

ARIZONA TAX COURT

TX 2004-000561

07/21/2005

HONORABLE MARK W. ARMSTRONG

CLERK OF THE COURT  
C. Danos  
Deputy

FILED: \_\_\_\_\_

ARIZONA STATE DEPARTMENT OF  
REVENUE

DAVID DIR

v.

ACCURATE CAD SVC, et al.

JAMES J EVERETT

**UNDER ADVISEMENT RULING**

This matter was taken under advisement after oral argument held June 6, 2005. The Court has considered the Plaintiff's Motion for Summary Judgment; Defendants' Motion for Summary Judgment and Plaintiff's Motion to Dismiss and/or Strike Cross-Claim and arguments of counsel.

**I. THE ISSUE**

This is a collection action resulting from Defendant Accurate Cad SVC, Inc.'s (hereinafter "Accurate Cad" or "Accurate") failure to pay an outstanding withholding tax that Plaintiff, STATE OF ARIZONA, ex rel., ARIZONA DEPARTMENT OF REVENUE (hereinafter "Plaintiff" or "ADOR") has determined is owed based upon filed withholding tax returns of Accurate Cad. ADOR argues under A.R.S. § 43-435, Samuel Vigil, President/Chief Executive Officer of Accurate Cad, and his wife, Ilana Vigil, Vice President and Director of Accurate Cad, are personally liable for the withholding tax. ADOR further argues, under A.R.S. § 42-1125(H), that Defendants are liable for a penalty equal to the total amount of the withholding tax (i.e. a 25% penalty). Also, ADOR argues that under A.R.S. § 25-215, the marital community of spouses Samuel and Ilana Vigil is liable for both the withholding tax and the 25% penalty. The Defendants deny any liability for the withholding tax and the 25% penalty.

**II. FACTUAL BACKGROUND**

Accurate CAD was incorporated in 1998, and commenced doing business as a provider of computer aided design drafting support services to architects and engineers. Samuel Vigil

ARIZONA TAX COURT

TX 2004-000561

07/21/2005

started the company on his own, and by 1999, it had grown to include twenty-two (22) full-time employees.

Prior to the third quarter of 1999, Accurate CAD had consistently filed its withholding tax returns on a timely basis; the funds withheld were paid over to the Arizona Department of Revenue in full and in a timely manner.

On or about May 24, 1999, Accurate CAD hired Sara Hall (hereinafter referred to as "Hall"), as a general bookkeeper. Hall's duties included, but were not limited to, collecting and entering timesheet information, responsibility for accounts payable (including negotiation of payment terms with vendors and preparation of payment checks for execution by Defendant Samuel Vigil), responsibility for accounts receivable (including depositing customer payments and invoicing customers), reconciling bank statements, purchasing office supplies, managing health and dental insurance benefits, and organizing and coordinating important company meetings. Hall's responsibilities included everything but the responsibility for payroll including the preparation and creation of payroll checks, payroll reporting including reports to the Arizona Department of Revenue and the Internal Revenue Service, and making the bi-weekly payroll deposits. At that time, Accurate CAD had outsourced the entire payroll function to ADP.

Commencing on or about August 1999, and continuing through and including April 2001, Hall instigated a plan to embezzle monies from Accurate CAD. To carry out her plan Hall had to obtain control over the payroll function and monies. Hall suggested to Defendant Samuel Vigil that Accurate CAD cease using the services of the payroll service, ADP, and move these functions in house, i.e., incorporate them into her job position. Hall reasoned that performing the payroll function in house would increase efficiency and ease of operation. Defendant Samuel Vigil finally agreed, and the entire payroll function including the responsibility of make the withholding deposits was moved in house. From that point forward, Hall maintained the bookkeeping records up-to-date, and the books and the checking accounts were balanced.

Although Hall prepared all of the checks and reports, she was not authorized to sign checks, she was not a signatory on Accurate CAD's bank accounts, and she was not authorized to sign any of the corporate reports. All checks and reports were presented to and signed by Defendant Samuel Vigil.

Hall prepared all of the checks to pay for corporate expenses and other obligations (including payroll checks), and presented them to Defendant Samuel Vigil for signature. After Defendant Samuel Vigil signed the checks, however, Hall then destroyed some seventy-two (72) of those checks and printed Accurate CAD checks payable to herself, forged Defendant Samuel Vigil signature thereon, and deposited the checks into her own account.

Hall prepared all of the appropriate reports including withholding reports for the Arizona Department of Revenue and the Internal Revenue Service, and presented them to Defendant Samuel Vigil for signature.

Hall prepared false bookkeeping reports indicating that deposits were being made to pay for withholding tax liability to the Arizona Department of Revenue and the Internal Revenue Service. Hall then altered the deposit characterizations at the bank to indicate that the Arizona Department of Revenue and the Internal Revenue Service were being paid. This gave Defendant Vigil the false impression that the withholding taxes were in fact being paid.

Utilizing this plan, Hall embezzled \$116,946.74 from the accounts of Accurate CAD during the period from August 1999 through April 2001.

In April 2001, Hall went on a vacation. Defendant Samuel Vigil received a telephone call from a creditor indicating that Accurate CAD had not paid his invoice. Defendant Samuel Vigil immediately checked the records, and the records reflected that the bill had in fact been paid and that the check had cleared. When Defendant Samuel Vigil conveyed this information to the creditor, the creditor insisted that he had neither received nor cashed the check. Defendant Samuel Vigil then ordered a copy of the check from the bank.

When Defendant Samuel Vigil received the copy of the check, he discovered that the check had been made payable to Hall, not the creditor, and that Hall had cashed the check.

Defendant Samuel Vigil immediately terminated Hall's employment, and hired a Certified Public Accountant to review the books to determine what Hall had done. It took several months to unravel the nature and extent of Hall's embezzlement. Upon discovering that the Withholding Tax Returns had not been filed, Defendant Samuel Vigil immediately had those reports prepared and filed. Hall's embezzlement bankrupted the Accurate CAD, Accurate CAD did not meet its withholding tax obligations.

On October 12, 2001, Defendants Vigil and Accurate CAD instituted a lawsuit against Hall for reimbursement of the funds embezzled by Hall. As a result of that lawsuit, Hall admitted embezzling the money and stipulated to a settlement in the amount of \$98,946.74. Neither Defendants Vigil nor Accurate CAD has ever received any reimbursement from Hall.

The Plaintiff seeks withholding taxes from Defendants in the amount of \$33,428.72, penalties in the amount of \$8,874.45, and interest pursuant to A.R.S. § 43-435.

### **III. ARGUMENTS OF THE PARTIES**

#### ***- The Arizona State Department Of Revenue's Arguments -***

#### **A. DEFENDANTS VIGIL ARE PERSONALLY LIABLE FOR WITHHOLDING TAX.**

ARIZONA TAX COURT

TX 2004-000561

07/21/2005

For the quarters ending September 30, 1999 through June 30, 2000, and December 31, 2000 through September 30, 2001, Accurate Cad untimely filed withholding tax returns and did not pay withholding taxes totaling \$33,428.72. Arizona law provides for personal liability on behalf of individuals responsible for payment of withholding tax on behalf of a taxpayer corporation. A.R.S. § 43-435:

Any person required to collect, truthfully account for and pay over any tax imposed by this title who fails to do so is, in addition to other penalties provided by law, personally liable for the total amount of the tax not collected or accounted for and paid over.

Here, the withholding tax was collected and the withholding tax returns were filed, but the withholding tax was not paid to ADOR. Defendants Vigil are the sole officers and directors of Accurate Cad. They failed to remit withholding taxes on behalf of Accurate Cad and are personally liable therefore. Interest continues to accrue pursuant to A.R.S. § 42-1123. Plaintiff is entitled to judgment against Defendants Vigil as a matter of law.

**B. THE MARITAL COMMUNITIES OF SAMUEL VIGIL AND ILANA VIGIL ARE LIABLE FOR TAX, PENALTIES AND INTEREST ASSESSED IN THIS MATTER.**

Ilana Vigil is the spouse of Samuel Vigil. All acts complained of by Defendants herein were done on behalf of their marital community. Plaintiff is entitled to judgment against the assets of Samuel Vigil and Ilana Vigil and their marital community. A.R.S. § 25-215,

**C. DEFENDANTS' LIABILITY FOR WITHHOLDING TAXES WERE NOT DISCHARGED IN SAMUEL VIGIL'S CHAPTER 7 BANKRUPTCY.**

Section 523(a) of the Bankruptcy Act exempts from discharge "any debt ...for a tax...of the kind...specified in section...507(a)(8) of this title, whether or not a claim for such tax was filed or allowed." 11 U.S.C. § 523(a)(1)(A).

Numerous decisions have upheld the non-dischargeability of taxes pursuant to 11 U.S.C. § 523(a)(1)(A) where the individual liability was derivative of an employer's liability. The Supreme Court has determined that the debt arising from a corporate officer's liability for unpaid withholding taxes was "unquestionably 'taxes.'" *United States v. Sotelo*, 436 U.S. 286, 275, 98 S.Ct. 1795, 1800, 56 L.Ed.2d 275 (1978) (interpreting the application of Bankruptcy Act § 17(a)(1)(e), the forerunner of § 523 (a)(1)(A)). *See also Matter of Clark*, 64 B.R. 437, 440 (Bankr. M.D.Fla. 1986) (debtor's liability as corporate officer for unpaid payroll taxes pursuant to Internal Revenue provision was "tax" rather than "tax penalty" and therefore nondischargeable under § 523 (a)(1)(A); and *In re Clate*, 69 B.R. 506 (Bankr. W.D.Pa. 1987) (individual debtor,

the sole responsible person of corporation which did not pay wage taxes, was personally liable and such debt was found nondischargeable under § 523 (a)(1)(A)).

Defendants' discharge itself states that the discharge does not apply to taxes. On page 2 of the discharge, the discharge form contains standard boilerplate language that states, "[s]ome of the common types of debts which are not discharged in a chapter 7 bankruptcy case are...Debts for most taxes." This reflects the decisions in the case law discussed above. As such, Defendants' Chapter 7 bankruptcy did not discharge their obligation to Plaintiff. *See* 11 U.S.C. § 507(a)(8)(C) and § 523(a)(1)(A).

**D. DEFENDANTS' DELEGATION OF DUTIES TO THEIR BOOKKEEPER DOES NOT ABSOLVE THE VIGILS OF LIABILITY AS RESPONSIBLE PARTIES.**

The Vigils essentially argue that the failure to pay the withholding tax is the responsibility of Hall, a former Accurate Cad employee whose illegal actions rendered Accurate Cad incapable of paying ADOR.

The Vigils claim Hall was under contract to manage and handle the finances and tax obligations of Accurate Cad. Further, the Vigils claim that they did not know of Hall's failure to pay the withholding tax until after the fact because Hall had given the fraudulent impression that the withholding tax was being paid. In sum, the Vigils argue that Hall is the responsible party and that they are therefore entitled to judgment as a matter of law. In a nutshell, the Vigils argue that they delegated responsibility for the withholding tax to Hall and that by doing so, they are relieved of any liability for non-payment. This position cannot withstand review.

An individual is a responsible person if the individual "had the final word as to what bills should or should not be paid." *Purcell v. U.S.*, 1 F.3d 932, 936-37 (9<sup>th</sup> Cir. 1993).

[A]n individual may be said to have "had the final word as to what bills should or should not be paid" if such individual had the authority required to exercise significant control over the corporation's financial affairs, regardless of whether he exercised such control in fact. The authority that permits control carries with it a nondelegable duty to ensure that withholding taxes are duly collected and paid over to the government.

*Id.* at 937.

In *Purcell*, the issue before the court was "whether a corporate president may be held personally liable for his corporation's failure to pay over federal withholding taxes to the Internal Revenue Service ("IRS") when he had delegated responsibility for all financial matters to his chief financial officer." *Id.* at 935. The CFO in *Purcell* embezzled over \$450,000 from the corporation during his tenure, using a signature stamp bearing the signature of Purcell, the corporate president, to issue corporation checks payable to himself. *Id.* After the CFO left the

ARIZONA TAX COURT

TX 2004-000561

07/21/2005

corporation, Purcell learned that the CFO had failed to file federal employment tax returns, and that the withheld taxes had not been paid over to the IRS. *Id.* The IRS sought a judgment from Purcell for the amount of the unpaid taxes. *Id.* at 936. As the Vigils in the instant case, Purcell argued that he was not a responsible person. *Id.*

The *Purcell* Court acknowledged that “[i]t is undisputed that Purcell delegated full authority for handling the Company's finances to Hatchard (the CFO), and that for so long as Hatchard remained with the Company Purcell took no active part in financial matters.” *Id.* Notwithstanding this fact, the Court reasoned that the answer to whether Purcell was a “responsible person” was dependent upon whether Purcell could “fairly be said to have ‘had the final word’ as to the payment of creditors during the period in which he delegated his authority to Hatchard and exercised no control over the Company's day-to-day financial decision making.” *Id.* On this issue, the Court set forth the following:

We note that in recent years other courts have uniformly and repeatedly rejected the delegation theory pressed upon us by Purcell. All courts agree, as we ourselves have said, that “responsibility is a matter of status, duty, and authority.” *Davis [v. U.S.]*, 961 F.2d [867] at 873 [(9<sup>th</sup> Cir. 1992), *cert. denied*, 506 U.S. 1050 (1993)] (citations omitted). Authority turns on the scope and nature of an individual's power to determine how the corporation conducts its financial affairs; the duty to ensure that withheld employment taxes are paid over flows from the authority that enables one to do so. *See Raba v. United States*, 977 F.2d 941, 943 (5<sup>th</sup> Cir. 1992) (“The crucial examination is whether a person had the ‘effective power to pay taxes.’”) (citation omitted); *Bowlen v. United States*, 956 F.2d 723, 728 (7<sup>th</sup> Cir. 1992) (“the key to liability under section 6672 is the power to control the decision-making process by which the employer corporation allocates funds”); *O'Connor v. United States*, 956 F.2d 48, 51 (4<sup>th</sup> Cir. 1992) (whether person is responsible “is considered in light of the person's authority over an enterprise's finances or general decision making”).

That an individual's day-to-day function in a given enterprise is unconnected to financial decision making or tax matters is irrelevant where that individual has the authority to pay or to order the payment of delinquent taxes. [Citations omitted.]

It follows that “delegation will not relieve one of responsibility; liability attaches to all those under the duty set forth in the statute.” *Thomsen v. United States*, 887 F.2d 12, 17 (1<sup>st</sup> Cir. 1989). *See Bowlen*, 956 F.2d at 728 (“delegation of the duty to turn over the taxes does not relieve a responsible person from liability”); *see also Brounstein v. United States*, 979 F.2d 952, 955 (3d Cir. 1992) (“Instructions from a superior not to pay

ARIZONA TAX COURT

TX 2004-000561

07/21/2005

taxes do not . . . take a person otherwise responsible under section 6672(a) out of that category.”); *Thibodeau v. United States*, 828 F.2d 1499, 1504 (11<sup>th</sup> Cir. 1987) (“an otherwise responsible person cannot be relieved of [his] obligation when directed by another person not to pay the taxes”).

*Id.* at 937.

The *Purcell* court concluded that Purcell had the requisite “authority” to qualify as a responsible person. *Id.* Like Purcell, Samuel Vigil had the requisite “authority” to qualify as a responsible person. Even though the Vigils argue that they delegated responsibility for the withholding tax to Hall, Samuel Vigil remained as Accurate Cad’s President/Chief Executive Officer, and Director, and his wife Ilana was its Vice President and Director. Given the above circumstances, Samuel Vigil had the authority required to exercise significant control over Accurate Cad’s financial affairs, regardless of whether he exercised such control in fact. Therefore, Samuel Vigil is a responsible person because he had the final word as to what bills should or should not be paid.

Samuel Vigil could not absolve himself, and his spouse, of liability simply by abdicating responsibility for Accurate Cad’s financial affairs to Hall, since as noted in *Purcell*, “[t]he authority that permits control carries with it a nondelegable duty to ensure that withholding taxes are duly collected and paid over to the government.” *Purcell*, 1 F.3d at 937. Consequently, the Vigils remain liable for the withholding tax.

Defendants argue that there can be no “personal liability where there is no personal fault” and cite *Slodov* in support of such proposition. *Slodov* is inapplicable here. *Slodov* held that where new management takes over a corporation when a delinquency in withholding taxes exists, and the withheld monies have already been dissipated by prior management, the new management’s use of after-acrued funds to satisfy creditors other than the IRS does not make it personally liable under the I.R.C. § 6672. *Slodov v. United States*, 436 U.S. 238, 98 S. Ct. 1778 (1978). Such is not the case here. The same persons managed Accurate Cad before and after the liability accrued and after the alleged embezzlement took place.

The Ninth Circuit has considered the narrow exception carved out in *Slodov* case, and has declined to extend such proposition to situations much closer to this instant matter. See *Davis v. United States*, 961 F.2d 867, 872 (9<sup>th</sup> Cir. 1992), *cert. denied*, 506 U.S. 1050, 113 S.Ct. 969 (1993)(declined to extend *Slodov* to excuse the use of after-acquired funds to pay commercial debts by the same persons who were responsible for the failure to pay withholding taxes in the first place); *Purcell*, at 938 (discussing *Davis* and failing to extend *Slodov* to those facts).

Instead of addressing *Purcell* and *Davis*, the Vigils have cited non-binding authority from other Circuit Courts that does not support their position in an attempt to argue their delegation claim. The majority of other Circuit Courts, in fact, disagree with the Vigils arguments:

At least six circuit courts of appeal, including the Tenth Circuit, have refused to extend *Slodov* to protect individuals who were responsible persons at the time the business failed to remit the withheld taxes. [citations omitted].

*Stauffer v. United States*, 1998 WL 681478 (D. Colorado).

**E. SECTION 43-435 DOES NOT REQUIRE WILLFUL FAILURE TO PAY TAXES AND THEREFORE DOES NOT MIRROR THE I.R.S. INTERPRETATION OF I.R.C. § 6672 IN THAT REGARD.**

The Vigils incorrectly state that “[s]ection 6672 of the Internal Revenue Code ... is the federal equivalent to A.R.S. § 43-435.” Section 6672 of the I.R.C. is the equivalent of A.R.S. § 42-1125(N). No language in § 43-435 requires a showing of any willful conduct to impose liability upon responsible parties. As such, Arizona only follows the federal interpretation of §6672 when seeking to impose a one-hundred per cent penalty under § 42-1125(N). Negligent conduct, therefore, is determinative of the associated penalties for failure to pay under § 42-1125(H), and that test is articulated below.

**F. TO ESCAPE PENALTIES REQUIRES DEFENDANTS TO SHOW BOTH THAT (1) THE FAILURE DID NOT RESULT FROM WILLFUL NEGLIGENCE, AND (2) THAT THE FAILURE WAS DUE TO REASONABLE CAUSE.**

A.R.S. § 42-1125(H) imposes a 25% penalty where there has been a failure to remit payment of the withholding taxes “unless it is shown that the failure is due to reasonable cause and not due to willful neglect.” A.R.S. § 42-1125(H). In interpreting this language, the Arizona Supreme Court has adopted the United States Supreme Court test articulated in *United States v. Boyle*, 469 U.S. 241, 105 S.Ct. 687, (1985) that states:

To escape the penalty, the taxpayer bears the heavy burden of proving both (1) that the failure did not result from ‘willful neglect,’ and (2) that the failure was ‘due to reasonable cause.’

*Id.*, at 245. The alleged embezzlement of funds is not reasonable cause for the failure to pay. Further, the Vigils were willfully negligent in failing to pay the withholding taxes.

**1. Reliance On An Employee Who Embezzled Is Not Reasonable Cause For Failure To Pay.**

A failure to pay will be considered due to reasonable cause to the extent the responsible parties have made a satisfactory showing that they exercised ordinary business care and prudence in providing payment of their tax liability. *Conklin Brothers of Santa Rosa, Inc. v. United States*, 986 F.2d 315, 317 (9<sup>th</sup> Cir. 1993)(citing 26 C.F.R. § 301.6651-1(c)(1)). In *Conklin*, the court



rejected an argument that the taxpayer was disabled as a result of an employee's misconduct. A corporation is disabled where criminal conduct by *those in control of the corporation* left the company unable to pay. *In re Am. Biomaterials Corp.*, 954 F.2d 919 (3<sup>rd</sup> Cir. 1992)(where no supervision or control of people was possible, company may be disabled, which can constitute 'reasonable cause'). As in *Conklin*, the responsible parties here "had control over" Hall. *Conklin*, at 318. Hall's activities "were subject to being supervised" by the Vigils. *Id.* As the court in *Conklin* states, "[a] decision was made that close supervision and review of [Hall's] payroll tax related duties was no[t] . . . necessary." *Id.*

The *Conklin* court concluded and held that:

Because Conklin was not disabled and cannot rely on its employee or agent to escape responsibility for the nonperformance of nondelegable tax duties, there are no genuine issues of material fact whether Conklin had reasonable cause to avoid late payment penalty fees. . . .

*Id.*, at 319. Here, the Vigils have not established reasonable cause to avoid penalties under § 42-1125(H). The Vigils cannot rely upon their employee's actions to escape responsibility for nonperformance of their nondelegable duties. The narrow exception in *Biomaterials* cannot apply. The Vigils therefore cannot escape imposition of the 25% penalty under §1125(H).

## **2. Defendants Were Willfully Negligent In Their Duties As Responsible Officers Of Accurate Cad.**

ADOR's determination of negligence is presumed to be correct. *Howard v. Commissioner*, 931 F.2d 578, 582 (9<sup>th</sup> Cir. 1991). The Vigils have the burden of proving that their conduct was not negligent. In *Kalb v. United States*, 505 F.2d 506, 511 (2<sup>nd</sup> Cir. 1974) the court stated that "[w]illful conduct...includes failure to investigate or to correct mismanagement after having notice that withholding taxes have not been remitted to the Government." In so holding, the court cited *United States v. Leuschner*, 336 F.2d 246 (9<sup>th</sup> Cir. 1964). *See also*, *Godfrey v. United States*, 748 F.3d 1568 (Fed. Cir. 1984)(requiring actual notice of delinquency to establish an affirmative duty to act); *Muck v. United States*, 3 F.3d 1378 (10<sup>th</sup> Cir. 1993)(once aware of a delinquency, responsible officer was obligated to apply unencumbered corporate funds to pay the tax liability); *Denbov. United States*, 988 F.2d 1029 (10<sup>th</sup> Cir. 1993) (holding that the responsible parties must do something once they learn of a failure to pay over withholding taxes). These cases cited evidence the higher showing of willfulness required in pursuing the 100% penalty provision in I.R.C § 6672. Clearly, such a showing supports the determination of ADOR that the lesser 25% penalty pursuant to A.R.S. §42-1125(H) was appropriate.

As shown above, the Vigils did not properly supervise Hall's activities as required through ordinary business care and prudence. Further, the Vigils have presented no evidence to

support a finding that the failure to pay over the withholding taxes did not result from willful neglect. In fact, Defendants admit that Accurate Cad remained in business for many months subsequent to the Vigils discovery of the alleged embezzlement.

The Vigils failed in their duty to manage and oversee the actions of Hall and ensure that the withholding taxes were being paid. The Vigils were made aware of significant withholding delinquencies on or about January 16, 2001 by ADOR. The Vigils failed to take action to pay these taxes when deficiencies were communicated to them by ADOR. Further, after discovering the alleged embezzlement, they had a duty to pay over any and all available funds to satisfy those debts to ADOR, and failed to do so. The Vigils have failed to show any evidence to the contrary. As such, they cannot satisfy the second prong of the test.

The Vigils have failed to carry their burden to satisfy the above two pronged test.

#### **G. ABATEMENT IS NOT WARRANTED**

Defendants allege abatement is warranted based upon reasonable cause – the alleged embezzlement of Hall. However, no Defendant made application for abatement to ADOR as required by A.R.S. § 42-2062. As Defendants did not exhaust their administrative remedies pursuant to § 42-2062(A), such abatement cannot now be sought.

Further, the Arizona Tax Ruling relied upon by Defendants states, in relevant part:

The timely payment and filing of a tax return are personal, nondelegable duties of the taxpayer. Placing those responsibilities with an employee, accountant or attorney, no matter how trustworthy that person may be, does not excuse the taxpayer. Reasonable cause [for abatement] does not exist if the taxpayer is aware that a return is required but the responsibility for filing and paying the return is delegated to a third party who fails to carry out the responsibility.

¶7, pg. 7 of Arizona General Tax Ruling GTR 04-2(emphasis in original). The Vigils failed to manage Accurate Cad with the care and prudence required. In order for abatement to be considered, it is important that “the taxpayer prove either that ordinary business care and prudence was exercised or that the failure was due to circumstances beyond the taxpayer’s control.” *Id.*, at 9. Defendants have failed to make any such showing, either here or to ADOR. The *Conklin* case discussed *supra* does not support their position; it supports ADOR’s imposition of penalties.

#### **- Accurate CAD Svc, et al.’s Arguments -**

#### **A. DEFENDANTS ARE NOT THE “RESPONSIBLE” PARTIES.**

**1. Defendants Are Not The Responsible Within The Meaning Of A.R.S. § 43-435 And I.R.C. §6672.**

Arizona generally follows the federal interpretation of similar or identical statutory language. *People of Faith, Inc. v. Arizona Department of Revenue*, 171 Ariz. 140, 829 P.2d 330 (App. 1992). Section 6672 of the Internal Revenue Code is the federal equivalent to A.R.S. § 43-435, the statute the Department of Revenue seeks to apply in this matter. Arizona therefore follows the federal interpretation of I.R.C. § 6672.

I.R.C. § 6672 provides that unpaid trust fund taxes (e.g. employment taxes) are to be assessed against a “responsible party.” More importantly, I.R.C. § 6672 does not impose personal liability where there is no personal fault. *See Slodov v. U.S.*, 436 US 238, 254 (1978). Whether an individual exercised significant control over the business’ finances is the central inquiry in determining whether a person should be held as a responsible person. *Hochstein v. United States*, 900 F.2d 543, 547 (2d Cir. 1990). A responsible person is one who has a final or significant, even if not exclusive, word as to which creditors should be paid. *Vinick v. United States*, 205 F.3d 1,9 (1<sup>st</sup> Cir. 2000).

In the present case, the Defendants employed Hall to assume the responsibility for handling all of the financial aspects of Accurate. Ms. Hall was responsible for maintaining the corporation’s books and records, including preparing and creating checks to pay vendors, payroll tax reporting, reconciling bank statements, accounts payable and accounts receivable duties.

Under current case law, courts have found the principal inquiry in determining liability to be the delegation of authority to issue payments to creditors, including the government. *United States v. Leuschner, Sr.*, 336 F.2d 246 (9<sup>th</sup> Cir. 1964). Samuel Vigil retained Hall to manage the corporation’s books and records, including the taxes. Mr. Vigil did not know of Hall’s failure to pay withholding taxes to the Arizona Department of Revenue until after said failure to pay occurred. More importantly, Ms. Hall purposefully deceived Mr. Vigil by surreptitiously writing herself a check from the Accurate system in the same amount as funds to be paid to its vendors.

This deception ensured that Mr. Vigil would not discover the misappropriation of funds by Ms. Hall, since he had already authorized the funds to be paid. Mr. Vigil did not, and could not, possess the requisite knowledge and authority under which he can be held accountable for Hall’s embezzlement and failure to pay withholding taxes to the Arizona Department of Revenue.

For the foregoing reasons, Samuel Vigil is not a responsible person within the meaning of A.R.S. 43-435 and I.R.C. §6672.

**2. Defendants Are Not Responsible As Defined By *Purcell*.**

A person is “responsible” if he has “the final word as to what bills should or should not

ARIZONA TAX COURT

TX 2004-000561

07/21/2005

be paid, and when.” *Purcell v. United States*, 1 F.3d 932, 936 - 37 (9th Cir. 1993). The word “final” in this context means “significant” rather than exclusive control. *Dudley v. United States*, 428 F. 2d 1196, 1201 (9th Cir. 1970); *Turner v. United States*, 423 F.2d 448, 449 (9th Cir. 1970). One of the factors to be considered is the person's control over the payment of bills. *Dudley, supra*. Furthermore, as long as the person is responsible for controlling corporate disbursements, it is not necessary that the person be an officer or even an employee. *Pacific Nat'l Ins. Co. v. United States*, 422 F.2d 26, 30 - 31 (9th Cir.), cert. denied, 398 U.S. 937, 90 S. Ct. 1838 (1970).

In making this “responsible party” determination, the courts have relied upon such considerations as the ability of the individual involved to sign checks of the corporation [*Jay v. United States*, 865 F.2d 1175 (10th Cir. 1989)], the identity of the individuals who were in control of the financial affairs of the corporation [*Jay v. United States, supra*], and who makes decisions regarding which, when and in what order outstanding taxes will be paid [*Vinick v. United States*, 205 F.3d 2000 (1st Cir. 2000)], among other indicia. The court must look at the totality of the circumstances, *Vinick v. United States, supra*, and, a responsible person does not have to be an officer, director, shareholder or employee of the corporation. *Vinick v. United States, supra*.

The Plaintiff relies on the decision in *Purcell, supra*, for the proposition that an officer of a corporation is still a responsible party and personally liable for the payment of withholding tax to the government even if he delegated responsibility for all financial matters to another officer within the corporation. The facts set forth in *Purcell*, however, are not in line with the facts in this case, and the “delegation theory” is therefore, not applicable in this case. *Purcell, supra*. In *Purcell* the corporate president not only delegated responsibility for all financial matters to his chief financial officer, but did not take an active part in the financial matters. In addition, the president granted full authority to the CFO to write checks, and conveniently provided the CFO with a stamp bearing the president's signature. Unfortunately, the CFO embezzled over \$450,000 from the corporation, failed to file federal employment tax returns, and failed to pay over the withheld taxes to the IRS.

In this case, however, Defendants Vigil did not delegate responsibility for financial matters to Hall, nor did they relinquish any check writing authority to Hall. In fact, Defendants Vigil did everything within their power to control the financial matters of the Defendant Accurate by reviewing the financial reports and signing all of the checks. Defendants Vigil believed that they were signing the checks and that they were being forwarded to the Plaintiff ADOR. Unfortunately, Defendants Vigil were unaware of the fact that through an elaborate scheme and artifice, Hall not only had totally usurped control of the financial matters of the Defendant Accurate CAD, but could “fairly be said to have 'had the final word' as to the payment of creditors” during the period in question.

**3. Hall Incapacitated Defendants From Responsibility.**

In the case of *In re Am. Biomaterials Corp.*, 954 F.2d 919 (3d Cir. 1992), the court dealt

with a situation where the chief executive officer and the chief financial officer both embezzled funds from the corporation. The penalties were abated upon the corporation's showing that it had exercised ordinary business care and prudence, and based upon the facts was "incapacitated" and unable to comply with the tax laws, i.e., its "failure to file, deposit and pay timely its employment taxes was excused ..." *Conklin Brothers of Santa Rosa, Inc. v. United States*, 986 F.2d 315, 318 (9th Cir. 1993), citing *In re Am. Biomaterials Corp.*, *supra* at 921, 928.

Throughout the time period that Hall embezzled money from the Defendant Accurate CAD, there was no reason for Defendants Vigil to believe that the taxes were not being paid to the Plaintiff. Thus, there was not any reason to investigate or correct anything. The Defendants Vigil were the unwitting victims of Hall's nefarious scheme.

This case involves a unique set of facts and circumstances where the "responsible" party affirmatively, unilaterally, and covertly took control of the financial matters despite the reasonable efforts of the Defendants Vigil reasonable efforts to maintain control. Defendants Vigil neither delegated any authority to Hall nor authorized Hall to exercise any authority over the financial matters of Defendant Accurate CAD. Despite the uniqueness of the situation, the Plaintiff maintains that the Defendants Vigil are personally liable for the failure to remit the taxes thereby imposing absolute liability upon the Defendants Vigil. If that is the case, then in reality there are not any circumstances where a corporate officer will not be held personally liable. Such a result flies in the face of basic fairness and justice, and the Defendants Vigil maintain that this was not the result that was intended by the statute.

**B. DEFENDANTS DID NOT WILLFULLY REFUSE TO PAY THE WITHHOLDING TAXES AS REQUIRED UNDER A.R.S. § 43-435.**

Even if this court finds that Defendants Vigil are "responsible parties" under the act, the criminal acts of Hall absolves them of liability as "responsible parties" as their actions cannot be categorized as "willful" as required under A.R.S. § 43-435. In order to hold Defendants Vigil personally liable for the payment of withholding taxes, the plaintiff must prove that they are not only responsible parties, but also that they willfully refused to pay the withholding taxes. As stated before, A.R.S. § 43-435 is the state equivalent to the federal statute, Section 6672 of the Internal Revenue Code, i.e., I.R.C. § 6672. A.R.S. § 43-435, titled, "Failure to collect and pay over tax; personal liability", provides as follows:

"Any person required to collect, truthfully account for and pay over any tax imposed by this title who fails to do so is, in addition to other penalties provided by law, personally liable for the total amount of the tax not collected or accounted for and paid over."

I.R.C. § 6672, titled, "Failure to collect and pay over tax, or attempt to evade or defeat tax", provides in pertinent part as follows:

ARIZONA TAX COURT

TX 2004-000561

07/21/2005

“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 for and pay over such tax, or willfully attempts in any manner to evade or defeat any 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.”

Since the statutes are substantially similar, and there does not appear to be any published legislative history underlying the enactment of A.R.S. § 43-435 upon which to garner information regarding the legislative intent, Defendants Vigil look to the Arizona courts for direction. Arizona generally follows the federal interpretation of similar or identical statutory language, *People of Faith, Inc. v. Arizona Department of Revenue*, 171 Ariz. 140, 829 P.2d 330 (App. 1992), so the federal case law is instructive and should be relied in cases like this which involve the imposition of personal liability with respect to withholding tax liability.

Pursuant to cases interpreting I.R.C. § 6672, it is clear that in order for Defendants Vigil to be held personally liable for failure to pay over withholding taxes, they must be “responsible persons” and must “willfully refuse” to pay the tax. *Teel v. United States*, 529 F.2d 903 (9<sup>th</sup> Cir. 1976). Therefore, the Plaintiff must not only prove that the Defendants Vigil were “responsible parties” within the meaning of the law, but also that they “willfully refused” to pay the tax. *Teel v. United States, supra*.

As set forth above, in order to impose liability on the part of Defendants Vigil for the failure to pay over withholding taxes, it must be shown that they willfully refused to pay the tax. The failure to pay withheld payroll taxes is “willful” if is “voluntary, knowing and intentional even though it is not done with a bad purpose or an evil motive.” *Barnett v. United States*, 594 F.2d 219, 222 (9<sup>th</sup> Cir. 1979). In order to impose liability on the Defendants Vigil, the court would have to find that there was either knowledge of nonpayment or reckless disregard of whether the payments were being made. Based upon the facts in this case, it is clear that Defendants Vigil were not aware of the fact that the withholding taxes had not been paid over to the Arizona Department of Revenue, nor were they reckless in any way with respect to their corporate financial obligations. To the contrary, the Defendants Vigil exercised reasonable care in the operation of the corporation.

As previously discussed, in the case of *In re Am. Biomaterials Corp.*, 954 F.2d 919 (3d Cir. 1992), the court dealt with a situation where the chief executive officer and the chief financial officer both embezzled funds from the corporation. The penalties were abated upon the corporation's showing that it had exercised ordinary business care and prudence, and was “incapacitated” and unable to comply with the tax laws, i.e., its “failure to file, deposit and pay timely its employment taxes was excused for reasonable cause and a lack of willful neglect excused.” *Conklin Brothers of Santa Rosa, Inc. v. United States*, 986 F.2d 315, 318 (9<sup>th</sup> Cir. 1993), citing *In re Am. Biomaterials Corp., supra* at 921, 928. Defendants Vigil and Accurate CAD were similarly “incapacitated” by the criminal actions of Hall, and thus were unable to

comply with the statute.

The Defendants Vigil did not delegate any authority to Hall with respect to the financial matters of the corporation generally, and did not delegate any authority to Hall with respect to writing checks and signing reports. It is undisputed that the Defendants Vigil did not give Hall signatory authority on the corporate bank accounts and Defendants Vigil personally reviewed and signed every check and report that was prepared on behalf of the corporation. Throughout the time period that Hall embezzled money from Accurate CAD, there was no reason for the Defendants Vigil to believe that the withholding tax reports were not being filed and that the withholding taxes were not being deposited to the Plaintiff. Furthermore, since the corporate accounting books were kept up to date, the books and check registers balanced, there was not any reason to investigate or correct any aspect of the corporation's financial affairs.

The Defendants Vigil did everything within their power to control the financial matters of Accurate CAD, and had a reasonable belief that all of the corporate financial obligations were being handled timely and properly. Unfortunately, Defendants Vigil were unaware of the fact that through an elaborate scheme and artifice, Hall not only had totally usurped control of the financial matters of the Defendant Accurate, but could fairly be said to have had the final word as to the payment of creditors during the period in question. The fact that the Defendants Vigil were the unwitting victims of Hall's nefarious scheme should negate any personal liability. This type of behavior is clearly not "willful".

**C. THE PENALTIES SOUGHT PURSUANT A.R.S. 42-1125(H) SHOULD BE ABATED.**

Employee embezzlement and the employer's financial difficulties can constitute reasonable cause to abate penalties. Arizona General Tax Ruling GTR 04-2, page 3, citing *Conklin Brothers of Santa Rosa, Inc. v. United States*, 986 F.2d 315 (9<sup>th</sup> Cir. 1993) and *Van Camp & Bennion v. United States*, 251 F.3d 862 (9<sup>th</sup> Cir. 2001).

In the present case, Hall took Accurate's monies for her own purposes while intentionally deceiving Mr. Vigil about the checks being paid from the corporation. As a direct result of Hall's illegal actions, Accurate was unable to pay its various creditors, including the Arizona Department of Revenue. Creditors initiated litigation against Accurate. As a direct and proximate result of Hall's actions, the Vigils were forced to declare bankruptcy and Accurate ceased doing business. These actions by Hall caused the Vigils' financial difficulties. Consequently, sufficient reasonable cause exists so to abate penalties.

**IV. THE COURT'S FINDINGS AND CONCLUSIONS**

The Court finds the case before it comparable to the *Purcell* case. Noting little difference in the two cases this Court decides likewise. The Court sees the Defendants faced with the same dilemma as those in *Purcell*. Unfortunately for both the defendant in *Purcell* and Defendants

ARIZONA TAX COURT

TX 2004-000561

07/21/2005

Vigil here, the acts of another do not free them from their tax liability.

As stated in *Purcell* -

[A]n individual may be said to have “had the final word as to what bills should or should not be paid” if such individual had the authority required to exercise significant control over the corporation's financial affairs, regardless of whether he exercised such control in fact. The authority that permits control carries with it a nondelegable duty to ensure that withholding taxes are duly collected and paid over to the government.

*Purcell v. U.S.*, 1 F.3d 932, 937 (9<sup>th</sup> Cir. 1993).

The Court finds that there are no genuine issues of material fact with respect to the issue of whether the Defendants are responsible persons for the withholding tax under A.R.S. § 43-435. The Court finds that they are.

The Court also finds, however, that there are genuine issues of material fact as to whether Defendants are responsible for the 25% penalty under the standard of A.R.S. § 42-1125(H).<sup>1</sup>

**IT IS THEREFORE ORDERED** granting Plaintiff's Motion for Summary Judgment in part and denying Defendants' Motion for Summary Judgment.

The Court having also received and considered Plaintiff's Motion to Dismiss and/or Strike Defendants' Cross-Claim Complaint Against Non-Party. Good cause appearing,

**IT IS FURTHER ORDERED** granting Plaintiff's motion.

---

<sup>1</sup> The Court would be willing to decide this issue on the motions if the parties stipulate to a trial upon their prior submissions.