# When Are Hard Times Hard Enough (for the IRS)? Examining Financial Distress as Reasonable Cause for Penalty Mitigation During an Economic Downturn

*By Hale E. Sheppard*

Hale E. Sheppard provides businesses and their tax representatives with the ammunition they need to mount a valiant (and hopefully successful) financial-distress defense to civil tax penalties.

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## Introduction

If one works in the tax-dispute arena long enough, a degree of cynicism often develops. This is not surprising given that nearly every taxpayer that one encounters has a plethora of reasons, some more credible than others, for not complying with the law. As the national, state and local economies continue to struggle, one *legitimate* justification for late payment of taxes is being raised by businesses with increasing frequency: financial distress. This phenomenon is commonly expressed in the following ways: "There simply wasn't enough money to go around," "The business couldn't give the IRS what it didn't have," or "We would have been forced into bankruptcy if the business had paid its taxes on time."

The good news is that the tax code, regulations, INTERNAL REVENUE MANUAL, and case law expressly recognize the financial-distress-merits-penalty-waiver argument. The bad news is that the IRS often rejects this contention. Such rejection might be attributable to intransigence by the IRS, but the taxpayer's own shortcomings are the more likely culprit in many instances. For example, the business may fail to utilize the IRS's recent public statements about helping downtrodden taxpayers to its advantage, ignore or misunderstand the fact-intensive law that could potentially bolster its case, and/or neglect to present the facts of its unique case such that they fall within the accepted parameters. As an increasing number of taxpayers face genuine financial distress amid this floundering economy, and as the IRS and other taxing agencies continue their campaigns to snatch all possible revenue to replenish the public coffers, this article seeks to provide businesses and their tax representatives with the ammunition they need to mount a valiant (and hopefully successful) financial-distress defense to civil tax penalties.[1]

## Helping Struggling Taxpayers—The IRS's Public Stance

The IRS has publicly committed itself to assisting beleaguered taxpayers. According to a recent report by the Treasury Inspector General for Tax Adminis-

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tration (TIGTA), the IRS took a proactive approach in late 2008 by establishing teams and tasking them with determining what additional actions the IRS could take to assist taxpayers facing economic challenges.[2] The ideas generated by these teams were initially summarized in the so-called Economic Challenges Action Plan and later disseminated to taxpayers, return preparers and IRS employees through various outlets.[3]

The TIGTA report identifies as one of the IRS's major communication efforts a news release in January 2009, which highlighted several steps that this agency intended to take. These included (1) increasing the period for terminating an installment agreement from 30 days to 60 days after a taxpayer misses a scheduled payment; (2) obtaining an independent review of home-value information where such value is the only issue impeding the IRS's acceptance of a taxpayer's settlement offer; (3) temporarily postponing collection action without reviewing full financial documentation in situations where the taxpayer has recently lost a job, relies solely on Social Security payments and/or faces significant medical bills; and (4) introducing expedited levy release procedures where the levy is causing an economic hardship for the taxpayer.[4] The news release in January 2009 also contained several pro-taxpayer comments by the IRS Commissioner, such as "We are creating new protections to help people trying to meet their tax obligations," "The IRS will do everything it can during these tough times," and "We want to go that extra mile to help taxpayers, especially those who've done the right thing in the past and are facing unusual hardships."[5]

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Predictably, the development of the Economic Challenges Action Plan and issuance of the IRS news release coincided with a congressional hearing in February 2009 before the Ways and Means Committee of the U.S. House of Representatives. The event, which was aptly named "Hearing on IRS Assistance for Taxpayers Experiencing Economic Difficulties," benefitted from contributions by several high-ranking IRS officials and other experts. During the hearing, both the IRS Commissioner and the Deputy Commissioner for Services and Enforcement recognized that the IRS should adjust its methods during the current economic crisis. Together, their words contain little ambiguity in this regard:

> Our effort to assist taxpayers during these difficult times is a confirmation of part of the IRS' core mission, which is to assist taxpayers in any way possible to meet their obligations ... . The IRS is committed to assisting America's taxpayers in any way it can during this difficult time. We understand that given the fragile state of the economy and the financial duress of many individuals, we may need to go even further. You have my commitment and that of Commissioner Shulman to work closely with you as we move forward.[6]

> [I]t is inevitable that during an economic downturn, taxpayers may fall behind in paying their taxes. As IRS Commissioner, I am committed to striking the right balance between collecting the revenues needed to fund the government, and using all the tools available to us to work with taxpayers who find themselves in difficult financial situations.[7]

Nina Olson, the National Taxpayer Advocate, took similar positions at the congressional hearing, urging the IRS to soften its tactics during the economic downturn:

> The IRS itself faces a difficult challenge in balancing its mission of collecting the tax revenue that our government requires to function with the fair and compassionate treatment of taxpayers who, for whatever reason, are unable to pay their tax bills. The nature of the challenge is no different in a recession, but the number of affected taxpayers is obviously much greater. The IRS has tools it can use to help these taxpayers, and it is now more important than ever that it use these tools appropriately and compassionately.
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> The general premise under which the IRS operates is that taxpayers should pay the full amount of the tax liabilities they owe. In my view, this general premise is correct. But there are times

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> when taxpayers experience financial difficulties and cannot reasonably pay their tax liabilities in full—or sometimes even at all. This may happen if a taxpayer has lost a job, becomes disabled, or experiences some other major financial setback. When this happens, the IRS's goal should be to collect as much of the tax as possible without imposing an undue financial burden on the taxpayer or the taxpayer's family.[8]

The IRS's official tune has not changed over time. Indeed, the IRS issued another news release in March 2010. Like the earlier release in January 2009, this one was replete with pro-taxpayer statements from IRS leadership, including, "Times are tough for many people, and the IRS wants to do everything it can to help people who have lost their job or face financial strain," and "We're doing everything we can to help ease the burden on struggling taxpayers."[9]

With one notable exception, discussed below, the recent TIGTA report concludes that the IRS has effectively implemented or reemphasized tax collection options that tend to help economically distressed taxpayers.[10]

## What to Do About Penalties–The IRS's Private Posture

As is so often the case, perhaps the most telling aspect is what was *omitted* from the two IRS news releases, congressional testimony and other public information. Conspicuously absent from these sources was the IRS's plan regarding the (potentially huge) penalties that continue to accrue against taxpayers who make late tax payments because of financial distress. The TIGTA report acknowledges that the IRS historically has had authority to abate penalties in cases where a taxpayer lacks the necessary funds to make timely tax payments, provided that the taxpayer can demonstrate that the financial shortfall occurred despite exercising ordinary business care and prudence.[11] The IRS apparently posted an "internal communication" in May 2009 reminding its employees of penalty abatement procedures and standards.[12]

For many taxpayers and their representatives, the problem arises from the fact that this posting of an "internal communication" about such a critical, pervasive issue seems to have missed the mark. More specifically, portions of the intended audience (*i.e.*, IRS employees in charge of collection actions, penalty abatement requests, *etc.*) are either unaware of the "internal communication" or simply choose to disregard it. This is evident from language contained in certain abatement-rejection letters issued by the IRS in 2010. The IRS letters contain the following erroneous statement or some variation thereof:

> You explained that you were unable to make your federal tax deposit on time because you lacked the necessary funds. You explained you did not have the funds because you had pressing business expenses. *We can understand your problem, but a lack of funds is not an acceptable reason for failing to deposit on time.* The money you withhold from the salaries of your employees must be treated as a trust fund and must be deposited timely.[13]

Acknowledging the law, analyzing the unique facts of a case, and determining that penalty abatement is inappropriate in a particular case is one thing, but outright rejection of legitimate abatement claims because of ignorance of the proper legal standards is quite another. This situation is particularly troubling when one realizes that if the taxpayer lacks the funds to pay the tax-related penalties, the taxpayer also generally lacks the funds to mount a serious dispute if the IRS wrongly denies the penalty abatement claim. In light of this apparent disconnect between the IRS's public stance and private actions, and cognizant of the financial constraints to forcing an issue into tax litigation, it is pivotal that taxpayers and their representatives grasp the applicable law. Indeed, who but the foolhardy would start a fight with a tax agency without knowing the true extent of one's ammunition?

## Analysis of the Law–Sizing up the Abatement Ammunition

Before advancing a penalty abatement issue, one must first identify and fully understand the relevant law. This may seem like a straightforward task at the outset, but it often proves to be extremely challenging in this age of *unregulated* Internet tax sites, blogs by self-professed tax gurus, webinars, infomercials, television ads featuring "paid actor portrayals" on behalf of supposed tax representation specialists and tax forums galore. In an effort to offset the contradictory, incomplete and often inaccurate guidance generated by these sources, the relevant law (with actual citations for the sake of accountability) is examined below.

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## Tax Provisions, Regulations and IRS Policies

Under Code Sec. 6651, the IRS may generally assert so-called delinquency penalties if a taxpayer fails to file certain returns and/or pay the corresponding taxes by the deadline. Moreover, pursuant to Code Sec. 6656, the IRS may assert federal tax deposit (FTD) penalties if a taxpayer fails to pay employment taxes in full, on time and in the manner required. The IRS cannot impose these sanctions, however, if the taxpayer manages to show that the infraction was due to "reasonable cause" and not due to "willful neglect."[14]

The Internal Revenue Manual contemplates reasonable cause in situations where the taxpayer's justification for late payment is tough economic times. On this note, the IRS adopted an official "policy statement" nearly 40 years ago, in 1970, to the effect that "lack of funds" constitutes reasonable cause for penalty abatement, as long as the taxpayer shows that the shortage happened even though it used ordinary business case and prudence.[15]

Like the IRS's longstanding "policy statement," the tax regulations also identify a bad economy as a potential reason for abatement. Excessive block-quoting can fatigue even the most avid tax fanatic; however, given that the regulations under Code Sec. 6651 form the foundation for all the taxpayer-favorable court decisions discussed later in this article, a significant portion of the relevant regulation is set forth below:

> A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship ... if he paid on the due date.
>
> [C]onsideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax.
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> Thus, for example, a taxpayer who incurs lavish or extravagant living expenses in an amount such that the remainder of his assets and anticipated income will be insufficient to pay his tax, has not exercised ordinary business care and prudence in providing for the payment of his tax liability.
>
> Further, a taxpayer who invests funds in speculative or illiquid assets has not exercised ordinary business care and prudence in providing for the payment of his tax liability unless, at the time of the investment, the remainder of the taxpayer's assets and estimated income will be sufficient to pay his tax or it can be reasonably foreseen that the speculative or illiquid investment made by the taxpayer can be utilized (by sale or as security for a loan) to realize sufficient funds to satisfy the tax liability.
>
> A taxpayer will be considered to have exercised ordinary business care and prudence if he made reasonable efforts to conserve sufficient assets in marketable form to satisfy his tax liability and nevertheless was unable to pay all or a portion of the tax when it became due.[16]

The regulations clarify that the IRS may be more stringent with trust fund items (such as employment taxes) than with income taxes; that is, the IRS will take into consideration the type of tax at issue in determining whether it was reasonable for a taxpayer to pay late.[17] In this regard, the regulations state that facts and circumstances constituting reasonable cause for nonpayment of *income* taxes may not represent reasonable cause for failure to pay over to the IRS taxes withheld from other persons (*i.e.*, trust fund taxes).[18]

## Taxpayer-Favorable Case Law

Consistent with the IRS's 40-year-old policy and the regulations described above, numerous courts at various levels (*i.e.*, federal district courts, courts of appeals and bankruptcy courts) have expressly recognized that an economic recession or other event causing unforeseen financial difficulties for taxpayers may constitute reasonable cause.[19] One court, based on its review of judicial precedent existing as of 2004, identified the following guidelines: Courts are more inclined to find that financial difficulties warrant penalty abatement when (1) a real choice existed between making payments to the IRS and going out of business, (2) the taxpayers believed that the crisis would be alleviated by the occurrence of one or more specific contingencies, (3) the duration

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of the financial crisis was limited, (4) the taxpayer did not unfairly favor other creditors over the IRS, (5) personal resources were contributed to avoid business collapse, and (6) the taxpayer was unjustly enriching neither itself nor or its owners.[20]

As one court astutely pointed out, "[a]lmost every non-willful failure to pay taxes is the result of financial difficulties."[21] The financial-distress-merits-penalty-waiver argument, therefore, is often raised by taxpayers. It is often rejected by the IRS, and the courts too, mainly because the taxpayer either fails to effectively argue the applicable law or fails to present its facts in a manner that would place its case within the scope of such law. At least five cases exist in which the court found that penalty relief was warranted. These cases are examined below in chronological order.

### *Glenwal-Schmidt*

The taxpayer in *Glenwal-Schmidt* was involved in the construction business.[22] The company contracted with the U.S. Navy to design and build family housing in Puerto Rico. Under the agreement, the Navy was to pay the company an initial lump sum, followed by monthly progress payments. The project lasted approximately three years, from 1972 to 1975. During this period, various disputes arose, resulting in the Navy withholding portions of the progress payments. The contract contained a dispute-resolution mechanism, which mandated that, in case of a rift between the parties, the company could not start an administrative or judicial appeal until after the Navy's Contracting Office had made a final decision. The Contracting Office never made a decision during the project; therefore, the company was contractually bound to continue working despite the lack of payment. At the time it entered into the contract with the Navy, the company knew it would have a tax liability, knew that the Navy had the contractual right to withhold money for liquidated damages and defective work, and knew that such withholding might negatively affect the company's ability to pay taxes.

The withholding of payments by the Navy for allegedly defective work, along with the extra work and delays, severely hampered the company's cash flow. To avoid defaulting on the contract, the company decided to use its limited cash to pay only the essential subcontractors and suppliers. Many vendors went unpaid, and the company failed to deposit certain employment taxes. The dispute eventually settled nearly two years after the project, at which point the company received its money, paid the entire liability (composed of taxes, penalties and interest), and started a refund action with the IRS.

The court held that the company was entitled to rely on the Armed Services Procurement Regulations, which contemplated a "speedy and orderly resolution" of any dispute related to a final decision by the Navy's Contracting Office. The court also recognized that the amounts withheld by the Navy were more than sufficient to cover the tax liability at issue. Citing to the regulations under Code Sec. 6651, the court explained that the company could not have foreseen that the Navy would not comply with the dispute-resolution clause of the agreement or the Armed Services Procurement Regulations. Thus, under the circumstances, the company exercised ordinary business care and prudence in providing for its tax liability and was nevertheless unable to pay on time without experiencing severe financial hardship (*i.e.*, defaulting on the contract and forfeiting its bond). The court concluded that the company "had reasonable cause for its failure to timely deposit and the penalties should be forgiven."[23]

### *In re Pool & Varga, Inc.*

The taxpayer in *In re Pool & Varga, Inc.* was in the printing business.[24] During the period at issue, the small company employed four people, including the president, George Varga. The company experienced a precipitous drop in sales and an inability to break even. Several factors contributed to this rapid downfall. For example, the company lost its largest client when it relocated, its second largest customer experienced financial woes of its own that caused it to reduce its printing orders, and the area in which the company was located—Flint, Michigan—was amid a severe recession.[25] The company failed to file certain returns and pay taxes, and it eventually declared bankruptcy. The IRS pressed its penalty position in the bankruptcy court.

At trial, Mr. Varga provided undisputed testimony that (1) valid reasons existed for the 50-percent drop in sales, (2) the IRS was not the only creditor that the company failed to pay on time, (3) the company eventually defaulted on a bank loan, a buy-out agreement with a major shareholder and an equipment lease, (4) all the workers were essential to the business, such that firing any one of them would have precluded the small company from functioning, (5) the company prioritized payments to creditors to keep the business running, (6) Mr. Varga reduced his salary

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to make more funds available to the company, (7) the company had no assets it could sell without going out of business, (8) Mr. Varga unsuccessfully attempted to borrow money for the company, and (9) the company made sporadic payments to the IRS to the best of its ability.[26] In the words of the court, the company "presented a fairly detailed—and grim—depiction of the severe financial difficulties it suffered during this period, which ultimately led to the decision to file for relief under Chapter 11 in 1985."[27]

The IRS neither rebutted Mr. Varga's testimony nor contended that the company did not face tough economic times. Instead, citing a district court case, the IRS argued that financial distress *never* constitutes a defense to late filing or payment, period.[28] The court agreed with the IRS in the sense that financial distress generally is not a valid defense to late filing of tax returns, but rejected the extreme position that financial distress cannot obviate late-payment sanctions. The court stated it in the following manner:

> Although the IRS' argument with regard to the failure to pay or deposit taxes seems logical, and upon first blush we were reluctant to accept the debtor's "times were tough" excuse as valid, the position of the IRS in this case is supported by neither the Internal Revenue Code nor the regulations issued and the cases decided thereunder. Neither the statute nor the regulations exclude the possibility that the taxpayer's financial difficulties may constitute reasonable cause. Instead, a fair reading of the regulations leads to just the opposite conclusion.[29]

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Referencing the regulations under Code Sec. 6651, the court noted that the company did not act recklessly or in any manner that jeopardized its ability to pay taxes. Moreover, noted the court, paying the taxes on time would have obligated the company to terminate its business and liquidate at sacrifice prices, which is the essence of "economic hardship."[30]

> In short, we conclude that the debtor has made a sufficient showing that its financial situation was such that its business would have been irreparably injured or terminated had it paid or deposited the taxes in full on the due date, in other words, that it would have imposed an undue hardship on the taxpayer. Therefore, it has shown reasonable cause for its failure to pay and that the penalty was improperly assessed.[31]

### *In re Arthur's Industrial Maintenance, Inc.*

During the periods at issue, the taxpayer in *In re Arthur's Industrial Maintenance, Inc.*, an electrical and mechanical construction subcontractor, had troubles getting the general contractors for which the company was working to pay.[32] Nevertheless, the company continued paying salaries to the owner and his wife, health and other insurance premiums, and many other obligations. The company made partial tax payments to the IRS while it was struggling, too.[33] The company eventually declared bankruptcy, and the IRS pressed for penalties.

The company's owner explained at trial that he did not pay all the employment taxes for certain periods because he decided to complete several large construction jobs, even though the general contractors would not pay the company until the job had been completed. The owner further explained that if the company had paid all the withholding taxes when due, it could not have afforded to pay for the materials and labor necessary to complete the jobs.[34] In defending against the penalties, the company cited to *Glenwal-Schmidt* and *In re Pool & Varga, Inc.*

In denying the IRS's request to assert late-payment penalties under Code Sec. 6651 and FTD penalties under Code Sec. 6656, the court noted that the company had "serious problems getting paid" both before and after it declared bankruptcy, the company's business expenditures were necessary and reasonable, the financial circumstances were not "ordinary," and the company made significant partial payments to the IRS during the relevant period.[35]

### *In re Slater Corporation*

The taxpayer in *In re Slater Corporation* was a general construction contractor working primarily on bonded and governmental projects.[36] The company had an employment tax liability for 1991 through 1994, it ultimately filed bankruptcy, and the IRS filed a proof of claim.

The evidence showed that the IRS took collection actions, including placing a lien on the company's property and levying on at least one of its bank accounts. In response, the company started making voluntary tax payments. During the years at issue, the owners of the company directed substantially all the company's cash resources to paying the IRS or to completing construction projects in order to receive payments from clients, which, in turn, were used to pay to the IRS.[37] The owners also contributed cash savings, commercial property and proceeds from a first

and second mortgage on their personal residence.[38] The testimony also revealed that the company made reasonable efforts to conserve its assets in marketable form, no assets were inappropriately dissipated, and the expenses of the company were reasonable.[39]

The IRS took the position that there was no reasonable cause for the unpaid employment taxes because the company had not been managed with ordinary business care and prudence. As evidence of this supposed unreasonableness, the IRS pointed to the company's failure to employ an accountant, attorney, comptroller or other professional to assist in the management of its income and expenses.[40] The IRS further argued that the company acted with willful neglect by favoring other creditors over the IRS, thereby "making the government its lender of choice."[41]

The court rejected the IRS's arguments and held that the company should not be penalized. In arriving at this conclusion, the court underscored several facts, including (1) the type of work in which the company was involved had "constant delays in payment" and normally required that a 10-percent retainage be withheld from the company; (2) governmental projects ordinarily require payment of the subcontractors and suppliers from each draw; therefore, the company was not voluntarily favoring other creditors over the IRS; (3) the company was making its "best efforts" to meet its employment tax obligations; (4) the company used ordinary care and prudence in its business dealings; (5) the owners of the company contributed substantial personal assets in an effort to meet all obligations; and (6) the revenue officer in the case applied the voluntary payments in a manner highly unfavorable to the company, which was a contributing factor to the demise of the company.[42]

### *East Wind Industries, Inc.*

The taxpayer in *East Wind Industries, Inc.* manufactured clothes and other items for sale to the U.S. Department of Defense.[43] The contracts went through various defense agencies. From 1966 to 1981, the company had a history of obtaining and completing government contracts. It had a history of timely filing and paying employment taxes during this 15-year period, too.[44] The company later encountered troubles paying employment taxes, which triggered this litigation.

In 1976, certain employees at the defense agencies began demanding bribes. The company initially capitulated, but later refused to pay as the bribes changed in form and increased in magnitude.[45] The company's repudiation generated the following consequences: The defense agencies would not pay for certain services previously performed and goods previously delivered, substantially delayed payment in other instances, wrongfully rejected inventory, and required the company to rework orders according to the "trumped up" specifications of the government inspectors.[46]

The company took several steps in an attempt to halt the shakedown, including approaching the legal staff of the relevant defense agencies. The company also consulted with accountants about cash flow, payables, cash conservation, payroll, personal loans and tax payments. Additionally, it talked with attorneys about collection of accounts receivable, advancing claims against the government, strategies for maintaining the company afloat, legal responsibility for taxes and other issues. The company even interfaced with other manufacturers to learn how they had responded to similar bribery demands.[47]

The company eventually brought a lawsuit against the defense agencies and then filed a separate bankruptcy petition. Ultimately, a settlement was reached with the agencies, whereby the company received $2.1 million. It paid its entire tax liability (including taxes, penalties and interest) from this sum and then initiated a refund action, alleging that there was reasonable cause for the late payments.[48] At trial, the district court granted summary judgment in favor of the government. The company appealed this decision to the Third Circuit Court of Appeals, relying on several cases, including *Glenwal-Schmidt*, *In re Pool & Varga*, *In re Arthur's Industrial Maintenance* and *In re Slater Corporation*.[49]

The appellate court addressed three main issues, the first of which was the proper legal standard for determining whether penalties should be abated. In ruling against the company at trial, the district court had relied on an earlier decision by the Sixth Circuit Court of Appeals, *Brewery, Inc.*[50] This case, regularly cited by the IRS, is commonly known for establishing a "bright line" test that a taxpayer's financial difficulties can *never* constitute reasonable cause for abatement of delinquency penalties under Code Sec. 6651 or FTD penalties under Code Sec. 6656. Describing the court's language in *Brewery* as a call to heightened personal accountability would be an understatement:

> The district court was correct in finding that that since the trust fund taxes are for the exclusive use of the government, the use of trust funds for the payment of other creditors cannot, as a matter

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> of law, constitute reasonable cause for abating the penalties assessed under [Code Secs. 6651 and 6656] ... . The court concludes that financial difficulties can never constitute reasonable cause to excuse the penalties for nonpayment of withholding taxes by an employer. We agree with the district court.[51]
>
> The [taxpayer] has conceded that it willfully chose to invade the funds held in trust for the government in order to pay other creditors. The [taxpayer] cannot now claim that this willful decision constituted reasonable cause. This was not a situation in which there were no funds available to pay the trust fund taxes. Rather, the [taxpayer] ran short of operating funds and willfully chose to invade the funds held in trust for the government in order to pay its creditors. We agree with the district court that such actions cannot, as a matter of law, constitute reasonable cause. The [taxpayer] must pay the price for its decision, and that price is mandated in the form of penalties assessed under [Code Secs. 6651 and 6656]. The [taxpayer] cannot be permitted to self-execute a government loan or to make the government "an unwilling partner in a floundering business."[52]

After reviewing the statutory language in Code Secs. 6651 and 6656, the applicable tax regulations containing the standards for "reasonable cause" and "undue hardship," and the judicial precedent involving these sources, the appellate court in *East Wind Industries* joined several other courts in finding that the reasoning in *Brewery* was, for lack of a better word, wrong.[53] What the court found particularly "troubling" was the fact that stringent standard established in *Brewery* was completely inconsistent with both legislative intent and the express language in the tax code and regulations.[54]

The second issue addressed in *East Wind Industries* was whether the company's failure to pay the employment taxes on time was a sign of "willful neglect." The government argued that the company created its own problems by initially participating in the bribery scheme and that such complicity rendered the nonpayment of taxes willful.[55] The court rejected the government's argument on several levels. The court first explained that, while the company was not entirely innocent, its cash flow and financial viability depended entirely on the government contracts and the corrupt employees of the defense agencies.[56] The court then highlighted the fact that the owners of the company paid only those creditors whose services were essential to maintaining business operations, keeping the company active was a prerequisite to starting the proceeding against the defense agencies and ultimately collecting the $2.1 million settlement (which went to pay the tax liability), and the owners were obligated to pay employees with funds received from the government contracts because it was a crime under applicable state law not to do so.[57] Finally, the court rejected the IRS's harsh approach, describing it as shortsighted and destructive to the company and the government alike.

> Although we recognize the need for stringent standards where trust fund taxes are involved, we cannot ignore the negative impact the Government's position has on public policy. The IRS has consistently taken the position that if a taxpayer cannot afford to pay trust fund taxes, no matter what the cause, it should close up shop. Both the economy and the federal fisc are negatively impacted by such an approach--the amount of money flowing into the economy and the fisc is reduced as a result of increased unemployment, idle buildings and plants, and decreased sales of goods and services. Under this approach, no one benefits. Where, however, a taxpayer keeps its business operating at a minimal level in order to collect monies contractually due so that it can pay trust fund taxes and other debts, and does in fact collect the funds owed and pays its back taxes and other debts, the economy and federal fisc, including the IRS, benefit.[58]

The third and final issue addressed in *East Wind Industries* was whether the company had reasonable cause for the late payments. The court had little problem finding that it did. In ruling that the company had demonstrated that timely payment of the employment taxes would have caused "economic hardship," the court looked to the following factors:

(1) The owners of the company incurred substantial personal debts by obtaining loans and a mortgage on their residence in order to provide additional cash for the business.

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(2) The personal funds were only used to pay essential creditors and a small number of employees.
(3) The company did not pay its rent during the relevant period.
(4) Without the reduced staff, the company would have been forced to halt operations, and this shutdown would have precluded the company from collecting on its claims against the defense agencies.
(5) The only market for the inventory in the company's warehouse was comprised of the very same defense agencies involved in the bribery scheme, which placed the company "at the mercy of the Defense Agencies as to whether [it] would have sufficient cash flow to operate the business."[59]

Satisfied that the company would have faced "economic hardship" if it had met its tax demands, the court in *East Wind Industries* then cited the following evidence in support of its conclusion that reasonable cause existed because the company exercised ordinary business care and prudence:

(1) All income received by the company from the government contracts was used to pay taxes or employee wages.
(2) The company did not pay suppliers, rent, insurance premiums or union dues.
(3) The company only paid the utility companies at the last minute, out of the owners' personal funds, when service shutoff was threatened.
(4) The owners personally guaranteed debts to company suppliers, which eventually led to lawsuits against the owners and the placement of liens on their personal assets.
(5) The owners sold personal assets and secured a mortgage on their personal residence to infuse more cash into the company.
(6) The company's bookkeeper loaned $65,000 of her personal funds to the company after the owners' funds had been exhausted.
(7) When problems arose, the owners sought advice from accountants, lawyers and similarly situated manufacturers.
(8) The company made reasonable efforts to conserve its assets in marketable form.[60]

The court seemed to recognize the narrow nature of its factually driven holding, explaining that *East Wind Industries* presents "that rare situation" where the taxpayer should not be penalized for late payment of employment taxes.[61]

## Conclusion

Some call it cynicism, others call it pessimism, still others call it reality. Regardless of the label, certain facts remain largely undisputed: The economy continues to struggle; many business taxpayers are facing serious financial distress; cash-flow problems frequently lead to late payment or nonpayment of taxes; the IRS and other taxing authorities aim to collect as much revenue as possible to meet their budgets; and granting abatement of late-payment penalties under Code Sec. 6651 and FTD penalties under Code Sec. 6656 conflicts with this mission by reducing the amount of revenue collected. It should come as no surprise, then, that penalty abatement requests rooted in a taxpayer's financial troubles are often denied.

To avoid becoming just another denial statistic in these tough times, taxpayers and their representatives would be wise to study the legal authorities that buttress the financial-distress-merits-penalty-waiver argument, strategically utilize the IRS's Economic Challenges Action Plan and, above all else, realize that seeking assistance from those experienced in these types of tax battles might be the most viable option.

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### Endnotes

[1] While this article focuses solely on whether the IRS can impose *civil* penalties in cases of financial distress, taxpayers and practitioners may also need to consider the financial-distress defense to *criminal* tax charges. *See, e.g.*, Steve R. Johnson, *Easterday and the "Inability to Pay" Defense for Tax Crimes*, 2009 TNT 161-7 (2009).

[2] Treasury Inspect General for Tax Administration, *Collection Alternatives Were Available to Economically Distressed Taxpayers, but Some New Processes Need Improvement,* Report No. 2010-30-032, Mar. 15, 2010, at 2.

[3] *Id.*

[4] *Id.*, at 3–4; IRS News Release IR-2009-2, *IRS Begins Tax Season 2009 with Steps to Help Financially Distressed Taxpayers; Promotes Credits, e-File Options*, Jan. 6, 2009.

[5] IR-2009-02, *id.*

[6] Written Statement by Linda E. Stiff, IRS Deputy Commissioner for Services and Enforcement, Hearing on IRS Assistance for Taxpayers Experiencing Economic Difficulties. U.S. House of Representatives, Committee on Ways & Means, Subcommittee on Oversight (Feb. 26, 2009).

[7] Written Statement by Douglas Shulman, IRS Commissioner, Hearing on Internal Revenue Service Operations and Fiscal Year 2010 Budget Proposals. U.S. House of Representatives, Committee on Ways & Means, Subcommittee on Oversight (June 4, 2009).

[8] Written Statement by Nina Olson, National Taxpayer Advocate, Hearing on IRS Assistance for Taxpayers Experiencing Economic Difficulties. U.S. House of Representatives, Committee on Ways & Means, Subcommittee on Oversight (Feb. 26, 2009). Ms. Olson made similar statements in her group's annual reports. *See, e.g.*, National Taxpayer Advocate, *2008 Annual Report to Congress,* 1 IRS Publication 2104 viii, ix (Dec. 31, 2008).

[9] IRS News Release 2010-29, *IRS Outlines Additional Steps to Assist Unemployed Taxpayers and Others*, Mar. 9, 2010.

[10] Treasury Inspect General for Tax Administration, *Collection Alternatives Were Available to Economically Distressed Taxpayers, but Some New Processes Need Improvement*, Report No. 2010-30-032, Mar. 15, 2010, at 2.

[11] *Id.*, at 4.

[12] *Id.* The TIGTA report identifies several other taxpayer-friendly collection alternatives from the Economic Challenges Plan that were publicly disseminated.

[13] IRS Letter 852C. Copies of several IRS notices with such language are on file with the author. Readers of this article likely have similar letters of their own.

[14] Code Sec. 6651(a); Reg. §301.6651-1(a)(1); Section 6656(a).

[15] I.R.M. §1.2.1.3.3 (Dec. 29, 1970) (IRS Policy Statement P-2-7).

[16] Reg. §301.6651-1(c)(1). *See also* Reg. §1.6161-1(b), which explains that the term "undue hardship" means more than an inconvenience to the taxpayer. It must appear that substantial financial loss (*e.g.*, loss due to the sale of property at a sacrifice price) will result to the taxpayer for making tax payments on time.

[17] Reg. §301.6651-1(c)(2).

[18] *Id.*

[19] *See, e.g., C.E. Wolfe*, DC-MT, 85-2 USTC ¶9476, 612 FSupp 605 (1985); *Rogers, Inc.*, DC-MI, 91-1 USTC ¶50,297 (1990); *In re Upton Printing Company*, BC-DC-LA, 95-2 USTC ¶50,377, 186 BR 904 (1995); *In re Sykes & Sons, Inc.*, BC-DC-PA, 95-2 USTC ¶50,620, 188 BR 507 (1995); *In re Savage, Inc.*, BC-DC-FL, 95-1 USTC ¶50,189, 179 BR 342 (1995); *Bostar Foods, Inc.*, DC-KY, 97-1 USTC ¶50,285 (1997); *Van Camp & Bennion*, CA-9, 2001-1 USTC ¶50,446, 251 F3d 862 (2001); *Fran Corp.*, CA-2, 99-1 USTC ¶50,208, 164 F3d 814 (1999); *Diamond Plating Co.*, CA-7, 2005-1 USTC ¶50,107, 390 F3d 1035 (2004); *Francis P. Harvey & Sons, Co.*, DC-MA, 2005-1 USTC ¶50,154 (2004); *Burt, Inc.*, DC-IN, 2007-1 USTC ¶50,416 (2007); *Moran*, 105 A.F.T.R. 2010-XXXX (2010).

[20] *Harvey & Sons, Inc., supra*, 94 A.F.T.R.2d 2004-7258, at *14.

[21] *Wolfe, supra* note 19.

[22] *Glenwal-Schmidt*, DC-DC, 78-2 USTC ¶9610 (1978).

[23] *Id.*

[24] *In re Pool & Varga, Inc.*, BC-DC-MI, 86-1 USTC ¶9445, 60 BR 722 (1986).

[25] *Id.*, at 725–26.

[26] *Id.*

[27] *Id.*, at 726.

[28] *Id.*, at 726.

[29] *Id.*, at 727. The court later stated that Code Sec. 6651 and Reg. §301.6651-1(c)(1) "permit a taxpayer to show that his or her particular financial difficulties constituted sufficient cause to excuse the assessment of the penalties."

[30] *Id.*, at 727.

[31] *Id.*, at 728.

[32] *In re Arthur's Industrial Maintenance, Inc.*, BC-DC-VA, 92-1 USTC ¶50,242, 71 A.F.T.R.2d 93-4437 (1992).

[33] *Id.*, at *1.

[34] *Id.*, at *7.

[35] *Id.*, at *8.

[36] *In re Slater Corporation*, BC-DC-FL, 96-1 USTC ¶50,043, 190 BR 695 (1995).

[37] *Id.*, at 696–97.

[38] *Id.*

[39] *Id.*, at 697.

[40] *Id.*, at 700.

[41] *Id.*

[42] *Id.*, at 700–01.

[43] *East Wind Industries, Inc.*, CA-3, 99-2 USTC ¶50,698, 196 F3d 499 (1999). The taxpayers in this case consist of East Wind Industries, Inc. and Delaware East Wind, Inc., the latter of which was a holding company of the former. For simplicity's sake, they are collectively referred to here as "the company."

[44] *Id.*, at 501.

[45] *Id.*

[46] *Id.*, at 502.

[47] *Id.*

[48] *Id.*, at 503.

[49] *Id.*, at 503, 506, note 6.

[50] *Brewery, Inc.*, CA-6, 94-2 USTC ¶50,435, 33 F3d 589 (1994), *aff'g*, DC-OH, 93-2 USTC ¶50,479 (1993).

[51] *Id.*, at 592 (internal citations omitted).

[52] *Id.*, at 593 (internal citations omitted).

[53] *Id.*, at 503–08. The *Brewery* case has been widely rejected. *See, e.g., Fran Corp. supra* note 9.

[54] *Id.*, at 507–08.

[55] *Id.*, at 508.

[56] *Id.*, at 508–09.

[57] *Id.*, at 509.

[58] *Id.*

[59] *Id.*, at 509–10.

[60] *Id.*, at 501–11.

[61] *Id.*, at 513.

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