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Taxes, business and responsible person liability: Are you covered?

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Federal, state and local governments have historically used a collection tool known as Responsible Person Liability (RPL") to recover unremitted taxes and trust fund obligations that a business fails to pay due to insolvency, sale, liquidation, or any number of other reasons.

Under RPL law (see e.g. 26 U.S. Code § 6672) the IRS may pursue an individual's personal assets to satisfy a business's tax liability if that individual qualifies as a "responsible person." However, many individuals to whom such liability could attach are completely unaware that they could find themselves on the hook for a hefty sum of money.

Consider this realistic responsible person scenario, a composite of real-life cases illustrating the grim financial consequences of a company's non-compliance upon its owners and employees:

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Alan was a vice president of tax at NFT Bank, a commercial bank focused on private clients, particularly those in the cryptocurrency and related industries. As part of his duties, Alan was responsible for the preparation of the bank's tax returns and remittance of various taxes, including sales and use taxes and employee withholding. In March 2023, the bank became insolvent and was placed in receivership, and its assets transferred to other banks and private equity firms.

Depositors were made whole; however, equity owners and bondholders lost everything. Alan was temporarily out of a job, which, unfortunately, was the beginning of his troubles.

Subsequent to the business being placed in receivership, several states audited and assessed sales tax against the bank in the amount of several million dollars, which could not be wholly satisfied by the bank's remaining assets. As a result, the several states pursued legal action against Alan in an amount greater than his net worth, for which he needed to retain legal counsel, and which he continues to contest today.

Usually if a company loses money fast enough or for long enough, it goes bankrupt and employees are generally not liable for a company's debt, absent some malfeasance. Few outside the tax community realize that employees can be held *personally liable* for what are called "trust fund taxes." These obligations may not be dischargeable in bankruptcy and employees, including the CEO, CFO, vice president of tax, and various other employees involved in the preparation of tax returns and remittance of tax payments can be held personally liable for some or all of these taxes.

Technical elements of trust fund taxes

The story above is a fictional, but realistic account of the possible tax consequences that a very large number of owners, officers, legal, accounting and other professionals associated with organizations face on a daily basis. These consequences are associated with a variety of taxes and often arise without regard to willful, knowing, reckless or negligent conduct. Even worse, errors and omissions insurance may not (and in many instances, will not) indemnify individuals subject to responsible personal liability, which can reach into the millions of dollars.

At the federal level, employee wage, Social Security and Medicare withholdings are the primary trust fund taxes, because a company acts as a withholding and remittance agent for the government.

States vary widely on what taxes are considered trust fund taxes and who qualifies as a "responsible person" (*i.e.*, personally liable for the tax); however, state taxes on alcohol, cigarettes, delivery, employment, event admission, gross receipts, marijuana, motor fuel, room occupancy, sales and use, and vehicle rentals are commonly subject to RPL.

In addition to taxes, a large number of trust fund obligations are subject to RPL, including unclaimed property escheatment,

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environment fund assessments and consumer protection assessments.

In certain states, such as Washington, all taxes collected by a partnership, even those not collected and remitted on behalf of others, are subject to RPL. This means that there is personal liability, for example, for the Business and Occupation Tax even though it is not held in trust for the state.

Errors and omissions insurance may not (and in many instances, will not) indemnify individuals subject to responsible personal liability, which can reach into the millions of dollars.

Although state statutes vary, generally any officer, director, return signer, partner in a partnership, LLC member, payer, or anyone with a similar role can be determined to be an RP. Analysis of the person's authority, duty to act, ability to hire and fire, day-to-day role in the business, and ownership of significant equity in the business are among the further important considerations in determining RP status.

There may be an opportunity for the purported RP to demonstrate that, while identified as an officer, the person actually had little or no connection with the business during the time period in which the liabilities arose, in which case the person might be able to avoid liability.

The standard of knowledge that the RP must have in order to be liable for the tax varies by state. In some states and for federal purposes, the standard is "willfulness" or "gross negligence," while for others, any failure of the company to pay over the tax may subject the person to liability. For example, for sales tax, New Jersey only requires that a person required to collect the tax by law fails to do so, regardless of whether or not there is willfulness.

Mitigating risk

It is both possible and advisable for companies to work with their advisors to minimize their RP risks. One simple strategy is to limit the number of officers and directors, return signers, check payers and similar persons to the bare minimum necessary for the business to function, or using the same person to carry out multiple functions. This can also include eliminating redundant entities and positions entirely (often described as "legal entity rationalization"), which can reduce other costs and taxes as well.

Another strategy involves eliminating the problem proactively. By auditing, maintaining effective institutional controls, implementing new controls as needed, evaluating taxability, improving document retention policies and consistently and punctually paying taxes to which RPL could attach, the company not only protects its key people from liability, it also protects itself from tax assessments, penalties, interest, reputational risk, and, in some states and for certain taxes, class action lawsuits.

Finally, companies should evaluate the feasibility of purchasing insurance coverage for their RPs. However, insurance is usually not available where the conduct is "willfulness" or "gross negligence." Further, case law addressing whether or not RPL is covered by errors and omissions insurance policies frequently finds that because RP assessments are often characterized as fines and penalties, absent a specific rider, there is no coverage.

The RPL landscape is inconsistent, generally poorly explored, and fraught with enormous personal risk. Individuals who conduct their business prudently and in good faith may find themselves facing potential financial ruin as a result of a confluence of factors well beyond their control. It is incumbent upon businesses to take into account and mitigate such exposures for their RPs.

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