REPORT #736

TAX SECTION

New York State Bar Association

REPORT ON CREATION OF FEDERAL RIGHT TO CONTRIBUTION/
DECLARATORY JUDGMENT FOR SECTION 6672 LIABILITY

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TAX SECTION
New York State Bar Association

October 20, 1992

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
2111 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Please find enclosed a report which recommends the creation of a federal right to contribution/declaratory judgment among persons liable for the penalty for the failure to collect and pay over employment taxes under section 6672 of the Internal Revenue Code.[1] Contribution rights among responsible persons would be determined under our proposal by each person's relative degree of responsibility for the nonpayment of employment taxes.

We would be pleased to discuss this report with you or members of your staff.

Very truly yours,

John A. Corry
Chair

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[1]The principal author of this report is Sherry Kraus. Substantial contributions were made by Michael Hirschfeld, Arnold Kapiloff, Robert Fink, Eugene Vogel, Victor Keen and Brian Skarlatos. Helpful comments were received from Carolyn Ichel, John Corry, Michael Schler and Peter Canellos.

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NEW YORK STATE BAR ASSOCIATION, TAX SECTION
COMMITTEE ON INDIVIDUALS
COMMITTEE ON COMPLIANCE AND PENALTIES[1]

REPORT ON CREATION OF FEDERAL RIGHT TO CONTRIBUTION/ DECLARATORY JUDGMENT FOR SECTION 6672 LIABILITY

This report recommends the creation of a federal right to contribution/declaratory judgment among persons liable for the penalty for the failure to collect and pay over employment taxes under Section 6672 of the Internal Revenue Code.[2] Contribution rights among responsible persons would be determined by each person's relative degree of responsibility for the nonpayment of employment taxes. The report does not undertake to analyze the need for substantive change to Section 6672.

OVERVIEW OF SECTION 6672

To assist in the collection of employment taxes, employers are required to withhold income taxes and the employee's one-half of Social Security taxes from an employee's wages prior to payment. Sections 3102, 3402. As a party responsible for collection of these taxes at their source,

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[1] The principal author of this report is Sherry Kraus. Substantial contributions were made by Michael Hirschfeld, Arnold Kapiloff, Robert Fink, Eugene Vogel, Victor Keen and Bryan Skarlatos. Helpful comments were received from Carolyn Ichel, John Corry, Michael Schler and Peter Canellos.

[2] Unless otherwise indicated, section references are to sections of the Internal Revenue Code of 1986, as amended

the employer becomes co liable with the employee for payment of these taxes.[3] The withheld employment taxes are held in trust by the employer until remitted on a quarterly or more frequent basis to the government. As such, the withheld taxes are generally referred to as “trust fund” taxes.

An employer's failure to collect and/or pay over employment taxes is one of the major sources of revenue loss to the government. Defaults in payment often occur when owners of businesses experience financial difficulties and use the withheld funds to pay other creditors in an effort to keep the business viable. If the business ultimately fails and the Internal Revenue Service is unable to recover amounts sufficient to satisfy the taxes due, the employee must nonetheless be given credit for both income and Social Security tax purposes for the amounts withheld even if the tax payments are never received. Section 31.

Because of the importance of collection of employment taxes, significant penalties exist to discourage default in the collection and payment of these taxes. One such penalty is imposed by Section 6672, which extends the liability for unpaid trust fund taxes to any individual who is “required to collect, truthfully account for, and pay over [employment taxes] ... and 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 ....”

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[3] In a recently-decided case, it was held that Congress intended for employers to be primarily liable for payment of an employee's share of FICA taxes. In Myers v. United States, 92-2 U.S.T.C. Paragraph 50,393, D. Ariz. (3/11/92), the Service was required to look to the employer first to satisfy any unpaid liability before proceeding against the employee.

Section 6672(a).[4] Because the tax can be collected in full from each individual meeting the requirements of Section 6672, the Section 6672 liability is generally referred to as the "one hundred percent penalty." Those who are subject to the penalty are generally referred to as "responsible persons."

While Section 6672 allows for assessment and collection of the penalty against each responsible person, it is the Internal Revenue Service's policy to collect only once for the unpaid taxes, whether from the business, one or more responsible persons, or a combination of the business and one or more responsible persons. IRS Policy Statement P-5-60 (5-30-83) (IRM 1218). If the Service succeeds in collecting an amount in excess of the unpaid trust fund taxes, the excess amount is refunded on a "last monies in, first monies out approach" (LIFO) after the later of the expiration of the statute of limitations for all one hundred percent penalty refund claims or the date of the final adjudication of all refund claims. IRM 5638.3(2).

Assertion of the Section 6672 penalty by the Internal Revenue Service against individuals as responsible persons usually occurs only after it becomes apparent that collection in full will not be made against the employer for unpaid taxes. The assessment against a responsible person must be made within three years of the date on which the corporate employment tax return was either filed or deemed filed, whichever is later. Section 6501(a). If employment tax returns have not been filed, the

[4] Section 6672 applies not only to employment taxes required to be withheld under Section 3401, but also to amounts withheld and treated as if they were employment taxes, such as amounts withheld from gambling winnings under Section 3402(q) and back-up withholding under Section 3406. See, Regs. Section 31.3402(q)-l (c)(5) and Section 3406(h)(10), respectively. Section 6672 is not applicable to taxes collected directly, such as the employer's portion of the Social Security tax.

statute of limitations on assessment does not commence until the returns are filed. Section 6501(c)(3).

If the Service cannot determine in the first instance the person responsible for withholding, collecting and paying over the employment taxes, it will usually proceed with assessments against the officers of the company; proceeding further, if necessary, to shareholders, employees and sometimes even third parties such as banks, creditors, suppliers or mortgagees.[5] IRS Policy Statement P-5-60.

The central inquiry in establishing "responsible person" status under Section 6672 is determining who in the business had responsibility for (1) the payment, accounting for and collection of payroll taxes, and (2) the decision either not to collect the taxes or to divert the withheld payroll taxes to payment of other creditors, maintaining business operations or other item. However, the scope of liability is much broader than is apparent from this simple inquiry. For example, the Internal Revenue Service has taken the position that the Section 6672 penalty may be assessed against any individual who has authority to order that the payments be made even if that authority is unexercised. Under the Internal Revenue Service standard, any owner or officer

[5] The Service will proceed against third parties under the provisions of Section 6672 if the evidence suggests that the outsider exercised control over the financial affairs of the employer. See, e.g., Silverberg v. United States, 355 F. Supp. 1163 (S.D. N.Y. 1973) for imposition of penalty on outsiders. See, Section 3505 for provisions imposing direct liability for withholding taxes on

with a right to review the corporate books and financial records and who has the power to cause the corporation to remedy the default cannot escape liability on the ground that the responsibility for payroll compliance is delegated to another and that the owner or officer had no authority over such matters and no role in determining which creditors should be paid. While the Service continues to apply this broad standard for assessment of the Section 6672 penalty, this interpretation of the scope of the Section 6672 liability has not enjoyed significant success in the courts. See, In Re Michael J. Premo, Debtor, U.S. Bankruptcy Court (E.D. Mich., 90-2 U.S.T.C. Paragraph 50,396 (7/3/90)); Joseph Lajus Brady, III, and Valerie Elaine H. Brady, Debtors, U.S. Bankruptcy Court, Dist. Nev., 90-1 U.S.T.C. Paragraph 50,050 (1/19/90). But cf, Tiffany, Jr. v. United States, 228 F. Supp. 700 (D. N.J. 1963); Turnbull v. United States, 91-1 U.S.T.C. Paragraph 50,196 (5th Cir. 1991); Heimark v. United States, 18 Cl. Ct. 15 (1989).

Even if the Service ultimately determines that more than one person is liable under Section 6672 and proceeds with assessments against more than one responsible person, it is not required to pursue collection against each liable party on a pro rata basis. Under Section 6672, the liability among responsible persons is joint and several and, if the Internal Revenue Service determines that collection may successfully be obtained by action against only one responsible person, it may pursue collection against only that individual without regard to that person's relative degree of responsibility among the class of responsible persons. Mrizek v. Long, 187 F. Supp. 830 (E.D., 111. 1959); Scott v. United States, 354 F.2d 292 (Ct. Cl. 1965).

Furthermore, there is no mechanism by which an individual can compel the Internal Revenue Service to pursue

assessment or collection against other responsible persons. While it is generally in the Service's best interest to pursue assessment of the liability against as many persons as meet the criteria of Section 6672, a defending or assessed responsible person cannot compel the Internal Revenue -Service to proceed with an assessment against another responsible person even if the defending person provides information to the Service implicating other individuals. As a general rule, parties charged with the Section 6672 penalty will defend against such liability, or endeavor to enlarge the class of liable persons, by providing evidence to the Internal Revenue Service to prove that other persons are liable under Section 6672.

Whether the Service will use this information to proceed with assessments against other individuals is often difficult to predict. The proceedings before the Service are not well designed to ensure the reliability of the accusations made. While the facts contained in any written protest of the liability are sworn to, the proceedings before the Internal Revenue Service are generally unilateral, involving only the party defending against the penalty. Furthermore, the Internal Revenue Service is not permitted to divulge any information to the defending party on the status of its assessment or collection efforts against other potentially responsible persons.

The absence of any requirement that the Service act on information implicating other individuals means that a person assessed with the Section 6672 penalty bears the repercussions of the Service's failure to proceed against other individuals within the statutory limitations period. A failure by the Service to proceed against all potentially liable persons limits the class of responsible persons against whom the Service ultimately can

seek collection, thus resulting in an increased likelihood of disproportionate collections.

Once the class of responsible persons has been established and assessed, the Service may pursue collection based solely upon considerations of success and immediacy in collection rather than upon any factors such as relative degree of responsibility of that person in contributing to the default in payment of payroll taxes. Scott v. United States, supra. The disproportionate collection of this penalty has given rise to many of the perceived inequities in the application of the Section 6672 penalty. However, given the importance of compliance in this area, the Service's need for liberal powers and flexibility in securing collection of unpaid employment taxes is generally recognized. Accordingly, any remedy offered to correct inequities resulting from disproportionate collections must take into account and be consistent with the need not to interfere unduly with the Service's ability to collect unpaid employment taxes in the most effective and efficient manner possible.

As a matter of administrative discretion, the Internal Revenue Service has developed a pre-assessment review procedure for appeal of the proposed Section 6672 penalty assessment. Revenue Procedure 84-78, 1984-2 C.B. 754, provides that when the Internal Revenue Service proposes the imposition of the Section 6672 penalty, the affected individual must be notified of the proposed assessment by the District Collection Division and given an opportunity either to agree to the assessment or to appeal by filing a formal protest within thirty days. If the individual fails to file a protest within the thirty-day period, the penalty is assessed. Filing of a timely protest will result in the proposed determination of liability being reviewed by Appeals.

Once the penalty is assessed, the only means by which it can be further challenged is by refund suit in either a Federal District Court or the Claims Court after denial of a refund claim based on partial payment of the tax (i.e. the withholding tax attributable to one employee's wages for each quarter in dispute). IRM 5549.1(3); Boynton v. United States, 566 F.2d 50 (9th Cir. 1977). 28 U.S.C. Sections 1346(a)(1), 1491(a)(1). While Section 6672(b)(1) imposes a post-assessment stay on collection upon partial payment of the tax, filing of a claim for refund and the posting of a bond, it is the Service's policy to withhold collection while a timely claim for refund is pending even if the bond requirement of Section 6672 (b)(1) is not met. IRS Policy Statement P-5-16. The Service also withholds collection during any subsequent refund suit in a District Court or the Claims Court unless it determines that jeopardy to collection exists.

Once the individual has exhausted or waived all review rights and it is determined that he or she is liable under Section 6672, the stay on collection is removed and the Internal Revenue Service will proceed with collection. The statute of limitations for collection of the penalty is ten years from the date of assessment (I.R.C. Section 6502), except where the Internal Revenue Service's determination has been brought to judgment[6], in which case the period for limitations is determined by state law (i.e., in New York State, twenty years for enforcement of judgments). The liability, once assessed, cannot be discharged in any form of bankruptcy. 11 U.S.C. Section 523, 11 U.S.C. Section 507(a)(3).

If collection is made by the Internal Revenue Service dis-proportionately against one of several responsible persons,

[6] This will occur in any judicial proceeding where the liability is challenged, e.g., a refund action where the Service counterclaims for the unpaid portion of the penalty.

that person presently has no federal right of contribution to pursue reimbursement from other responsible persons even if others have been assessed by the Service or the person can independently prove that such persons are also liable under Section 6672. D'Ambrosi v. United States, No. 89-CV-0792 (N.D., Ohio 1990); McDermitt v. United States, 91-1 U.S.T.C. Paragraph 50,094 (S.D. Ohio 1991). While many responsible persons against whom disproportionate collections have been made have sought contribution from other parties under state law theories of action, such have met with only limited success in the state courts. For cases holding there was no state law right to contribution among responsible persons, see, Rebelle v. United States, 588 F. Supp. 49 (M.D. La. 1984); Moats v. United States, 564 F. Supp. 1330 (W.D. Mo. 1983). For cases holding there is a right to contribution under state law among responsible persons, see, Swift v. Levesque, 614 F. S p. 172 (D. Conn. 1985); Esstman v. Boyd, 605 S.W.2d 237 (Tenn. Ct. App. 1979). Some courts have held that there cannot be a right to contribution with respect to the Section 6672 penalty under any state law. See, e.g., Conley v. United States, 773 F. Supp. 1176 (S.D. Ind. 1991); Cline v. United States, No. 89-CV-73312-DT, 1991 U.S. Dist. LEXIS 11036 (E.D. Mich. 1991); DiBenedetto v. United States, 75-1 U.S.T.C. Paragraph 9503 (D.R.I. 1974).

Given the potentially broad scope of the liability under Section 6672 and the policy of the Service to pursue collection by the most effective and immediate means possible even if that results in a disproportionate collection against one of several responsible persons, this absence of a clear right to contribution has raised significant concerns regarding the potential inequities resulting from application of this penalty.

PROPOSAL FOR CREATION OF FEDERAL RIGHT TO CONTRIBUTION/DECLARATORY JUDGMENT

We urge the enactment of legislation to create a federal right of contribution/declaratory judgment to alleviate the lack of uniformity that now exists among the states regarding state law contribution actions and to promote greater fairness in the application of the Section 6672 penalty. The creation of such a right will have the benefit of rectifying many of the inequities now resulting from the Service's power to make disproportionate collections without the need for either substantive revision to Section 6672 or interference with the current collection policies of the Service.

While few would argue with the importance of preserving to the Service the power and discretion to effectively and efficiently collect unpaid employment taxes, substantial inequities may result from the Service's power to make disproportionate collections. These collection policies can result in the entire burden of the liability falling on the individual whose assets are most readily available to the collection process without regard to that individual's relative degree of responsibility among the class of responsible persons. Also, such policies fail to spread the burden of the liability among all responsible persons, thus diminishing the “in terrorem” effect of the penalty.

Although the improper use of trust fund taxes must be discouraged and is rightfully subject to severe sanctions, the circumstances giving rise to nonpayment vary enormously, ranging from the reprehensible conversion of funds for the personal use of the owner to the unfortunate actions of desperate owners who use the funds as temporary loans from the government to pay

salaries, operating expenses or business creditors in an effort to keep the business viable during what they believe to be a temporary downturn. Often, the persons found to be responsible under Section 6672 do not have a full understanding of the nature of withholding taxes (viewing the government as just another creditor) or of their own potential liability for nonpayment.

Perhaps the greatest inequity in disproportionate collections results from two factors: (1) the broad range of personal involvement and culpability which can form the basis for the assessment and (2) the absence of any differentiation in liability for the penalty among the class of responsible persons based on degree of responsibility. The creation of a federal right of recovery among persons liable for the Section 6672 penalty would provide a means by which the inequities resulting from disproportionate collection could be rectified by private civil action without the need to interfere with the current collection policies of the Service.

Summary of Proposal. We recommend the creation of a federal right to contribution/declaratory judgment wherein each person determined to be a responsible person would be liable for a share of the aggregate liability paid pursuant to Section 6672 as measured by that person's relative degree of responsibility for nonpayment of employment taxes. To obtain contribution, the plaintiff would have to prove not only that the defendant met the criteria for liability under Section 6672, but also that the plaintiff paid more than his or her allocable share of the liability and that the defendant paid less.

Under our recommendation, any party who is a responsible person could sue or be sued for contribution/declaratory judgment with jurisdiction in the federal courts even in the absence of

diversity since the claim would be based on a federal right of action. The contribution/declaratory action could be asserted by the plaintiff against another person asserted by that plaintiff to be a responsible person without regard to whether such assertion had ever been made by the Service, whether such an assessment had ever been made by the Service and without the presence of the Service as a party. Furthermore, even if the Service had concluded that the defendant was or was not liable as a responsible person and, as such, had proceeded with or abated an assessment against that person, such determination by the Service would not be binding on the court in making the determination as to whether the defendant had met the criteria for liability under Section 6672, although that determination would be admissible as evidence in the proceeding.[7] State courts could be given concurrent jurisdiction with the federal courts to adjudicate this federally created cause of action.

While we recommend creating a federal right to contribution/ declaratory judgment under Section 6672, there are aspects of the right of action which raise difficult issues in achieving the goal of equity among the class of responsible persons. The following discussion analyses several of these issues.

Basis of Recovery. Our committee debated the relative merits of a recovery based on an equal "pro rata" (i.e., per capita) division of the liabilities among the responsible persons

[7] We propose this rule because of the multitude of circumstances which can give rise either to an assessment or a lack of an assessment. In many cases, the assessment will become final simply by reason of the individual's failure to file a protest within the thirty-day period. Even where there has been a review of the facts by the Service at the Appeals level, the unilateral nature of the proceedings may not allow for a fair hearing of the proof, thus affecting the reliability of the determination.

against a recovery rule based on comparative responsibility for the nonpayment of employment taxes While we concluded that the “pro rata” rule has the benefit of simplicity, we questioned whether such a rule was the most equitable basis for recovery. Given the broad range of culpability which can form the basis for an assessment under Section 6672, a majority of the members of our committee and of the Tax Section's Executive Committee concluded that a recovery based on comparative responsibility for the default had greater merit and achieved a greater degree of fairness than a pro rata rule.

Achieving a more equitable allocation of the Section 6672 penalty was of primary importance to the committee since, often the person directly responsible for the default in payment of employment taxes will not be pursued for collection by the Service because that person has no assets, is in bankruptcy or presents some other obstacle to collection. In that event, a disproportionate collection of the tax is likely to occur against another person meeting the criteria for liability under Section 6672 even though that person may bear little direct responsibility for the default.

We believe that a recovery based on comparative responsibility for the default will result in greater equity in allocating the burden of this penalty among responsible persons than now results under the Service's current policy of collection. A recovery based on comparative responsibility will add complexity to the legal proceeding, however. Since comparative liability based on degree of responsibility for the default has never been a factor in determining liability under Section 6672, the courts will need to make such determinations without the benefit of prior guidance from the case law under Section 6672. Given the factual nature of such a determination,

the courts should be allowed considerable flexibility in determining the relative liabilities of the parties. However, we favor a legislative directive that the ability to pay of a party to the proceeding should not be taken into consideration for this purpose.

Whether recovery among the class of responsible persons is based on a comparative responsibility rule or a pro rata rule, difficult questions can arise. Assume, for example, a total unpaid liability of $100,000 and three responsible persons, A, B and C. Assume also that the Service has collected $60,000 from A, $30,000 from B and $10,000 from C. What is the appropriate recovery from B if A sues only B because a judgment against C is likely to be unenforceable?

For purposes of this example, assume that a comparative recovery rule is in effect and that A is ten percent liable for the default, B is thirty percent liable and C is sixty percent liable. Since B has already paid $30,000 to the Service, should B be able to defend against A's contribution action by demonstrating that he has already paid his allocable share of the taxes and, therefore, should not be required to reimburse A for C's share of the tax? Put another way, should B be allowed to limit his reimbursement to A on the basis that he has already paid his share of the unpaid taxes when measured by reference to a class of responsible persons not all of whom are before the court?

We believe the preferable rule in this case is to limit the scope of the judgment to determining the relative liabilities among the parties to the contribution action without regard to payments made by other responsible persons who are outside the proceeding. Under this rule, if A sues only B, the aggregate

amounts considered as paid toward the Section 6672 liability for purposes of the action would be $90,000 ($60,000 from A and $30,000 from B). As between A and B, their relative liabilities would be twenty-five percent and seventy-five percent respectively. Assuming that A could establish B's liability under Section 6672, B would be ordered to pay $37,500 to A, representing the amount paid by A in excess of his allocable share (twenty-five percent) of the total taxes paid by A and B. The end result would be that A would pay $22,500, B would pay $67,500 and C would pay $10,000 toward the unpaid trust fund taxes, thus achieving a reallocation of the tax burden only as between A and B.

We come to this conclusion for the following reasons: In many instances, a determination of all the persons liable under Section 6672 is impossible or impractical. Accordingly, it would not be appropriate for the court to establish the total liability paid or the relative degree of liability by inclusion of responsible persons who are not parties to the proceeding. Furthermore, the fact that the Service may have assessed and collected against C would not, under our proposal, be binding in the A-B contribution action on the issue of C's Section 6672 liability. Unless B impleaded C and either independently established C's liability under Section 6672 or demonstrated that C's liability had been established in a separate judicial proceeding (e.g., a refund action or separate contribution/declaratory judgment action), C's relative liability and tax payments should not be taken into account in the A-B contribution action.

Another obstacle to including C's liability and/or payments in the A-B contribution action is that, under current law, the Internal Revenue Service may not disclose the status of

its assessment or collection action against other responsible persons. Accordingly, verification that an assessment or collection had been made against C would have to be made without the assistance of the Service. For the above reasons, we believe the action should be limited to allocating, the Section 6672 burden as to the parties to the action.[8]

The question then arises as to whether B should be allowed to diminish or limit A's potential recovery against B by enlarging the class of responsible persons by the use of impleader. If, for example, B impleads C and establishes C's liability under Section 6672, B's recovery under existing rules of impleader will be limited to a judgment against C for any amounts paid by B in excess of his allocable share of the aggregate Section 6672 liability paid by B and C (including amounts paid by B to A in the A-B contribution/declaratory judgment action). Accordingly, B would obtain a judgment against C for $41,667, representing the excess of B's allocable share (one-third)[9] of aggregate taxes paid by the parties in the B-C impleader action, i.e., one-third of $77 ,500 ($67,500 paid by B to A and to the Internal Revenue Service and $10,000 paid by C to the Internal Revenue Service). Even if B could enforce the judgment against C, C would still pay less than his allocable share of the total tax and A would pay more than his allocable share. Such a result may be appropriate, however, since A elected not to join C in his action.

While the committee did not reach a conclusion on this question, it should be possible to allow the court to determine

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[8] Similar issues would arise under a pro rata recovery regime, where we believe the result should be the same.

[9] As between B and C only, B is 33-1/3 percent liable and C is 66-2/3 percent liable when based on the assumed relative liabilities of A - 10 percent, B - 30 percent and C - 60 percent

the relative liabilities of all parties to the proceeding, whether joined by impleader or sued in the original action. The court could then determine contribution rights among all parties to the proceeding for all taxes paid by the parties, thus avoiding the complexities and potential inequities that could result under current impleader rules. Such a rule would have the effect of diminishing A's recovery against B in the above example and of forcing A to bear the economic burden of an unenforceable judgment against C.[10]

Nature of the Action. Our proposal recommends the creation of a federal right of recovery among responsible persons that combines the features of a contribution action and a declaratory judgment action. In making this recommendation, we have given consideration to several different approaches for relief, including one based strictly on contribution and one based strictly on declaratory judgment.[11] We have concluded that the theory best suited to provide the relief desired for this penalty combines the features of both a declaratory judgment action and a contribution action. The reasons for our recommendation are as follows:

A cause of action based strictly on a contribution theory would not ripen until a collection has been made by the

[10] There is also a question as to whether the contribution recovery should include interest and penalties paid by the plaintiff, as well as amounts paid toward the unpaid taxes. Interest and penalties owed will differ for each responsible person depending on the date of assessment of the Section 6672 penalty. In the interest of simplicity, we have concluded that the "aggregate amounts paid by the parties toward the Section 6672 liability" subject to recovery in the contribution action should include interest and penalties as well as taxes.

[11] For a proposal which recommends the creation of a federal right of contribution, see Proposal to Create a Federal Right of Contribution Among "Responsible Persons" Under Section 6672, Association of the Bar of the City of New York, Tax Analyst Daily, Tax Highlights and Documents, Vol. 24, No. 11, January, 1992.

Service against the plaintiff. Mere assessment of the Section 6672 penalty against the plaintiff would not be sufficient to bring the claim. Accordingly, if the theory of recovery were limited to a contribution claim only, there is the potential for delaying the determination of the Section 6672 liability of the defendant for inordinately long periods of time even if the limitations period for bringing the contribution action were made relatively short (e.g., two years from the date of payment).

Under Section 6502, the statute of limitations for collection by the Internal Revenue Service is ten years from the date of assessment. If the Service does not pursue collection from the plaintiff until near the end of the ten year collection period, a defendant in a contribution action could be sued for the first time as long as twelve years after the date of assessment against the plaintiff. The contribution action by the plaintiff could be commenced even later against the contribution defendant if the assessment against the plaintiff is reduced to judgment by the Service, thus allowing the Service a longer period for collection. The passage of such a long period of time could jeopardize the plaintiff's ability to prove the liability of other parties as well as impair the defendant's ability to defend the action. Furthermore, the delay permits the parties more opportunity to transfer or secrete assets, thus making any judgment obtained against them more likely to be uncollectible.

A further unfortunate aspect of limiting the theory of recovery to one based strictly on contribution is that multiple federal court actions may be required if the Service collects from the plaintiff piecemeal over the collection period rather than in one lump sum. Incremental collection by the Service is not uncommon for this penalty, particularly since the liabilities are usually large and collection by levy is often necessary.

While the doctrines of res judicata and collateral estoppel would relieve the plaintiff of having to prove the liability of the defendant in subsequent actions to recover contribution against that same defendant, it would appear that separate enforcement actions would be necessary if there are incremental collections by the Service spanning more than the limitations period for bringing the action (e.g., two years from date of payment).

In contrast, a cause of action for declaratory judgment to determine the relative liabilities of the parties would allow ripening of the claim at the time of assessment against the plaintiff without regard to whether a collection had been made by the Service. Such a right of action, however, would require the plaintiff to move forward with any claims against other persons liable under Section 6672 within, for example, three years from the date of assessment and, thus, could result in the expiration of the limitations period before the individual even realized the nature of the assessment against him.

It is not uncommon for the Service to make protective Section 6672 assessments long before any collection action is likely to commence against responsible persons since the Section 6672 assessments may be made at any time after the Service concludes that full recovery of the unpaid tax will not be like from the business. Once the Section 6672 assessment is in place, the Service has ten years in which to proceed against the responsible persons. In many cases, until a collection has occurred, the individual assessed does not realize the full implications of the penalty, much less the need to establish, by means of a court proceeding, the liabilities of other responsible persons to whom he can look for recovery in the event of a disproportionate collection by the Service. Often, it will not be until collection action has commenced that the individual even

seeks professional tax advice on the matter. Accordingly, a theory of relief limited only to declaratory judgment would likely result in many claims being time-barred before the plaintiff even realizes the nature of the liability assessed against him, much less the relief available to him.

We have concluded that a theory of recovery which incorporates the features of both a contribution claim and a declaratory judgment action will provide the relief needed, but without many of the unfavorable features- resulting from either theory of recovery alone. Such an action would allow for determination in a single proceeding of the relative liabilities and contribution rights among the parties for amounts paid or to be paid toward the Section 6672 liability.

The claim would ripen upon the earlier of assessment of the liability or payment of the tax. The action would have a limitations period of three years from the date of assessment or two years from the date of payment, whichever is later.

Thus, under the above ripening rule, the proceeding may be commenced by the plaintiff upon assessment of the liability without the necessity of waiting until an actual collection of the tax has been made. By allowing the claim to be brought within three years of assessment, the court can determine the relative liabilities of the parties before proof of liability has been compromised by the passage of time. If a payment has already been made by the plaintiff, contribution can be directed by the court among the parties for any amounts paid in excess of each party's allocable share of the liabilities. If no collection has been made against the plaintiff or any other party at the time of the declaratory judgment proceeding, the court can establish the

relative liabilities of the parties and determine the contribution rights for all future payments of the tax.

Under our recommended theory of recovery, a plaintiff who fails to seek a determination of liability within three years of the assessment against him or who has never had a Section 6672 assessment made against him[12] will not be precluded from seeking contribution from other responsible persons so long as his action is commenced within two years of payment of the tax. [13]

To reduce the need for multiple proceedings in the event collection has not yet been made against the plaintiff at the time of the initial proceeding or if collections have been made against the plaintiff spanning more than the two year limitations period from the date of payment, the judgment should be capable of directing contribution for future collections. Take, for example, the case where there are two equally responsible persons, A and B, and unpaid trust fund taxes of $100,000. If both A and B are assessed with the Section 6672 liability in year one and the Service proceeds with collection of $30,000 against A in year three, A must pursue his claim against B by year five or lose his right to contribution from B for the payment made. If, by year five, the Service has not proceeded with any further collections against either A or B, B will be ordered to reimburse A for $15,000 (one-half of the aggregate Section 6672 liabilities paid by the parties) in the contribution/declaratory judgment action.

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[12] If our recommendation is accepted and a right of recovery among responsible persons is created, an individual may be required to make contribution payments to another responsible person without ever having a Section 6672 assessment against him/her by the Internal Revenue Service.

[13] This would include payments not only to the Internal Revenue Service, but also to other responsible persons by reason of contribution.

At the conclusion of this action, however, the Service will still have five years in which to proceed against A and/or B for further collection. If the Service proceeds in year seven with a $10,000 collection against A and a $60,000 collection against B, how can the judgment be structured to minimize the need for the parties to bring another action to have the court direct contribution between the parties as to those subsequent payments?

If the judgment in the initial proceeding could be framed in terms of A's and B's proportionate contribution liability for all taxes paid or to be paid, this could reduce the need for future litigation in determining contribution rights between the parties. In the above example, in year seven B could enforce contribution against A for $25,000 based on the original judgment which allocated liability on an equal basis. In that case, another legal proceeding would be necessary only if there were a dispute between the parties regarding amounts actually paid or other unresolved issues. Under the doctrines of res judicata and collateral estoppel, the determination of liability in the earlier action would be binding in any subsequent action, thus eliminating the need to relitigate the liability issue.

Furthermore, in determining the aggregate payments made toward the Section 6672 liability by the parties to the contribution/declaratory judgment action, we would include not only payments made directly by the parties to the Internal Revenue Service, but also payments made by the parties to other responsible persons as a result of other contribution actions. If, in the above example, there were a third responsible person, C, against whom collection action had been taken by the Service and who had already sued B and recovered contribution from B, B should be able in the A-B contribution action to count the

payment to C as an amount paid by B toward the Section 6672 liability.

It is also possible that the plaintiff in a contribution action could obtain recovery from a defendant for amounts paid by the plaintiff which are subsequently refunded to the plaintiff. If, for example, the plaintiff has not waived or exhausted all rights to review of the penalty assessment either by the filing of a refund claim, the initiation of a refund suit or the appeal of an adverse judgment, a subsequent cancellation of the assessment against the plaintiff could occur, with the result of a refund of payments made by the plaintiff toward the liability. While we do not favor delay in the ripening of the contribution/declaratory judgment action until the plaintiff has exhausted or waived all procedural remedies which could result in cancellation of the assessment, we believe that the procedural status of the plaintiff's liability should be considered in structuring the judgment in the contribution/declaratory judgment action. If, at the time of judgment, the possibility exists for subsequent cancellation of the assessment against the plaintiff and for refund to the plaintiff of amounts collected, the judgment could provide either (i) for escrowing of the amounts paid by the contribution defendant until the plaintiff's liability has become fixed or (ii) for restitution to the contribution defendant by the contribution plaintiff if the plaintiff ultimately is found not liable and receives a refund of monies paid.[14]

[14] Under current law, the Service is prohibited from divulging the status of assessment or collection action against other responsible persons. Unless this disclosure provision is altered to permit disclosure, it may be difficult for the contribution defendant to determine whether the plaintiff has complied with an order for restitution. In such event, escrowing of the monies received may be the appropriate solution.

In summary, we recommend a theory of recovery which combines the relief available in both a contribution action and a declaratory judgment action. This will allow for ripening of the cause of the action upon assessment of the liability, without precluding recovery from other responsible persons within two years from the date of payment.

Consolidation of Related Actions. Our proposal would allow the plaintiff in a refund action against the Service to join the contribution/declaratory judgment action with the refund claim so that the contribution claim may be determined in the same proceeding as the refund claim. We do not believe that the consolidation of these related actions will interfere with the right of the Service to collect on the Section 6672 liability. Under current law, the Service can join other potentially liable persons in defending a refund claim action. Rev. Proc. 84-78, 1984-2 C.B. 754.

Such a rule would have the beneficial effect of consolidating related issue proceedings. This would not only reduce the burdenon the federal court system, but also would allow greater access to this right of action to plaintiffs who may not have the financial resources to commence a separate contribution/declaratory judgment action at the conclusion of the refund action. Adequate access to the federal court system is of particular concern in Section 6672 penalty cases since the penalty is often assessed against owners of small, closely-held businesses who have exhausted their personal financial resources as well as the business resources in trying to keep the business viable. Furthermore, collection action against the individual is likely to begin by the Service once the individual loses the refund suit with the effect of further diminishing the financial

resources available to the plaintiff to separately pursue his contribution claim in the federal court system.

More important, however, is the fact that the refund claim will likely be established by proof that another person is responsible. Therefore, the option of joining the contribution/declaratory judgment action with the refund claim will have the benefit of eliminating unnecessary duplication of related-issue judicial proceedings and will allow the plaintiff to have the contribution/ declaratory judgment claim determined in the same proceeding in the event the refund claim is denied.

A likely obstacle to joining the contribution/declaratory judgment action with the refund claim will be the absence of jurisdiction over the contribution defendant since the refund action must be sitused in the jurisdiction of the plaintiff's residence. To allow greater flexibility in consolidating these actions, we favor allowing as an alternative situs for the refund claim/contribution action the jurisdiction of the business entity (i.e., principal place of business) with respect to which the Section 6672 liability arose. If the entity is no longer in existence, the jurisdiction of its last domicile would be appropriate. We favor this jurisdictional rule since the common bond to the parties is their relationship with the business entity.[15] Under this rule, a plaintiff would have the option of consolidating the refund claim action with the contribution action and allow determination of related issues in a single proceeding.

[15] The statute should also allow for nation-wide service of process to create a uniform rule, for conferring personal jurisdiction over defendants.

Judgment Comparable to Service Enforcement Rights. We recommend that the judgment obtained in the contribution/declaratory judgment action be made as comparable to the enforcement rights of the Service under Section 6672 as possible. Once the Section 6672 penalty is assessed against a responsible person, it is not dischargeable in bankruptcy. If a contribution plaintiff succeeds in an action against another responsible person, such would create simply a right to collect on a judgment. If that judgment can be avoided in bankruptcy or has an enforcement limitation period which is not comparable to that available to the Internal Revenue Service against the contribution plaintiff, the contribution/declaratory judgment action will, to that extent, fall short of rectifying current inequities resulting from the Service's disproportionate collection policies. To make the judgment more comparable to the Service's collection rights against the contribution plaintiff, we recommend that Sections 527 and 507 of the Bankruptcy Code be amended to make any judgment obtained in a Section 6672 contribution/declaratory judgment action have the status of a priority claim and be nondischargeable.

Effect of Binding Agreements Between Responsible Persons. Often, the liabilities of owners of a business are addressed in binding shareholder or partnership agreements. In cases where the parties have reached an agreement among themselves regarding reimbursement in the event a Section 6672 collection is made against one or more party, we believe that such agreements should be given effect and should supersede any federal right to contribution created under this proposal. If, for example, two owners of a business have a binding written shareholder agreement which allocates seventy percent of any Section 6672 liability to owner A and thirty percent of the liability to owner B, owner B should be able to limit his

contribution liability to A to thirty percent of the aggregate liability even though a different recovery would have resulted under the federal action.

SUMMARY

We recommend the creation of a federal right of action for contribution/declaratory judgment among responsible persons to alleviate the inequities which now result from the joint and several nature of the Section 6672 liability and the Service's disproportionate collection policies. The proposed right of action will not interfere with the Service's current powers to collect unpaid employment taxes. While the proposal creates new complexities in administration of this penalty and is not an ideal solution to the problems that can arise under Section 6672, we believe the proposed right of action will result in a fairer allocation of the burden of this penalty than is presently the case. Furthermore, while the creation of a federal right of contribution/declaratory judgment will represent a major step in rectifying the inequities of the Section 6672 penalty, many aspects of this penalty still need to be reviewed, particularly in the context of the changes in this area contained in H.R. 11 when, as and if such provisions are enacted.