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THIRD PARTY LIABILITY FOR WITHHOLDING TAXES: SECTION 3505

INTRODUCTION

Congress enacted section 3505 of the Internal Revenue Code,¹ which became effective January 1, 1967, and extended liability for the payment of withholding taxes to persons, other than employers, who furnish payroll funds. The provision was enacted to combat tax avoidance through the practice of "net payroll financing."² Prior to the inception of section 3505, sureties who had guaranteed the obligations of defaulting contractors would often provide the contractors with funds sufficient to pay the net wages of the contractor's employees, but insufficient to pay withholding taxes.³ Similar practices were employed by prime contractors who paid the wages of subcontractors' employees.⁴ Since the wages had been reduced by the amount of the withholding taxes

1. INT. REV. CODE OF 1954, § 3505 provides:

(a) Direct payment by third parties. —For purposes of sections 3102, 3202, 3402, and 3403, if a lender, surety, or other person, who is not an employer under such sections with respect to an employee or group of employees, pays wages directly to such an employee or group of employees, employed by one or more employers, or to an agent on behalf of such employee or employees, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) required to be deducted and withheld from such wages by such employer.

(b) Personal liability where funds are supplied. —If a lender, surety, or other person supplies funds to or for the account of an employer for the specific purpose of paying wages of the employees of such employer, with actual notice or knowledge (within the meaning of section 6323(i)(1)) that such employer does not intend to or will not be able to make timely payment or deposit of the amounts of tax required by this subtitle to be deducted and withheld by such employer from such wages, such lender, surety, or other person shall be liable in his own person and estate to the United States in a sum equal to the taxes (together with interest) which are not paid over to the United States by such employer with respect to such wages. However, the liability of such lender, surety, or other person shall be limited to an amount equal to 25 percent of the amount so supplied to or for the account of such employer for such purpose.

(c) Effect of payment. —Any amounts paid to the United States pursuant to this section shall be credited against the liability of the employer.

2. *Hearings on H.R. 11256 Before a Subcomm. of the House Comm. on Ways and Means*, 89th Cong., 2d Sess. 83 (1966).

3. *Id.* at 86.

4. *Id.* at 83.

due, the taxes were not assessable against employees,⁵ nor were the taxes collectable from the defaulting contractor or subcontractor who had no funds to pay them.

Before the passage of section 3505, third parties who furnished payroll funds could not be held liable for the withholding taxes. Efforts to collect withholding taxes from sureties were hampered by judicial determinations that taxes were not wages and hence not covered by the typical sureties bond.⁶ Similarly, judicial construction of the existing statutory scheme prevented recovery of withholding taxes from other third parties, such as prime contractors.

The government attempted to counter the practice of net payroll financing with sections 3402(a)⁷ and 6672⁸ of the Internal Revenue

5. INT. REV. CODE OF 1939, § 1608 (now INT. REV. CODE OF 1954, § 3307) provided, as to amounts which an employer was required or permitted to deduct from the remuneration of an employee, that, "for the purposes of this subchapter the amount so deducted shall be considered to have been paid to the employee at the time of such deduction."

6. The rationale of this doctrine may be traced to *United States Fidelity and Guar. Co. v. United States*, 201 F.2d 118, 121 (10th Cir. 1952), where the court held that the employee's full wages was the difference between his gross pay and his withholding taxes. Under this logic, the sureties were liable under their bonds only for the net wages of employees. Despite tenacious frontal attacks on the *United States Fidelity* doctrine that taxes were not wages within the coverage of a surety's bond, the doctrine was repeatedly affirmed by the federal courts. See, e.g., *United States v. Crosland Constr. Co.*, 120 F. Supp. 792 (E.D.S.C.), *aff'd*, 217 F.2d 275 (4th Cir. 1954); *Westover v. William Simpson Constr. Co.*, 209 F.2d 908 (9th Cir. 1954); *General Casualty Co. of America v. United States*, 205 F.2d 753 (5th Cir. 1953). However, the Government's efforts finally proved successful in *United States v. Phoenix Indem. Co.*, 231 F.2d 573 (4th Cir. 1956). In *Phoenix*, the construction contract required the contractor to pay taxes collectible because of the work, and the surety's performance bond was a broadly worded guaranty to perform the conditions of the contract. On facts substantially the same as *United States Fidelity*, *supra*, the court held that the bond made the Government a beneficiary. The Fifth Circuit distinguished its own decision in *Crosland*, *supra*, because the bond that Phoenix Indemnity issued "covered not only the obligation of the employer to pay the wages earned by his employees but also to pay the taxes collectable because of the work." *Id.* at 573. The decision reached in *Phoenix* was not followed in subsequent cases. E.g., *United States v. Hill*, 368 F.2d 617, 625 (5th Cir. 1966); *United States v. Maryland Cas. Co.*, 323 F.2d 473 (5th Cir. 1963); *United States v. Seaboard Supply Co.*, 201 F. Supp. 630 (N.D. Tex. 1961); *First Nat'l Bank v. New York*, 177 F. Supp. 175 (S.D.N.Y. 1959). *But cf.* *Home Indem. Co. v. F. H. Donovan Painting Co.*, 325 F.2d 870 (8th Cir. 1963). For a discussion of the general types of problems that may arise with respect to surety bonds, see Cushman, *Surety Bonds on Federal Construction Contracts: Current Decisions Reviewed*, 25 *FORDHAM L. REV.* 241 (1956).

7. INT. REV. CODE OF 1954, § 3402(a), formerly INT. REV. CODE OF 1939, § 1622(a), which provides:

Code of 1954. To establish the liability of a third party for the payment of withholding taxes under section 3402(a), it was necessary to show that he was an employer.⁹ The section's effectiveness was hindered severely when courts consistently held that a third party who furnished, but lacked control¹⁰ over the actual payment of, wages was not an employer within the meaning of the Code.¹¹ Section 6672 provides *inter alia* that a "person" responsible for the collection of withholding taxes who fails to do so will be liable for a penalty equal to the tax uncollected.¹² Section 6672, unlike section 3402(a), had no predecessor in

Income tax collected at source

(a) Requirement of withholding. —Every employer making payment of wages shall deduct and withhold upon such wages (except as otherwise provided in this section) a tax determined in accordance with the following tables. For purposes of applying such tables, the term "the amount of wages" means the amount by which the wages exceed the number of withholding exemptions claimed, multiplied by the amount of one such exemption as shown in the table in subsection (b)(1).

8. INT. REV. CODE of 1954, § 6672.

9. INT. REV. CODE of 1954, § 3401(d), defines employer in terms of control.

That section provides:

For purposes of this chapter, the term "employer" means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that—

(1) if the person for whom the individual performs or performed the services does not have control of the payment of the wages for such services, the term "employer" (except for purposes of subsection (a)) means the person having control of the payment of such wages, and

(2) in the case of a person paying wages on behalf of a non resident alien individual, foreign partnership, or foreign corporation, not engaged in trade or business within the United States the term "employer" (except for purposes of subsection (a)) means such person.

10. When the Code speaks of "control" over the payment of wages as in § 3401 (d) (*see note 9 supra*), it means the legal power to control the actual payment of wages rather than merely what actually may have been practiced by voluntary forbearance. *Educational Fund of Elect. Indus. v. United States*, 426 F.2d 1053, 1057 (2d Cir. 1970); *Century Indem. Co. v. Riddell*, 317 F.2d 681 (9th Cir. 1963).

11. *See Century Indem. Co. v. Riddell*, 317 F.2d 681 (9th Cir. 1963); *General Cas. Co. v. United States*, 205 F.2d 753 (5th Cir. 1954); *United States v. Crosland Const. Co.*, 120 F. Supp. 792 (E.D.S.C.), *aff'd*, 217 F.2d 275 (4th Cir. 1954); *American Fidelity Co. v. Delaney*, 114 F. Supp. 702 (D. Vt. 1953); *United States v. Zschach Constr. Co.*, 110 F. Supp. 551 (E.D. Okla. 1953), *aff'd per curiam*, 209 F.2d 347 (10th Cir. 1954). Similarly prime contractors who advanced money for wages to subcontractors were held not to be employers of the subcontractors' employees. *Westover v. William Simpson Constr. Co.*, 209 F.2d 908 (9th Cir. 1954); *Arthur Venneri Co. v. United States*, 340 F.2d 337 (Ct. Cl. 1965).

12. Section 6672 of Internal Revenue Code of 1954 is commonly referred to as the "100 percent penalty provisions." *See Cable, One Hundred Percent Penalty Assessments*, 42 TAXES 507 (1964). That section provides:

Any person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax, or truthfully account

the 1939 Code, and it was argued that the enactment of the section evinced a Congressional purpose to expand third party liability for the payment of withholding taxes.¹³ The two sections, however, were treated as largely duplicative. The term "person" in section 6672 was generally construed as meaning "employer"¹⁴ or an employer's officers or agents.¹⁵ While a few decisions indicated that a third party might fall within section 6672 when he was not an employer or an employer's officer or agent,¹⁶ section 6672 was largely ineffective against the prac-

for and pay over such tax, or willfully attempts in any manner to evade or defeat such tax or the payment thereof shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected or not accounted for and paid over. No penalty shall be imposed under section 6653 for any offense to which this section is applicable.

The requirement that the responsible person *willfully* fails to collect the trust fund taxes has been interpreted to require "voluntary, conscious and intentional" preference for payment of corporate creditors over the United States. *Bloom v. United States*, 272 F.2d 215, 223 (9th Cir. 1959), *cert. denied*, 363 U.S. 803 (1960). The section does not require an evil motive to render a party liable. See *Cable, supra* at 508-09. See also Yukin, *Corporate Officers in Increasing Numbers Face Penalties for Default on Withholding Taxes*, 18 JOURNAL OF TAXATION 248 (1963), citing *Paddock v. Siemonect*, 218 S.W. 26, 28 (Tex. 1944); *Bloom v. United States*, 272 F.2d 215 (9th Cir. 1959), *cert. denied*, 363 U.S. 803 (1960); *Griswold v. United States*, 209 F. Supp. 98 (S.D. Calif. 1962). Cf. *United States v. Murdock*, 290 U.S. 389 (1933). *But see Cushman v. Wood*, 149 F. Supp. 644, 646 (D.C. Ariz. 1966), where the basic elements of willfulness were considered to be evil motive, lack of justification, bad purpose or something done or not done without justifiable excuse.

13. *Reagan & Co. v. United States*, 290 F. Supp. 470, 479-80 (E.D.N.Y. 1968).

14. See *Girard Trust Corn Exch. Bank v. United States*, 259 F. Supp. 215 (E.D. Pa. 1966).

15. *United States v. Hill*, 368 F.2d 617, 621 (5th Cir. 1966).

16. *Pacific Nat'l Ins. Co. v. United States*, 422 F.2d 26 (9th Cir. 1970); *Regan & Co. v. United States*, 290 F. Supp. 470 (E.D.N.Y. 1968). In *Regan* the taxpayer was president of a corporation formed to execute and perform a prime contract with the Army and was in overall charge of the entire project. Funds from Regan's firm were diverted directly to the subcontractor. Originally the president of the subcontracting company signed all checks including those for payroll taxes. A dispute arose as to the use of the transferred funds and the procedure was changed so that the defendant opened a new account for the benefit of the subcontractor, but in which only the defendant-taxpayer and another officer of the prime contractor had the authority to draw checks. The court held that the person liable for payment of payroll taxes is not limited to the employer but includes the one whose discretion is exercised in finally deciding which creditors are to be paid and when. A factor which was given weight was the desire of the prime contractor to use the subcontractor's employees but without entering into an employer-employee relationship with them. The court noted that this was proper if the prime contractor had merely advanced sufficient funds to cover wages. The court rejected taxpayer's argument that it was not until § 3505 was enacted, subsequent to the time the acts which the defendant was accused of were committed, that he or the corporate defendant could be held liable as a "third party paying or providing for wages." 290 F. Supp. at 478 *et seq.*

tice of net payroll financing.¹⁷

SECTION 3505

Congressional recognition that the existing Code provisions could not be utilized to remedy net payroll financing prompted the passage of section 3505.¹⁸ The section subjects *lenders, sureties*¹⁹ or *other persons* to liability for withholding taxes for funds advanced *directly*²⁰ or *indirectly*²¹ to pay the wages of other person's employees.²² To date, section 3505 has resulted in a minimum of litigation, and on this basis may, perhaps, be judged as successful. Still, an examination of the provision and legislative history reveals several uncertainties which may precipitate litigation.

Third party liability under section 3505(a) and (b) for the payment of withholding taxes extends to "lenders, sureties and other persons."²³ The use of the categories of lender and surety in conjunction with the category "other person" may indicate that the "other person"

Similarly, in *Pacific National* it was held that, "Section 6672 imposes a liability separate and distinct from the employer's liability for the withheld taxes, and it imposes that liability upon persons other than the employer. . . ." 442 F.2d at 30. The court held that the section reaches those who have "the final word as to what bills should or should not be paid and when." *Id.* at 31, citing *Wilson v. United States*, 250 F.2d 312, 316 (9th Cir. 1958). *Accord*, *Dunham v. United States*, 301 F. Supp. 700 (D. Conn. 1969). The gloss put on § 6672 by the courts in *Regan*, *Pacific* and *Dunham* may be largely accounted for by their desire to render a third party liable for conduct which would have subjected them to liability under § 3505, but for the fact that the acts complained of occurred prior to the effective date of the section. The legislative history of § 6672 provides strong evidence that the section was intended to reach only employers. S. REP. NO. 1182, 85th Cong., 2d Sess. 2188 (1958). *Accord*, *United States v. Hill*, 368 F.2d 617 (5th Cir. 1966).

17. S. REP. NO. 1182, 85th Cong., 2d Sess. 2188 (1958), hypothesizes a situation under § 6672 in which a prime contractor advances money to a subcontractor: "The prime contractor in this case, since he is responsible for the completion of the job is willing to provide the net wage payments but since he is not the 'employer' cannot be required to provide the taxes to be withheld by the 'employer'."

18. S. REP. NO. 1708, 89th Cong., 2d Sess. 21 (1966) noted:

Under present law only "employers" are liable for income, social security and railroad retirement taxes required to be withheld and deducted for wages.

19. *See, e.g., Gallagher, The Good and the Bad for Surety Companies Under the Federal Tax Lien Act of 1966*, 34 INS. COUNSEL J. 214, 218, for a discussion of § 3505 as it applies to sureties.

20. INT. REV. CODE OF 1954, § 3505(a).

21. INT. REV. CODE OF 1954, § 3505(b).

22. Amounts paid by the third party for withholding taxes are credited to the employee. INT. REV. CODE OF 1954, § 3505(c).

23. INT. REV. CODE OF 1954, § 3505.

who pays wages must stand in a formal relationship established by agreement with the party for whose benefit funds are advanced, like the relationship between a lender and his debtor, or a surety and its assured. There is some support for this view in the legislative history.²⁴ If a contractor were to advance his subcontractor funds for the payment of wages with or without expectation of repayment, he would apparently be within the ambit of section 3505. The contractor-subcontractor relationship is a formal one, established by agreement. On the other hand if the relatives or friends of the owner of a failing business were to give him funds to pay his employee, section 3505 may be inapplicable, since the person advancing the funds and the person receiving the funds would stand in no formal relationship. Yet, the necessity of a formal relationship is uncertain, and the persons donating funds under the latter factual situation may be subject to the provisions of section 3505.

According to the legislative history, the only third party who may advance funds²⁵ used for the payment of another's employee's wages and who is exempted from liability under section 3505 is the lender of a working capital loan.²⁶ Neither the Code nor the legislative history define working capital or working capital loan. Presumably, however, the exemption anticipates situations where money is loaned for payment of capital expenditures arising in the course of a business undertaking, including the payment of wages.²⁷ Doubt concerning the meaning of working capital may create confusion, since it is unclear to what extent a party may advance funds for payment of wages and be exempted from section 3505.²⁸

24. S. REP. No. 1708, 89th Cong., 2d Sess. 22 (1966) noted:

The reference to "other person" in this provision is intended to include anyone similar to a lender or surety who pays the wages of employers of another out of his funds.

25. Funds are advanced for the specific purpose of paying wages where the supplier of funds knows that the funds are to be used for wages at the time of the advance even though the agreement under which the wages are advanced states a different purpose. The legislative history also evinces an intent to exempt those acting as agents of the employer or employee who pay but who do not provide funds for wages.

26. H.R. REP. No. 1184, 89th Cong., 2d Sess. 65 (1966).

27. Cases have defined "working capital" as the "value of that with which an enterprise carries on its activity." Commissioner of Internal Revenue v. McKay Prod. Corp., 178 F.2d 639, 642 (3d Cir. 1949). See also Alaska S.S. Co. v. Federal Maritime Comm'n, 344 F.2d 810 (9th Cir. 1965); *In re Diamond State Tel. Co.*, 51 Del. 525, 149 A.2d 324 (1959). See the discussion at note 35 *infra* and accompanying text.

28. H.R. REP. No. 1184, 89th Cong., 2d Sess. 65 (1966), notes that funds are advanced for the specific purpose of paying wages where the supplier of funds knows

Section 3505(a) subjects a third party who *directly* pays the wages of another's employees to liability for withholding taxes.²⁹ The liability of such a party arises only when the employer fails to pay the taxes,³⁰ but once this occurs, the third party is liable for a sum equal to the unpaid taxes with interest.³¹ Under section 3505(b), third parties are liable for withholding taxes due on funds advanced to pay wages *indirectly* through an employer or other person.³² Unlike subsection (a), subsection (b) of section 3505 limits the amount recoverable from a third party to twenty-five percent of the amount supplied to the employer and used for wages.³³ Subsection (b) is not as easily applied as subsection (a); two conditions must be met before the third party becomes liable. First, the lender, surety, or other person must advance funds to or for the account of an employer for the "specific purpose" of paying wages. Second, the third party must have "actual notice or knowledge" that the employer does not intend to or will not be able to make timely payment or deposit of withholding taxes.³⁴

The meaning of the phrase "for the specific purpose of paying wages" in section 3505(b) is unclear. It may be urged that the phrase means exclusively for, or restricted to, the purpose of paying wages.³⁵ On the other hand, the phrase may mean "explicitly," but not "exclusively" for the payment of wages. If the former alternative is taken, a third party furnishing funds used in part for the payment of wages would fall outside the ambit of section 3505(b). Any doubt with respect to the meaning of the phrase should be resolved in favor of finding such parties liable for withholding taxes. If courts were to hold that "specific" meant "exclusive," third parties could easily avoid the consequences of section 3505(b) by advancing funds to pay wages along with a nominal sum for other purposes. Yet, such an interpretation may be in accord with at least some of the legislative history. As noted

that the funds are to be used for wages even though the written agreement under which the advances are made states a different purpose. See text accompanying note 35 *infra*.

29. INT. REV. CODE of 1954, § 3505(a).

30. S. REP. NO. 1183, 89th Cong., 2d Sess. 22 (1966).

31. *Id.*

32. INT. REV. CODE of 1954, § 3505(b).

33. *Id.*

34. INT. REV. CODE of 1954, § 3505.

35. "Specific" was defined in *People v. Thomas*, 25 Cal. 2d 880, 898, 156 P.2d 7, 17 (1945) (criminal case involving meaning of specific intent): "restricted, definite, explicit of an exact nature." *Accord*, *People v. Johnson*, 191 Cal. App. 2d 694, 702, 13 Cal. Rptr. 1, 6 (1961).

earlier, Congress intended to exempt the makers of working capital loans from the operation of section 3505. Working capital loans may include funds which are used in part to pay wages³⁶ and therefore, constitute one type of transaction where partial use of funds for wages is outside the purview of section 3505(b). Only working capital loans, however, are recognized as an exemption by the legislative history, and their exclusion does not compel the conclusion that all transactions involving the partial use of funds to pay wages are outside the coverage of section 3505.

To be liable under section 3505(b), a business which advances funds for the specific purpose of paying wages must have "actual notice or knowledge" that the employer receiving the funds does not intend to, or will not be able to make timely payment or deposits of the withholding taxes due. Section 6323(i)(1)³⁷ provides *inter alia* that an organization will be deemed to have actual notice or knowledge of a fact if such a fact is brought to its attention or if the exercise of due diligence would have revealed such a fact.³⁸

The due diligence requirement of section 6323(i)(1) places a burden upon the third party providing funds to make an inquiry concerning the ability or intent of the employer who receives money for the specific purpose of paying wages to pay withholding taxes. If the third party fails to make such an inquiry and the inquiry would have revealed the inability of the employer to pay withholding taxes, the supplier of funds is deemed to have actual knowledge or notice of such facts and is subject to liability under section 3505(b) even though such facts were not brought to his attention.

It is unclear how thorough a third party's investigation must be in order to meet the due diligence requirements. The meaning of due diligence under section 6323(i)(1) has not been litigated.³⁹ Courts faced

36. S. REP. NO. 1708, 89th Cong., 2d Sess. 23 (1966).

37. INT. REV. CODE OF 1954, § 6323(i)(1). The committee reports indicate that § 6323(i)(1) was adopted from the 1962 amendments to the Uniform Commercial Code. S. REP. NO. 1708, 89th Cong., 2d Sess. 14 (1966).

38. The use of the terms "actual notice and knowledge" in § 3505(b) seems misleading, since a party may be charged with liability under the section when he has no real notice or knowledge of an employer's inability to pay withholding taxes or intent not to do so. Thus, the "actual notice and knowledge" test does not establish a party's liability on the basis of his subjective awareness of the situation, but rather according to an objective "reasonable man" standard.

39. Nor have state court decisions construing the Uniform Commercial Code provision from which § 6323(i)(1) was adopted passed on the point. INT. REV. CODE

with this question in differing contexts have indicated that the issue must be decided in each case in light of the relevant circumstances⁴⁰ and on the basis of the degree of diligence normally exercised by a reasonably prudent man.⁴¹ It may be that the very presence of section 3505 imposes a rather heavy burden on the reasonably prudent man. Nevertheless, the duty of the person providing funds to inquire into the affairs of the person receiving funds is not unlimited. The legislative history indicates that the duty of the third person who provides funds to inquire into the intent or ability of the recipient to pay withholding taxes extends only to the time of actual advancement of the funds.⁴²

CONCLUSION

With the passage of section 3505, Congress has removed judicial precedent which obstructed the collection of withholding taxes when contractors or sureties provided funds for wages of another's employees. Unfortunately, the effectiveness of section 3505 may be impaired by the use of inadequate definitions and unclear terminology. Particularly the failure to indicate the meaning of "working capital loan" in the legislative history and the failure to define "specific purpose" under section 3505(b) may stimulate litigation. Litigation may also be precipitated by congressional failure to prescribe how thorough a third party's inquiries must be to satisfy the due diligence requirements of

of 1954, § 6323(i)(1), provides that an organization exercises due diligence, if it maintains reasonable routines for communicating significant information to the person conducting the transaction and there is reasonable compliance with the routine.

40. *Davis v. State*, 245 Ala. 589, 591, 18 So. 2d 282, 284 (1944); *Krieger's Cleaners and Dryers, Inc. v. Benner*, 123 Ohio St. 482, 175 N.E. 857 (1931).

41. In *South Milwaukee Boulevard Heights Co. v. Harte*, 95 Wis. 592, 596, 70 N.W. 821, 822-23 (1897), the court gave an instruction to the jury that "by due diligence is meant such diligence as ordinary prudent men would use. . . ." See also the discussion in A. BROMBERG, *SECURITIES LAW FRAUD* § 7.2(4)(d), at 154.1-154.2 (1969), discussing *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971): "The secondary test for violation . . . as laid down by the Second Circuit in TGS is whether the issuance of the release 'resulted from a lack of due diligence'. The diligence test is applied only if the information is found misleading by the reasonable man test . . ." (Emphasis added.) Liability under the due diligence test may be imposed for mere negligence. *SEC v. Texas Gulf Sulphur Co.*, supra at 860. In order to present a due diligence defense a party must establish that he has put forth the requisite effort; in *Kennedy v. Crawford*, 138 Pa. 561, 569, 21 A. 19, 20 (1890) the court noted, "Due diligence requires some overt effort, it is not satisfied by surrender without attempt."

42. H.R. REP. No. 1184, 89th Cong., 2d Sess. 65 (1966).

section 6323(i)(1). Yet the lack of clarity in section 3505 may serve a positive function. Although clearer definitions might make the section easier to apply, greater precision would probably result in loss of flexibility. Narrow definitions of transactions to which section 3505 applies might tempt parties to devise methods of advancing funds calculated to circumvent those definitions. More flexible, albeit less clear, definitions allow the Commissioner and the courts to shape third party liability for withholding taxes in accordance with the realities of business practices.

Section 3505 imposes heavy burdens on lenders and sureties who advance funds to contractors and other employers. Especially burdensome is the requirement that third persons advancing funds must exercise due diligence in ascertaining whether the funds advanced are to be used specifically for the payment of wages, and if so, whether the recipient has the ability and intent to pay withholding taxes. Third persons subject to potential liability under section 3505 may encounter difficulty in determining the amount of withholding taxes due, since they may not have access to payroll information. Congress, however, was fully warranted in placing liability for the payment of withholding taxes on third parties providing funds for wages in view of the considerable loss of revenue which the Treasury suffered as a result of net payroll financing.⁴³ With the increased use of the subcontracting device, section 3505 will become an increasingly important provision.⁴⁴

43. The construction industry, in which the practice of net payroll financing was most widespread, accounted in 1964 for only five percent of industrial "trust fund" taxes; however, the construction industry accounted for twenty-eight percent of the trust fund uncollectables in that year. *Hearings on H.R. 11256 Before a Subcomm. of the House Comm. on Ways and Means*, 89th Cong., 2d Sess. 83 (1966).

44. As of the date of this article, § 3505 has been applied only twice. In *United States v. Algernon Blair, Inc.*, 441 F.2d 1379 (5th Cir. 1971), the prime contractor paid the wages of its subcontractor's employees. The security interest which was given by Blair to its subcontractor recited in part, "Whereas Whitehead [subcontractor] has performed a portion of said sub-contract and has exhausted its funds and can obtain no financing by which it can meet its payrolls and pay for the material needed to complete said subcontract." *Id.* at 1380. This statement the court felt was conclusive evidence that met the "knowledge of insolvency" requirement. *Id.* at 1381. In addition, the contractor was told a number of times by I.R.S. agents that his subcontractor was not paying taxes due.

The prime contractor fared no better in *United States v. Whilmar Gen. Contractors, P-H 1970 FED. TAXES, EST. & GIFT* (Am. Fed. Tax R.2d) ¶ 70-606 (N.D. Tex. Jan. 29, 1970), where the court held that since the prime contractor had been apprised of the subcontractor's inability to pay withholding taxes, he had actual knowledge within the meaning of § 3505.