The total assessed penalties equaled $86,902.76.

Kaplan contended that he was merely a passive investor in Merchants and therefore not a responsible person. He claimed he had little access to the employment tax records and estimated the quarterly tax payment due for one employee. He determined that $100 was proper, given the low wages and part-time work of the restaurant industry. Kaplan made payments of $100 for each of the three applicable quarters and submitted a claim for refund of the amounts paid. Shortly thereafter, the IRS mailed a determination letter to Kaplan denying his three refund claims.

In July 2011 Kaplan timely filed a refund suit in the U.S. Court of Federal Claims. In August 2013, following pretrial discovery, the government filed a motion to dismiss for lack of subject matter jurisdiction. The government contended that Kaplan failed to demonstrate that his payment of $100 per quarter satisfied the required jurisdictional divisible payment.

Ransier v. United States, No. 2:12-cv-00538-EJL (D. Idaho Aug. 12, 2013) (''a taxpayer need only pay the withholding tax of one employee for one quarter'').

Kaplan responded that he had support for the $100 computation. He obtained and produced payroll records for one week from the third quarter of 2008, showing that four of the 30 employees had withholding tax of less than $7.69 per week. Kaplan asserted that the evidence supported his estimate of $100, because multiplying $7.69 by the 13 weeks per quarter equals $99.97 per quarter. Further, Kaplan contended that the *Cohan* rule allowed the court to estimate the employees' withholding taxes.[9]

The court vacated the trial date just a few weeks before trial and dismissed the case for lack of subject matter jurisdiction. In its opinion, the court stated that Kaplan had the burden to establish subject matter jurisdiction and had failed to substantiate that at least one employee had withholding taxes of $100 for each quarter at issue. The court concluded that it would be unreasonable to extrapolate an entire quarter's worth of information from just one week's payroll report. The court also held that the *Cohan* rule was not applicable, as it applies to disputes regarding business deductions, not employment taxes.

Analysis

The holding in *Kaplan* is unsettling for tax practitioners because it represents a departure from the normal evidentiary proof necessary to establish the jurisdictional amount for a trust fund recovery penalty case. When considering motions to dismiss for lack of subject matter jurisdiction, the court can weigh the evidence before it and make factual determinations.[10] And ''if a material fact concerning jurisdiction is disputed, a plenary hearing may be necessary to resolve the contested issue.''[11] The *Kaplan* decision appears to alter the common practice of establishing the divisible payment computation with reasonable certainty. Indeed, the Internal Revenue Manual states that ''if the amount required cannot be accurately determined, the Service may accept a representative amount.''[12] Kaplan asserted in his complaint that he paid one employee's employment tax for each quarter with his claim for refund, and his calculation proved reasonable based on the available evidence.

Many taxpayers, especially those who are in fact not responsible persons, do not have access to the

[9]*Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930) (court permitted the taxpayer to deduct certain business expenses, even though the taxpayer failed to produce receipts supporting the claim).

[10]*See Arbaugh v. Y & H Corp.*, 546 U.S. 500, 514 (2006).

[11]Steven Baicker-McKee, William M. Janssen, and John B. Corr, *Federal Rules Civil Handbook 2013*, 427, West Publishing (2013).

[12]IRM section 8.25.1.7.4.2. (Dec. 7, 2012).

payroll information containing each employee's quarterly withholding. That material is in the hands of the third-party corporation, which may or may not still be in existence when the refund claim is submitted to the IRS or the case is filed in court. As a result, taxpayers may have to estimate the divisible portion for purposes of filing the claim for refund.

Under the *Kaplan* holding, however, it now appears that the taxpayer must prove with a level of exactitude that the payment meets or exceeds the divisible amount. That heightened burden of proof may prevent a subset of taxpayers who are the most deserving of judicial review from having their day in court — those who have nothing to do with the underpaid taxes, can't afford to pay the entire penalty asserted, and don't have access to the data needed to compute the divisible portion. Further, the court's rationale could lead to illogical results. Even if Kaplan had paid $10,000 per quarter as his divisible portion, an amount clearly exceeding withholding for one employee, without the payroll records, he still would not be able to prove that $10,000 equaled the necessary jurisdictional deposit.

The IRS generally receives employee quarterly withholding tax information during its audit of the employer and may use the information to calculate the penalty. The Department of Justice should have access to that information in preparing for trial. Courts have found it best not only for the parties but also for preserving judicial resources to deny motions to dismiss for lack of subject matter jurisdiction without further fact-finding. Instead, the court will allow the taxpayer an opportunity to review the payroll tax information and identify the exact jurisdictional amount, or to pay additional sums to an amount that all parties and the court comfortably and reasonably believe satisfies or exceeds the required amount.[13]

That judicial practice applies beyond trust fund recovery penalty cases. Section 6226(e)(1) allows courts to find the jurisdictional deposit requirement for readjustment of partnership items is satisfied "where there has been a good faith attempt to satisfy such requirements and any shortfall in the amount required to be deposited is timely corrected." Therefore, courts allow the taxpayer to increase the size of the deposit while still in court to satisfy the jurisdictional prerequisite.[14] The approach does not harm the government and avoids having to restart what can be a multiyear process.

Under the *Kaplan* holding, the government has little incentive to share information (for example, payroll records, employer tax returns, employee Forms W-2) that might allow the taxpayer to make an accurate determination of the necessary payment amount. However, if the government challenges the amount paid and files a motion to dismiss, the taxpayer has the burden of proof. As a result, the taxpayer will be left with few options.

If the government provides the taxpayer with Form 941, the taxpayer may divide the total amount withheld by the number of employees. The average figure would necessarily equal or exceed at least one employee's withholding tax for the quarter. Alternatively, if the government does not have documentation, the taxpayer may have an employee sign a declaration stating the amount of taxes withheld for the quarter, or obtain employment tax records (such as pay stubs or Forms W-2) from an employee. However, the *Kaplan* decision does not state what information would prove one employee's withholding tax. Consequently, taxpayers may be effectively barred from litigating a claim for refund.

To conserve the resources of the judiciary, the IRS, and the parties, the Justice Department should look to IRS policy in dealing with similar cases. The divisible tax exception is not a statutory rule; rather, it was born out of case law. If the Justice Department had followed the IRS rule of accepting a representative amount when the exact amount cannot be accurately determined, Kaplan's claim would have not been dismissed and he would have had his day in court. Now, however, he may have to pay $86,902.76 in trust fund recovery penalties even though he may not be a responsible person. If he is unable to pay the full amount, he'll be deprived of a proper determination on the merits regarding the appropriateness of the penalty. To rectify that potential inequity, a change in Justice Department litigation policy, consistent with the IRS's representative amount as articulated in the IRM, is appropriate.

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[13]*See, e.g.*, *Wright v. United States*, No. PGW-12-2855, 2013 WL 3776922 (D. Md. July 17, 2013); *Gutherie v. United States*, 359 F. Supp.2d 693, 697 (E.D. Tenn. 2005); *Turk v. United States*, No. S92-307M, 1993 WL 402902 (N.D. Ind. Apr. 23, 1993).

[14]*See, e.g.*, *Gail Vento LLC v. United States*, Nos. 3:09-cv-00003, 3:09-cv-00004, 3:09-cv-00005 (D.V.I. Nov. 8, 2011); *Kislev Partners LP ex rel. Bahar v. United States*, No. 1:07-cv-00625 (2008); *Maarten Investerings P'ship v. United States*, No. 98 Civ. 3839, 2000 WL 174962 (S.D.N.Y. Feb. 15, 2000).