Office of Chief Counsel
Internal Revenue Service

memorandum

CC:SB:HQ:TMRath
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VIA EMAIL

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date: August 12, 2024

to: Maha Williams, Deputy Commissioner, SB/SE Division

from: Thomas M. Rath, Assistant Division Counsel (GL), SB/SE Division Headquarters

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subject: Trust Fund Diversions As Taxable Income

This memorandum responds to your request for assistance and was drafted in coordination with the Office of Associate Chief Counsel (Income Tax and Accounting). It provides non-taxpayer specific legal advice regarding the application of I.R.C. § 61 to diverted trust fund taxes. This advice may not be used or cited as precedent.

ISSUE

When an individual diverts/appropriates (diverts) trust fund taxes, does that individual have taxable income in the amount of the diverted taxes for the taxable year in which the taxes are diverted.

CONCLUSION

When an individual diverts trust fund taxes for whatever reason, including to pay personal or business expenses, the diverted taxes are taxable income to the individual and must be reported on the individual's return for the taxable year in which the diversion occurs. If the individual fails to report the diverted taxes, they will be liable for additional taxes and various income tax civil penalties. This conclusion is not limited to responsible officers under I.R.C. § 6672. Anyone who diverts the trust fund taxes will have taxable income for the taxable year of the diversion. If the individual who diverts the trust fund taxes is a responsible individual, they will also be liable for the trust fund recovery penalty under I.R.C. § 6672. They may also be subject to criminal prosecution under I.R.C. § 7202 for willful failure to collect or pay over the tax. Depending upon the circumstances, if the individual repays the diverted trust fund taxes, they may be entitled to a deduction in the year of repayment.

LAW AND ANALYSIS

When an individual diverts trust fund taxes, the individual realizes and must recognize taxable income in the amount of the diverted trust fund taxes for the taxable year of the diversion.

Section 7501(a) of the Internal Revenue Code provides, in part, that "[w]henever any person is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of tax so collected or withheld shall be held to be a special fund in trust for the United States." Trust fund taxes are income taxes, social security taxes, and Medicare taxes required to be withheld from the wages of employees. Those taxes must be held as a "special fund in trust for the United States." I.R.C. § 7501(a).

Section 61(a) of the Internal Revenue Code defines gross income as "all income from whatever source derived." I.R.C. § 61(a). All income from whatever source derived, includes all "accessions to wealth clearly realized, and over which the taxpayers have complete dominion." *James v. United States*, 366 U.S. 213, 219 (1961) (quoting *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)). Thus, "[w]hen a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition," the taxpayer has received income even though repayment may be required. *James* at 219.

The taxpayer in *James* embezzled money from his employee union and an insurance company with which it was doing business, then failed to report those funds on his tax return in the embezzlement years. *James v. United States*, 366 U.S. 213, 214-15 (1961). Embezzlement is generally defined as the "fraudulent appropriation of property by a person to whom such property has been entrusted, or into whose hands it has lawfully come." *Moore v. United States*, 160 U.S. 268, 269 (1895).

Before *James*, it was well-established that other types of illegal gains were taxable, making it illogical to exclude embezzled funds as taxable income. *James* at 218-19. The Supreme Court in *James* deemed it unlikely that Congress intended unlawful gains to receive special treatment when compared to lawful gains and held that the embezzled funds (the same as lawfully obtained funds) are included in income in the years of the embezzlement. *James* at 220. Therefore, under *James*, when an individual diverts trust fund taxes for whatever reason, they have taxable income in the amount of the diverted funds in the year of diversion. *Cf. Gilbert v. Comm'r*, 552 F.2d 478, 479 (2d Cir. 1977) (in non-trust fund context, diverted funds were not taxable income because the taxpayer intended to restore the funds, reasonably expected he would be able to make those payments, had reason to believe that the corporation would approve, and used his own assets to secure the amount owed).

The Supreme Court in *James* recognized that a taxpayer may be able to deduct the embezzled funds in the years repayments are made. *James* at 220. The following cases provide some possible deduction scenarios; *Senyszyn v. Commissioner*, 146 T.C. 136 (2016) (repayments to a victim of embezzlement should be credited against the perpetrator's taxable income for the year)*; Walters v. Commissioner*, T.C. Memo. 1998-111 (embezzler's repayments to clients' trust accounts were expenses of the illegal activity and

ineligible for deduction because the payments helped to perpetuate the fraud); *Shipley v. Commissioner,* T.C. Memo. 1981-630 (gift taxes paid on embezzled funds not deductible against the embezzled funds).

Courts generally have not considered how diverted funds were used in determining the tax consequences of the diversion. The important fact is the diversion itself. For example, in *Walters v. Commissioner*, T.C. Memo 1998-111, the taxpayer owned an insurance and financial services company and embezzled $9.7 million from his clients' employee benefit trusts. The taxpayer used the money to keep his business afloat during a period where it was suffering from losses. He kept the remainder of the embezzled funds for personal use and did not include these funds on his tax return for the year at issue. The taxpayer argued that he did not have unreported income from his embezzlement activities that year because the money all eventually ended up in his company's account. The Tax Court found that the focus should remain on the diversion of funds and not the disposition. Embezzlement creates a taxable event, regardless of the income's final, destination. The funds embezzled by the taxpayer were unreported income, less any funds that had previously been reported as income on his tax returns.

In *Leighton v. Commissioner*, T.C. Memo 1995-515, the taxpayer diverted funds from trust accounts he had set up for joint investment ventures with clients and friends. He used this money for personal purposes but also used it to financially prop up the various joint ventures. The Tax Court stated, "it is well established that gross income for income tax purposes includes income that a person takes or receives and that is subject to his control and disposition, even if the income be illegally obtained." The court did not differentiate between the funds the petitioner used for personal expenses and those he put back into the business.

In summary, when an individual diverts trust fund taxes, regardless of how the funds are used, they have taxable income in the year of the diversion that must be reported on the individual's return for the taxable year in which the diversion occurs. I.R.C. § 61(a). If the individual fails to report the diverted taxes, they will be liable for additional taxes and various income tax civil penalties. The individual may also be liable for the trust fund recovery penalty under I.R.C. § 6672 and subject to criminal prosecution under I.R.C. § 7202. The individual who diverts the trust fund taxes may be able to deduct the repayments of the taxes in the years the repayments are made.

Please call if you have any further questions.