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Man Draws $4.3M IRS Penalty For Lending $100K To Struggling Business

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No good deed goes unpunished, as the saying goes. On first impression, that's what happened to Dr. Robert McClendon, a Texas physician. He lent $100,000 to a business to cover its payroll. And then he got hit with a $4.3 million IRS penalty for the company's payroll taxes, a penalty that was just upheld in court. But, as often happens with taxes, the situation is more complex. The business was Dr. McClendon's, and sadly, one of his employees embezzled the payroll tax money.

The court concluded that Dr. McClendon was responsible, and acted willfully. You can be 'willful' under the tax law even if you didn't have a bad motive or evil intent. Dr. McClendon was the owner of Family Practice, a medical services provider. Family Practice hired Richard Stephen as its CFO. By 2009, Family Practice owed over $10 million in unpaid payroll and other withholding taxes. Dr. McClendon learned that the taxes were unpaid on May 11, 2009. Mr. Stephen plead guilty to three counts of felony theft of money that he embezzled.

Family Practice stopped operating and remitted its remaining receivables to the IRS to pay toward the tax liability. Dr. McClendon made a $100,000 personal loan to Family Practice "for the restricted purpose of…using the funds to pay the May 15, 2009 payroll". Family Practice used that loan to pay its employees. IRS assessed a $4.3 million responsible person penalty on Dr. McClendon. Dr. McClendon conceded that he was a responsible person, but said he was never willful. It was a technical argument, and he arguably did not raise it early enough.

In the end, the court rejected Dr. McClendon's argument. It was true that most payroll tax penalty cases involve a responsible person who pays other people, not the IRS. You pay vendors, landlords, etc. Here, the money was only to pay his employees. Even so, the court did not buy it. He knew there were huge payroll taxes due, and he did not step up to pay them. The burden of proof here was on Dr. McClendon, not the IRS. He had to show that he wasn't a responsible person or didn't willfully fail to pay the taxes owed, but the court said he failed to do that. Dr. McClendon has filed a motion to appeal the ruling.

The IRS is aggressive in going after payroll taxes. In one recent case, a man could face 5 years for his payroll tax violation. More generally, the IRS is being urged to prosecute more payroll tax violations. This is trust fund money that belongs to the government. Any failure to pay is serious. Using the money to pay suppliers and keep the business open isn't a good reason in the IRS view. Payroll services are one common answer, so the employer doesn't have discretion to use the money to pay vendors or for anything else. But what if the payroll service takes the money?

That horrific possibility featured prominently in a report from the Treasury Inspector General. So be careful who you hire too. When a tax shortfall occurs, the IRS will usually make personal assessments against all responsible persons who have ownership in or signature authority over the company and its payables. The IRS can assess a Trust Fund Recovery Assessment, also known as a 100-percent penalty, against every "responsible person" under Section 6672(a).

You can be liable even if have no knowledge the IRS is not being paid. If you're a responsible person the IRS can pursue you personally for payroll taxes if the company fails to pay. The 100% penalty equals the taxes not collected. The penalty can be assessed against multiple responsible persons, allowing IRS to pursue them all to see who coughs up the money first. "Responsible" means officers, directors, and anyone who makes decisions about who to pay or has check signing authority.

When multiple owners and signatories all face tax bills, they generally do their best to direct the IRS to someone else. Factual nuances matter in this kind of mud-wrestling, but so do legal maneuvering and just plain savvy. One responsible person may get stuck, while another may pay nothing. Meanwhile, the government will still try to collect from the company that withheld on the wages.

The IRS also wants to make sure this kind of bad tax situation doesn't occur again. The government can move to shut down the business so the situation doesn't get worse. In extreme cases, the government may seek criminal penalties. More commonly, the government can seek an injunction to stop the bleeding so the government gets its tax money. Where a business gets deeper and deeper into tax debts, the practice is sometimes referred to as pyramiding.

If a company is making minimal payments of tax debts, the IRS may try to induce voluntary compliance. In some cases, the Justice Department will seek an injunction to require timely deposits and payments of all withheld employment taxes and to timely file all employment tax returns. Whatever your situation, try to steer clear of these issues. Get help early. Stay ahead of payroll taxes. Consider using a payroll service that doesn't allow you the choice whether to use the payroll tax money for something else. And choose wisely.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.