FirstPay Decision: IRS Bests Trustee in Local Tax Case

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A decision last month from the U.S. Court of Appeals for the Fourth Circuit marks a disappointing end to a decade-long tax case affecting many Washington-area businesses. The case, *Wolff v. United States of America*, Adversary Proceeding No. 13-2116, stems from the bankruptcy case of FirstPay, Inc., a Silver Spring, Maryland-based payroll management company.

In 2003, FirstPay provided payroll services to more than 1,500 employer clients. In accordance with its master services agreement, FirstPay would, prior to each payroll date, withdraw funds from the client's bank account. The withdrawal would be of an amount sufficient to cover the payment of the client's employees' wages, the payroll taxes due on those wages and the fees owed to FirstPay for its services; FirstPay would then issue checks to the employees and pay the IRS for its clients' tax liability. When FirstPay suddenly shut down, clients learned that the company's owner was dead, and he had been skimming millions from the funds owed to IRS by its clients. Victims of fraud, however, are not exempt from tax payments. Although some of FirstPay's clients' taxes were paid in full, some were only paid in part and some not at all.

In May 2003, creditors put FirstPay into an involuntary chapter 7 bankruptcy in the US Bankruptcy Court for the District of Maryland. Michael Wolff was appointed trustee, and in 2005, he filed a nine-count complaint against the IRS on behalf of the bankruptcy estate. He sought recovery, under several theories, of $28 million that FirstPay had actually remitted to the IRS on behalf of its clients in the ninety-days prior to its bankruptcy filing. His count to avoid the payroll tax payments as a preference under 11 U.S.C. § 547 is the subject of the recent appeal and decision.

The Bankruptcy Code gives a trustee in bankruptcy the power to avoid and recover certain payments made by an insolvent debtor to creditors in the ninety day period prior to bankruptcy in order to avoid any "preference" of one creditor over another. The bankruptcy court first granted summary judgment in favor of the IRS on the Trustee's preference count; the district court reversed and remanded, and over the course of many years the case went up and down the court system. Most recently, the bankruptcy court determined that the funds transferred to the IRS were not the property of FirstPay's estate and therefore could not be recovered as a preference. The district court agreed, and the Trustee appealed to the Fourth Circuit. The sole issue on appeal was whether the $28 million transferred to the IRS during the preference period was property of the bankruptcy estate and could be recovered by the Trustee.

The Fourth Circuit decided that it was not property of the estate and could not be recovered. First, the Court determined that under Maryland law, FirstPay held the $28 million in an express trust and therefore had no equitable interest in the funds. This is despite a provision in the master services agreement that FirstPay became indebted to its client for the amount of taxes included in their routine withdrawal; the Court refused to accept what they referred to as a “stipulated” “legal conclusion.” Second, the Court, using common law principles, determined that FirstPay’s commingling of funds did not defeat the express trust for the benefit of FirstPay clients and the U.S. government.

In the end, the Court expressed regret that the victimized FirstPay clients would remain liable to the IRS for moneys already paid to their payroll manager. The IRS has, in many cases, waived fees and interest, and in certain charitable cases, the entire tax liability to the fraud victims.

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