Current Federal Tax Developments

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SECTION: 71
LAST MINUTE CHANGES TO SEPARATION AGREEMENT REQUIRED ENTIRE PAYMENT TO BE TREATED AS NOT ALIMONY

Citation: Quintal v. Commissioner, TC Summary Opinion 2017-3, 2/2/17

At first glance the payments made by the taxpayer in the case of *Quintal v. Commissioner*, TC Summary Opinion 2017-3 would appear to be deductible alimony—but last minute changes made to the divorce documents would end up changing the nature of the payments in the view of the Court.

To be deductible alimony a series of cash payments must meet the following initial criteria:

- Such payment is received by (or on behalf of) a spouse under a divorce or separation instrument,
- The divorce or separation instrument does not designate such payment as a payment which is not includible in gross income under this section and not allowable as a deduction under section 215,
- In the case of an individual legally separated from his spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and
- There is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse. [IRC §71(b)(1)]

If the payments meet this criteria they must also not be found to be child support, either by explicitly providing amounts payable for the support of the child/children [IRC §71(c)(1)] or having the payments reduced on the happening of:

- A contingency specified in the instrument relating to a child (such as attaining a specified age, marrying, dying, leaving school, or a similar contingency), or
- At a time which can clearly be associated with a contingency of a kind specified above. [IRC §71(c)(2)]

Mr. Quintal and his former spouse had entered into last minute negotiations in their divorce just before the agreement was signed, making major changes to many exhibits. In one case entire paragraphs of an exhibit were lined through with handwritten statements replacing the deleted items.

The resulting document was, to say the least, not a model of consistency and the rushed nature of the document showed in various ways—including a statement in one exhibit that directed the reader to a special definition of "unemancipated" to be found in the exhibit—except that there was no such definition (it did pop in a totally different exhibit).

Exhibit B was originally titled "Alimony" but was revised to be titled "Unallocated Support." Despite that change the text continue to indicate that the payments were designed to be deductible alimony to Mr. Quintal.

As the opinion notes:

> Exhibit B stated in part that petitioner would "pay to * * * [Ms. Gramlich-Quintal] the sum of $900.00 per week commencing forthwith by implemented wage assignment. (See Exhibit J)" and that "[a]ny alimony payments shall terminate" upon the earlier of the death of petitioner or Ms. Gramlich-Quintal or the latter's remarriage. Exhibit B further stated that the parties "acknowledge that husband anticipates that the above payment is deductible to him and includable to wife".

Changes were also made to the section of the agreement dealing with child support. The Court continues:

> Exhibit J was titled "CUSTODY, SUPPORT, VISITATION". Although exhibit J originally referred to petitioner's obligation to make child support payments, that statement was lined through and was replaced with the phrase "See Exhibit B implemented wage assignment forthwith." Exhibit J included a

> statement acknowledging that, as a result of disabilities, two of the couple's children might never become self-sufficient or emancipated and defined the term "emancipation" of the minor children generally as occurring on the child's death, marriage, entering into military service, or graduation from high school or a four-year college program.

Exhibit J also contained the following statement:

> In accordance with Section 71(b)(1)(B) of the Code, the Husband and Wife expressly agree to designate and hereby do designate all payments required in this Exhibit as excludable and non-deductible payments for purposes of Sections 71 and 215 of the Code, respectively.

The IRS pointed to the above statement, arguing that a proper reading of the revised agreement finds that Exhibit J refers to the payments specified in Exhibit B, and that Exhibit J's language makes the payments not deductible as alimony.

The taxpayer disagrees, as the Court summarized:

> Petitioner relies on exhibit B of the separation agreement, which expressly provides for "unallocated support" payments, as opposed to alimony or child support payments. Noting that exhibit J does not expressly require any form of payment, petitioner avers that the statement in exhibit J that respondent relies upon is not relevant to the question whether the disputed payments constitute alimony. Petitioner further asserts that the parties' last-minute negotiations and revisions to the separation agreement were intended to ensure that the disputed payments would be treated as alimony for purposes of sections 71 and 215.

The Tax Court first holds that the issue of the parties intent is no longer relevant, noting:

> As an initial matter, we reject petitioner's contention that we should evaluate his and Ms. Gramlich-Quintal's intent regarding the characterization of the disputed payments. As we have explained in the past: "Congress eliminated any consideration of intent in determining the deductibility of a payment as alimony in favor of a more straightforward, objective test that rests entirely on the fulfillment of explicit requirements set forth in section 71." See *Okerson v. Commissioner*, 123 T.C. 258, 264-265 (2004) (citing *Hoover v. Commissioner*, 102 F.3d 842, 844-845 (6th Cir. 1996), *aff'g* T.C. Memo. 1995-183).

Rather the decision rests on interpreting the document as written:

> Under the circumstances, we focus on the requirement in section 71(b)(1)(B) that the settlement agreement not state that the payment is neither includible in gross income nor allowable as a deduction. We acknowledge, as petitioner contends, that exhibit J does not expressly require any payment or otherwise fix an amount to be paid as alimony or child support. Petitioner's narrow focus on this aspect of exhibit J, however, gives no effect to the cross-references in exhibits B and J. As we see it, a proper consideration of the separation agreement requires a construction of the document as a whole, including the exhibits and the cross-references within the exhibits. "Where a separation agreement sets the parties' support obligations, the language of the contract, if plain and unambiguous, must be construed in accordance with its ordinary and usual sense." *Shaw v. Turcotte*, 922 N.E.2d 179, 2010 WL 565388, at *2 (Mass. App. Ct. 2010) (quoting *Larson v. Larson*, 28 Mass. App. Ct. 338, 340 (1990)).
>
> Reading the separation agreement as a whole, we conclude that exhibits B and J must be read in tandem and that the unallocated support payments prescribed in exhibit B are subject to the provisions of both that exhibit and exhibit J. In this regard, the handwritten revisions to the settlement agreement were poorly conceived. Specifically, although exhibit B was revised to state that the parties "acknowledge that husband anticipates that the above [unallocated support] payment is deductible to him and includable to wife" (emphasis added), exhibit J states more definitively: "In accordance with Section 71(b)(1)(B) of the Code, the Husband and Wife expressly agree to designate and hereby do designate all payments required in this Exhibit as excludable and non-deductible payments for purposes of Sections 71 and 215 of the Code, respectively." We conclude that the latter, more definitive statement

controls in this case. Because the settlement agreement provides that the unallocated support payments are excludable from income and not allowable as deductions, it follows that the payments do not satisfy the definition of alimony under section 71(b)(1)(B).

SECTION: 106
FIXED INDEMNITY MEDICAL PLAN PAYMENTS ARE TAXABLE AS WAGES WHEN RECEIVED IF PREMIUMS WERE NOT PAID FROM AFTER-TAX FUNDS

Citation: Chief Counsel Advice 201703013, 1/20/17

Normally employees who have employer paid health insurance (or who pay for such insurance via §125 cafeteria plans) do not include either the premiums nor the medical costs paid by the policy as income. But in Chief Counsel Advice 201703013 we are reminded that this treatment will not apply for payments from fixed indemnity health plans.

For traditional health plans the plan reimburses only amounts actually paid (or billed) for medical care incurred by the covered individual. However, a fixed indemnity plan is different, as explained in the memorandum:

> A fixed indemnity health plan is a plan that pays covered individuals a specified amount of cash for the occurrence of certain health-related events, such as office visits or days in the hospital. The amount paid is not related to the amount of any medical expense incurred or coordinated with other health coverage.

The fact that the amount is paid regardless of the amount of expense incurred changes the tax treatment of the payment. As the memorandum notes:

> In general, § 106(a) provides that gross income of an employee does not include employer-provided coverage under an accident or health plan. Under § 106(a), an employee may exclude from income premiums for accident or health insurance coverage that are paid by an employer. Also, under § 105(b), an employee may exclude amounts received through employer-provided accident or health insurance if those amounts are paid to reimburse expenses incurred by the employee for medical care (of the employee, the employee's spouse, or the employee's dependents, as well as children of the employee who are not dependents but have not attained age 27 by the end of the taxable year) for personal injuries and sickness. To the extent amounts received through employer-provided accident or health insurance are paid without regard to the amount of expenses incurred by the employee for medical care, the amounts are not excluded from gross income because the amounts are not paid to reimburse expenses incurred by the employee for personal injuries and sickness.

The memorandum seeks to answer two questions. The first one is stated as follows:

> Are payments received by an employee from an employer under a fixed indemnity health plan excludible from the employee's income under § 105 of the Code?

Based on the above analysis, the memorandum provides the following answer:

> An employer may not exclude from an employee's gross income payments under an employer-provided fixed indemnity health plan if the value of the coverage was excluded from the employee's gross income and wages.

The second question posed was:

> Are payments received by an employee from an employer under a fixed indemnity health plan excludible from the employee's income under § 105 of the Code if the amounts paid by the employee (employee premiums) for coverage under the fixed indemnity health plan were made by salary reduction through a § 125 cafeteria plan (and thereby not included in the employee's compensation income at the time the amounts were paid)?

With the answer being:

> An employer may not exclude from an employee's gross income payments under an employer-provided fixed indemnity health plan if the premiums for the fixed indemnity health plan were originally made by salary reduction through a § 125 cafeteria plan.

The following examples, adapted from the memorandum, illustrate the application of the law in the eyes of the author of the memorandum.

EXAMPLE 1

An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a fixed indemnity health plan that would qualify as an accident and health plan under § 106 of the Code. Employees pay premiums for the plan by deducting the amount of the premium each pay period from the employee's salary; the amount of the deducted premium is included in gross income and wages for federal tax purposes, notwithstanding that the plan would qualify as an accident and health plan under § 106. The fixed indemnity health plan pays employees $100 for each medical office visit, and $200 for each day in the hospital, without regard to the amount of medical expenses otherwise incurred by the employee.

Because the premiums for the fixed indemnity health plan are included in the employee's gross income and wages (and thus paid with after-tax dollars), amounts paid by the plan are excluded from gross income and wages under § 104(a)(3).

EXAMPLE 2

The facts are the same as Example 1 except that the employer provides the coverage to the employees at no cost to the employee.

Because the premiums for the fixed indemnity health plan are paid with amounts that are not included in the employee's gross income and wages, the exclusions under §§ 105(b) and 104(a)(3) do not apply to the payments and any amount paid by the plan are included in the employee's gross income and wages, regardless of the amount of any medical expenses incurred by the employee upon which the payment is conditioned.

EXAMPLE 3

Instead of the employer providing the coverage at no cost as in Example 2, employees electing to participate in the fixed indemnity health plan pay premiums by salary reduction through a § 125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid).

For the same reasons as are provided for Example 2, the benefits received must be included in the employee's gross income and wages regardless of any medical expenses actually incurred.

EXAMPLE 4

An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a "wellness plan" that qualifies as an accident and health plan under § 106. Employees electing to participate in the wellness plan pay an employee contribution by salary reduction through a § 125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid). The wellness plan pays employees a fixed indemnity cash payment benefit of $100 for completing a health risk assessment, $100 for participating in certain prescribed health screenings, and $100 for participating in other prescribed preventive care activities, without regard to the amount of medical expenses otherwise incurred by the employee.

Because the premiums for the wellness plan are paid with amounts that are not included in the employee's gross income and wages, the exclusions under §§ 105(b) and 104(a)(3) do not apply to the fixed indemnity cash benefit payments and any payments are included in the employee's gross income and wages, regardless of the amount of any medical expenses incurred by the employee upon which the payment is conditioned.

EXAMPLE 5

An employer provides all employees, regardless of enrollment in other comprehensive health coverage, with the ability to enroll in coverage under a wellness plan that qualifies as an accident and health plan under § 106. Employees electing to participate in the wellness plan make an employee contribution by salary reduction through a § 125 cafeteria plan (and therefore the amount of the salary reduction is not included in compensation income at the time the salary would otherwise have been paid). The wellness plan pays employees a fixed indemnity cash payment benefit each pay period (for example, equal to a percentage of the salary payable for the pay period) for participating in the wellness plan, without regard to the amount of medical expenses otherwise incurred.

As with Example 4, the benefits are going to be included in gross income and wages for the same reasons. When the premiums are not included in income when paid, the benefits will be included in income when received.

SECTION: 460
CONTRACT, WHETHER A CONSTRUCTION OR MANUFACTURING CONTRACT, WAS REQUIRED TO BE REPORTED ON PERCENTAGE OF COMPLETION BASIS

Citation: Basic Engineering, Inc. v. Commissioner, TC Memo 2017-26, 2/1/17

While most practitioners likely think of the tax percentage of completion method of accounting as something only affecting construction contractors, in fact such provisions can impact other types of contracts under certain conditions. In the case of *Basic Engineering, Inc. v. Commissioner*, TC Memo 2017-26 the key issue was whether the contract the taxpayer had was really not a construction contract and, if not, whether it would still be required to be accounted for under the percentage of completion method of accounting for tax purposes.

The case involved two contracts where the taxpayer was hired to assist in constructing refineries. In each case the taxpayer was hired to help in removing and refurbishing equipment in a refinery in the United States, transporting the equipment to a distant location (Bulgaria in one case, Pakistan in another), installing the equipment in new refinery and, finally, testing the equipment to get it certified to be used in production.

The Internal Revenue Code taxes long-term contracts pursuant to IRC §460 and normally requires the use of the percentage of completion method of accounting to record income over the term of the contract. A long-term contract is defined as one where work begins in one tax year but ends in a later tax year.

There are two potentially applicable exceptions to the requirement to use the percentage of completion method of accounting.

- Manufacturing contracts are exempt unless the contract involves the manufacture of:
    - Any unique item of a type not normally included in the finished goods inventory of the taxpayer *or*
    - Any item which normally requires more than 12 months to complete
- Certain construction contracts are exempted if:
    - The taxpayer estimates, at the time the contract is entered into, that the contract will take less than 2 years to complete *and*
    - The taxpayer's average annual gross receipts for the three years before the contract is entered into do not exceed $10 million

The taxpayer argued initially that this was a manufacturing contract rather than a construction contract—they had primarily been engage to refurbish the refinery equipment which the taxpayer argued was a manufacturing activity.

The Tax Court, however, found that if the contract was viewed as a manufacturing contract it would fail the 12 month test, noting:

> At issue are two contracts -- each for the disassembly, transportation, refurbishing, assembly, and certification of a new oil refinery. Petitioner introduced sufficient evidence, corroborated by the testimony of Mr. Balke, showing that the processes involved normally require more than 12 calendar months to complete. Respondent's expert, Mr. Harris, agreed, stating that the assembly process alone "could hardly be expected in less than one year." Assuming without finding that these contracts are for the manufacture of two oil refineries, each would fall under the section 460(f)(2)(B) requirement that it be treated as a long-term contract under section 460 and thus generally accounted for using the percentage of completion method of accounting.

Since the taxpayer's average annual gross receipts were less than $10 million for the three prior years the Court did consider whether, if they were construction contracts, they could qualify for the exception for those contracts. That would require that the taxpayer could show that it reasonably estimated the contracts would be completed within 24 months from the date the contract was entered into.

The Court found that the evidence indicated that the taxpayers could not show that reasonable estimate. The Court, taking the testimony the experts, found that the projects could not be completed within that time frame. While it is possible the equipment could be refurbished within that time frame, the Court noted that the taxpayer's obligations did not end at that time.

Once the refurbishment was completed, the equipment had to be transported to Bulgaria in one case and Pakistan in the other. The simple shipping of the equipment to the new refinery location would take many months, along with the assembly process and then an extended testing/certification period. The Court found that the math simply didn't work to make it feasible to have assumed these projects could have been completed within 2 years.

The Court also imposed the 20% accuracy related penalty for substantial understatement of tax on the taxpayer in this case, declining to agree with the taxpayer that it had reasonable cause for its reporting. The taxpayer noted that this was a complex area of tax law—a statement that certainly appears reasonable.

The taxpayer argued that it had relied upon the CPA who had prepared the returns for the year in question. But the taxpayer could not show that it had relied on the CPA's advice with regard to the use of a proper method for reporting such contracts.

As the opinion notes:

> Petitioner used the services of the same CPA from at least 2005 through 2010. However, the only evidence of petitioner's reliance upon professional advice rendered by its CPA is the fact that its Federal income tax returns were filed. Nothing in the record indicates that petitioner either requested of or received from its CPA advice regarding the application of the long-term contract exception under section 460(e) to the Petromaxx or Amber SPAs. Based on the absence of evidence indicating that petitioner even addressed this issue with its CPA, the Court cannot find that it exercised ordinary business care and prudence here.

SECTION: 6038
TAXPAYER DID NOT HAVE REASONABLE CAUSE FOR FAILURE TO FILE FORMS 5471

Citation: Flume v. Commissioner, TC Memo 2017-21, 1/31/17

Edward Flume was looking at penalties for failing to file Forms 5471 from 2001 through 2009, with the total penalties the IRS was looking to collect over that time amounting to $110,000. In the case of *Flume v.*

Commissioner, TC Memo 2017-21 the taxpayer argued as one defense that he should be excused from any penalties based on reasonable cause for reliance on a tax professional.

As the Tax Court notes, the Internal Revenue Code imposes a requirement for a U.S. person who controls a foreign corporation to report certain information each year, with Form 5471 being used to report that information. The Court goes on to explain:

> A person controls a foreign corporation if he owns or constructively owns stock that is more than 50% of the total combined voting power of all classes of voting stock or owns more than 50% of the total value of shares of all classes of stock. Sec. 6038(e)(2). A U.S. person must furnish, with respect to any foreign corporation which that person controls, information that the Secretary may prescribe. Sec. 6038(a)(1). Form 5471 and the accompanying schedules are used to satisfy the section 6038 reporting requirements. The Form 5471 must be filed with the U.S. person's timely filed Federal income tax return. Sec. 1.6038-2(i), Income Tax Regs.
>
> Additionally, the information reporting requirements prescribed in section 6038(a)(1) also are imposed on any U.S. person treated as a U.S. shareholder of a corporation that was a CFC for an uninterrupted period of 30 days during its annual accounting period and who owned stock in the CFC on the last day of the CFC's annual accounting period. Secs. 951(a)(1), (b), 6038(a)(4); see also Rev. Proc. 92-70, sec. 2, 1992-2 C.B. 435, 436. A U.S. shareholder, with respect to any foreign corporation, is a U.S. person who owns under section 958(a), or is considered as owning under section 958(b), 10% or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation. Sec. 951(b).
>
> Section 6046 requires information reporting by each U.S. citizen or resident who is at any time an officer or director of a foreign corporation, where more than 10% (by vote or value) of stock is owned by a U.S. person. Sec. 6046(a)(1)(A). The stock ownership threshold is met if a U.S. person owns 10% or more of the total value of the foreign corporation's stock or 10% or more of the total combined voting power of all classes of stock with voting rights. Sec. 6046(a)(2). A U.S. person who disposes of sufficient stock in the foreign corporation to reduce his interest to less than the stock ownership requirement is required to provide certain information with respect to the foreign corporation. Sec. 1.6046-1(c)(1)(ii)(c), Income Tax Regs.

A failure to comply with the requirements exposes the individual to substantial penalties. As the Court notes:

> When a taxpayer, who was required to do so, fails to complete and file a Form 5471 on time, a fixed penalty of $10,000 per foreign corporation per annual accounting period is imposed. Secs. 6038(b)(1), 6679. If any failure to provide the required information continues for more than 90 days after the day on which the Secretary mails notice of the failure to the U.S. person, the person shall pay a penalty (in addition to the amount required under section 6038(b)(1)) of $10,000 for each 30-day period, or fraction thereof, during which the failure continues with respect to any annual accounting period after the expiration of the 90-day period; however, the increase in any penalty under section 6038(b)(2) shall not exceed $50,000. Sec. 6038(b)(2). Similar penalties apply for failure to timely file Form 5471 or otherwise provide the information required by section 6046 with respect to an annual accounting period. See secs. 6046(f), 6679(a).

The Court determined that Mr. Flume had been required to file such forms but, in fact, failed to do so for the years in question.

Mr. Flume argued that he should not penalized, as his behavior should qualify as his failure to provide the information was due to "reasonable cause" as provided for in IRC §6038(c)(4)(B).

The Tax Court determined the bar that Mr. Flume would have to clear to show reasonable cause which it described as follows:

> Although there are no regulations defining "reasonable cause" within the specific context of section 6038, the few cases that have confronted this issue have adopted the Supreme Court's definition as

> stated in *United States v. Boyle*, 469 U.S. 241, 246 (1985). See, e.g., *Congdon v. United States*, No. 4:09-CV-289, 2011 WL 3880524, at *2 (E.D. Tex. Aug. 11, 2011); *In re Wyly*, 552 B.R. 338, 442 (Bankr. N.D. Tex. 2016). That is that a taxpayer must demonstrate that he exercised ordinary business care and prudence but nevertheless was unable to file within the prescribed time. *Boyle*, 469 U.S. at 246. Similar rules apply with respect to the civil penalties imposed under section 6679 for failure to file information required under section 6046. Sec. 6679(a)(1); sec. 301.6679-1(a), Proced. & Admin. Regs. If a taxpayer exercises ordinary business care and prudence and is nevertheless unable to obtain and provide the required information, a failure to file will be considered to be due to reasonable cause. Sec. 301.6679-1(a)(3), Proced. & Admin. Regs.

The taxpayer attempted to show that he had exercised such ordinary business care and prudence since he had hired a tax professional to prepare his returns for the years in question. As the opinion notes:

> Petitioner hired Leonard Purcell, a tax preparation firm in Mexico, to prepare his tax returns during the years in issue. Adriana Luna, a Leonard Purcell employee, prepared petitioner's tax returns.

Ms. Luna had not prepared Forms 5471 nor had she advised Mr. Flume that he needed to file such forms.

However, the Court found that there were problems with his claimed reliance on Ms. Luna. One key fact was that Mr. Flume had not actually informed Ms. Luna that he owned interests in the corporations until approximately 2008. He also testified that he was not aware of Ms. Luna's qualifications.

To be able to show reasonable cause in such matters, the taxpayer generally must show that:

- The taxpayer had engaged the prepare to advise him/her on the matter in question;
- He/she had made reasonable inquiries to assure him/herself that the selected preparer had the proper expertise to give advice on the matter in question;
- The taxpayer provided the preparer with all information necessary for the preparer to advise on the situation and
- The taxpayer actually relied on the advice given.

In this case the taxpayer had neither shown he had made a reasonable inquiry to determine Ms. Luna was qualified to advise on this issue, nor had given her the information necessary for her to provide advice on the matter. Thus, the Court found that Mr. Flume had not demonstrated reasonable cause for his failure to file the Forms 5471.

SECTION: 6672
NO REASONABLE CAUSE DEFENSE TO TRUST FUND PENALTY ALLOWED IN NINTH CIRCUIT, CEO LIABLE FOR RESPONSIBLE PERSON PENALTY

Citation: United States v. Liddle, 119 AFTR 2d ¶2017-381 (USDC, ND CA), 1/23/17

In the case of *United States v. Liddle*, 119 AFTR 2d ¶2017-381 (USDC, ND CA) the CEO of two different companies that each had failed to remit trust fund taxes argued that while he was clearly a responsible person for purposes of the trust fund penalty, he should not be liable because he had acted with reasonable cause.

Some Circuit Courts of Appeal have taken the position that a responsible person may be relieved of liability for the trust fund recovery penalty under IRC §6672 based on a reasonable cause defense.

As the District Court opinion notes:

> The Second Circuit recognizes a reasonable cause defense to liability under § 6672 where the responsible person reasonably believed the trust fund taxes were being paid. See *Winter v. United States*, 196 F.3d 339, 345 (2d Cir. 1999). The Fifth Circuit has found reasonable cause where the responsible party relied upon advice of counsel. See *Newsome v. United States*, 431 F.2d 742, 748 (5th Cir. 1970). The Tenth Circuit applies the defense where the responsible person's efforts to pay the taxes

have been frustrated by circumstances outside his or her control. See *Smith v. United States*, 555 F.3d 1158, 1170 (10th Cir. 2009).

In this case the taxpayer became aware that the first company (Home Director Technologies, Inc.) had failed to pay its trust fund taxes in October or November of 2004. The taxpayer discussed the matter with the CFO of the company and the Board of Directors. While the Board passed a resolution that the company would pay its trust fund taxes and not allow them to go unpaid in the future, the CEO, CFO, and other company officials decided to pay payroll and other operating expenses while the trust fund taxes remain unpaid.

The same person that was CFO of Home Director Technologies, Inc. was also the CFO of Home Director, Inc., a company that Liddle was also the CEO of from January 1, 2007 through March 31, 2008. By September of 2007 he became aware this company had also fallen behind in paying trust fund taxes while it was receiving revenue and paying other corporate obligations including payroll.

The Court noted:

> The United States has presented evidence that Liddle learned of Home Director Technologies, Inc.'s failure to pay trust fund taxes at latest by October or November 2004. Liddle Dep. 7816-80:7, Exh. 3 to Sampson Decl., ECF 36-6. However, instead of ensuring that all available corporate funds were remitted to the federal government to pay down the delinquency, Liddle authorized use of corporate funds to satisfy payroll and operating expenses. Form 4180, Report of Interview with Individual Relative to Trust Fund Recovery Penalty at 4, Exh. 23 to Nicholas Decl., ECF 36-26; Stemm Dep. 65:22-25, 74:1-16, Exh. 7 to Sampson Decl., ECF 36-10.
>
> The United States also has presented evidence that Liddle learned of Home Director, Inc.'s failure to pay trust fund taxes at latest by September 30, 2007. Liddle RFA 59, Exh. 1 to Sampson Decl., ECF 36-4. After learning of the delinquency, Liddle permitted Home Director, Inc.'s funds to be used to pay payroll and other expenses rather than to pay the overdue trust fund taxes. Liddle Dep. 230:2-231:17, Exh. 3 to Sampson Decl., ECF 36-6.
>
> … Moreover, because Stemm acted as the CFO for both companies, Liddle had a duty to be particularly vigilant with respect to the trust fund tax obligations of Home Director, Inc. given his knowledge of Stemm's previous failure to pay trust fund taxes for Home Director Technologies, Inc. See *Leuschner*, 336 F.2d at 248.

Given these facts, it's not clear that the CEO's actions would have been deemed reasonable cause under the standards applied in the three cases in other Circuits that the taxpayer pointed to.

But the Court notes that the Ninth Circuit Court of Appeals, the Court of Appeals that would have jurisdiction to hear an appeal of this decision, simply doesn't recognize any reasonable cause defense to the trust fund penalty.

The opinion notes, citing Ninth Circuit holdings:

> "Willfulness, within the meaning of section 6672, has been defined as a voluntary, conscious and intentional act to prefer other creditors over the United States." *Davis*, 961 F.2d at 871 (internal quotation marks and citations omitted). "An intent to defraud the government or other bad motive need not be proven." *Id*. Thus "conduct motivated by a reasonable cause may nonetheless be willful." Id.

The opinion continues:

> In the Ninth Circuit, even "'reckless disregard' of whether the taxes are being paid over, as distinguished from actual knowledge of whether they are being paid over, may suffice to establish willfulness." *Phillips*, 73 F.3d at 942. The Ninth Circuit held in *United States v. Leuschner* that where a CEO knew that the company's controller previously had failed to pay trust fund taxes on behalf of a different company at which both the CEO and controller had worked in the past, the CEO's failure to take action to prevent a recurrence at the second company was willfulness as a matter of law. *United States v. Leuschner*, 336 F.2d 246, 248 (9th Cir. 1964).

A responsible person may be liable for unpaid trust fund taxes that accrued before he became aware of the delinquency. In *Davis*, the Ninth Circuit held that the company's president was subject to penalty under § 6672 even if he lacked knowledge of the company's failure to pay trust fund taxes until after they were due, because after learning of the delinquency he used company funds to satisfy other creditors rather than to pay the past-due taxes. *Davis*, 961 F.2d at 876. The rule has been summarized as follows: "If a responsible person knows that withholding taxes are delinquent, and uses corporate funds to pay other expenses, even to meet the payroll out of personal funds he lends the corporation, our precedents require that the failure to pay withholding taxes be deemed 'willful.'" *Phillips* 73 F.3d at 942.

The Ninth Circuit has recognized that the standards articulated above "may seem oppressive to the employer and employees," and may result in liability where the defendant is "unwittingly" willful. *Phillips*, 73 F.3d at 942. However, the Court has applied these "harsh, even somewhat counter-intuitive" standards because "it is the law." *Buffalow*, 109 F.3d at 573.

The Court found that the CEO was liable personally for the unpaid trust fund taxes.