Trust Fund Taxes: "Borrowing" from the Government? Or "Theft" of Government Funds?

By Shelby L. Ranier and Terry W. Vincent

When a lien came due on one of its facilities, XYZ Company found itself short of funds. The executive team decided to dip into its taxes trust fund. After all, that money wasn't due for payment for another six months: they had plenty of time to recoup the funds in time to pay the government, right?

In theory, yes. Trust fund taxes are taxes collected and paid by a third party — for example, money withheld from employees by employers to pay state and federal employment taxes or sales taxes collected by retailers.

Employers and retailers, in these instances, are acting as trustees. When a company fails to remit those taxes, not only is the company at risk for penalties, the person (or persons) at the company responsible for making the payments is subject to personal liability because the trustee concept creates liability beyond a partnership or other business arrangement.

Why might a business fail to remit taxes it has already collected?

A business will usually fail to remit trust fund taxes because they've spent the money on another debt. It withholds the necessary tax amounts but 'borrows' from those withholdings to pay, say, outstanding vendor invoices or other operational expenses, and it snowballs from there.

Failure to remit taxes can happen because a business lacks internal controls, but sometimes it's a result of simple, and often innocent, disorganization.

What are the consequences for failure to remit taxes?

Identifying businesses that have neglected to pay taxes has become much easier, largely because of technology, so state and federal governments can quickly identify who hasn't paid. If the business is evasive, an investigation will be launched to see if the failure is criminal.

Depending on the amounts and the reasons for nonpayment, there could be criminal penalties and even jail time for the offender — any person directly responsible for making the tax payment. There is a test to determine who that person would be. Typically, if the company representative is authorized to pay — is someone approved to sign checks on behalf of a business — that person could be held personally liable when there's not remittance.

State penalties for nonpayment differ from federal penalties. Failure to pay federal taxes could result in up to five years in prison. However, federal criminal penalties are typically imposed when something else is done in addition to not paying the taxes — falsifying a statement, for example.

States are quicker to pull the trigger, and their penalties are as high as six months in jail and restitution. Some states are more inclined to pursue these crimes than others.

However, the tax-paying company can enter into a payment plan to pay off unpaid taxes. Some states have voluntary disclosure programs that can garner the offending company either reduced penalties and interest or give a shorter look-back period. But if the state sends the company a notice regarding failure to pay, then the company can no longer participate in voluntary disclosure programs.

Who should a business owner turn to if they are challenged by the government for failing to properly remit taxes it has collected?

It's best to consult with an attorney who has experience dealing with tax authorities. While an accountant or financial adviser can start with a review of the books and records to find where the missteps occurred and how much tax should have been reported, there is no such thing as accountant-client privilege, in the criminal context. That's why it's best to engage a lawyer first and ask the lawyer to hire the accountant. Called a Kovel arrangement, this extends the attorney-client privilege to cover the relationship with the accountant, who, in this relationship, works for the attorney.

States, on the whole, are getting more aggressive in their pursuit of these taxes — Ohio among them. Pursuit of these failures to remit due taxes is expected to increase as much as 10-fold, a trend that's already starting to show.

Businesses that are struggling may see trust fund taxes as a quick fix to catch up in other areas. But it tends to snowball quickly, get out of hand, and lead to often devastating consequences.

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