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THE NINTH CIRCUIT HOLDS THAT AN
EMPLOYER'S FINANCIAL DIFFICULTIES
CAN CONSTITUTE REASONABLE CAUSE
FOR FAILURE TO PAY EMPLOYMENT
TAXES—*VAN CAMP & BENNION,*
P.S. v. UNITED STATES

*Sarah S. Brieden**

THE Courts of Appeals have differed in determining whether a taxpayer's financial difficulties can constitute "reasonable cause" sufficient to waive the penalty, required by the Internal Revenue Code, for failure to pay employment taxes.¹ The Sixth Circuit, in *Brewery v. United States*,² established the rule that financial difficulties cannot, as a matter of law, constitute reasonable cause for failure to pay both the trust fund and the non-trust fund portions of employment taxes.³ The Second⁴ and Third⁵ Circuits have rejected *Brewery's* rule. Most recently, in *Van Camp & Bennion, P.S. v. United States*,⁶ the Ninth Circuit joined the Second and Third Circuits in rejecting the *Brewery* rule, holding that financial difficulties can constitute reasonable cause for failure to pay employment taxes.⁷ The court stated that following the Sixth Circuit's reasoning would effectively do away with the reasonable cause exception to penalties.⁸ By rejecting the *Brewery* rule, the court failed to consider two points: (1) a portion of the employment taxes were withheld from em-

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1. The Internal Revenue Code sections that deal with penalties for failure to pay tax and failure to make deposits both require an addition to the tax owed "unless it is shown that such failure is due to reasonable cause and not due to willful neglect." 26 U.S.C. § 6651 (1989 & Supp. 2001) (failure to file tax return or to pay tax) and 26 U.S.C. § 6656 (1989 & Supp. 2001) (failure to make deposit of taxes). For a discussion of what is considered reasonable cause, see Joyce L. Sugawara et al., *Defining Reasonableness Before the Internal Revenue Service*, L.A. Law., May 2000.

2. *Brewery v. United States*, 33 F.3d 589 (6th Cir. 1994).

3. *Id.* at 592-94.

4. *Fran Corp. v. United States*, 164 F.3d 814, 818 (2d Cir. 1999).

5. *East Wind Indus., Inc. v. United States*, 196 F.3d 499, 508 (3d Cir. 1999).

6. *Van Camp & Bennion, P.S. v. United States*, 251 F.3d 862 (9th Cir. 2001).

7. *Id.* at 869.

8. *Id.*

ployees' paychecks and technically held in trust for the government, and (2) factors other than financial difficulties can constitute reasonable cause,⁹ and therefore, the reasonable cause exception is still available to taxpayers without considering financial difficulties.

Walter R. Van Camp and Irving R. Bennion, both attorneys, owned 60% and 40%, respectively, of the professional services corporation Van Camp & Bennion, P.S. ("the Corporation").¹⁰ Van Camp served as the Corporation's president and Bennion was the vice president and secretary-treasurer.¹¹

Van Camp, a specialist in personal injury, attracted clients to the firm¹² and performed the vast majority of the legal services provided by the Corporation.¹³ On the other hand, Bennion's involvement with the Corporation was limited and he carried a reduced case load.¹⁴ Because 99% of Van Camp's fees came from contingent fee agreements, the Corporation's income and cash flows were irregular.¹⁵

The Corporation suffered financial difficulties in 1989.¹⁶ Van Camp experienced serious personal problems, which included long-term hospitalizations, depression, divorce, personal bankruptcy, and the loss of several associates of the firm.¹⁷ These personal problems negatively affected Van Camp's ability to provide legal services to his clients.¹⁸ They also resulted in the Corporation's insolvency from 1989 to 1991.¹⁹ Because of limited cash flow, the Corporation failed to pay employment taxes in 1989 and 1991.²⁰

After an IRS audit, the Corporation paid \$34,000 in withholding and social security taxes, interest, and penalties that the Corporation failed to pay in 1989 and 1991.²¹ The IRS rejected a timely-filed claim for a refund of this payment.²² The Corporation then filed a complaint in federal court for a refund of the payment.²³ This case was consolidated with a second complaint seeking a refund of other taxes, interest, and penalties

9. See *United States v. Boyle*, 469 U.S. 241, 243 n.1 (1985). The IRS has given eight reasons for late filing that it considers reasonable cause. *Id.* (citing Internal Revenue Manual (CCH) § 4350, (24) ¶ 22.2(2) (Mar. 20, 1980)).

10. *Van Camp*, 251 F.3d at 864.

11. *Id.*

12. *Id.*

13. *Van Camp & Bennion, P.S. v. United States*, No. CS-94-409-CI, 1996 WL 529225, at *2-3 (E.D. Wash. July 17, 1996).

14. *Id.* at *3.

15. *Id.* at *2.

16. *Id.* at *1.

17. *Id.* at *6.

18. *Van Camp & Bennion*, 1996 WL 529225, at *6.

19. *Id.*

20. *Van Camp*, 251 F.3d at 864.

21. *Van Camp & Bennion*, 1996 WL 529225, at *1.

22. *Id.*

23. *Id.* The original complaint was filed in the Western District of Washington, but was transferred to the Eastern District of Washington.

relating to the wages paid to Van Camp and Bennion.²⁴ In its complaints, the Corporation claimed, in part, that the penalties paid on the taxes should be abated because financial difficulties experienced by the Corporation constituted reasonable cause to excuse the failure to pay the taxes.²⁵

Following the *Brewery* rule, the district court concluded that the Corporation's financial problems²⁶ did not, as a matter of law, constitute reasonable cause for failure to pay employment taxes.²⁷ The Ninth Circuit rejected the reasoning in *Brewery* holding that financial difficulties may constitute reasonable cause.²⁸ The court reversed the district court's ruling and remanded the case for a determination of whether the Corporation's problems actually were reasonable cause.²⁹

Writing for the Ninth Circuit, Judge Beezer considered the Corporation's assertion that penalties were not due on the unpaid employment taxes.³⁰ He noted that the Sixth Circuit³¹ disagreed with the Second³² and Third³³ Circuits on whether financial difficulties of the taxpayer corporation excuse nonpayment of employment taxes.³⁴ In this case of first impression for the Ninth Circuit,³⁵ Judge Beezer considered the conflicting reasoning of the courts that previously decided this issue to determine if financial difficulties can constitute reasonable cause for failure to pay employment taxes.³⁶

The court concluded that financial difficulties of the taxpayer corporation may constitute reasonable cause for failure to pay employment taxes and determined that the penalties for failure to pay may be excused.³⁷ The Ninth Circuit, in so holding, agreed with the *Fran Corp. v. United States* and *East Wind Industries, Inc. v. United States* decisions and rejected the "bright line rule" of the *Brewery* case that financial difficulties

24. *Id.* The IRS assessed a deficiency against the corporation for failure to pay employment taxes with respect to wages paid to Bennion and Van Camp. *Van Camp*, 251 F.3d at 864. The Corporation asserted that the attorneys were not employees of the corporation, but were independent contractors, and therefore the corporation was not responsible for employment taxes for these wages. *Id.* On this issue, the Ninth Circuit affirmed the district court's ruling that Van Camp was an employee of the firm while Bennion was an independent contractor. *Id.* at 865.

25. *Van Camp*, 251 F.3d at 866.

26. As part of its factual findings, the district court concluded that Van Camp's testimony about the personal problems he experienced was credible. *Van Camp*, 251 F.3d at 867. The court further concluded that the problems faced by Van Camp placed sufficient financial stress on the Corporation to put its survival in question. *Id.* at 868.

27. *Id.*

28. *Id.* at 867.

29. *Id.*

30. *Id.* at 866-67.

31. *Brewery*, 33 F.3d at 592-94.

32. *Fran*, 164 F.3d at 816-18.

33. *East Wind*, 196 F.3d at 504-08.

34. *Van Camp*, 251 F.3d at 867.

35. *Id.*

36. *Id.* at 866-67.

37. *Id.* at 868.

cannot, as a matter of law, constitute reasonable cause.³⁸ As part of its analysis, the court said, "If the potential ruin of a corporation is not relevant, then the reasonable cause exception is virtually meaningless."³⁹

Citing the Third Circuit's opinion in *East Wind*, the court noted that Treasury Regulations⁴⁰ require the court to look at the taxpayer's financial situation when determining if the taxpayer had reasonable cause for failure to pay taxes.⁴¹ The court found that the facts in this case illustrated the need to reject the Sixth Circuit's reasoning because the personal and financial difficulties of Van Camp put the survival of the company in jeopardy.⁴²

The *Van Camp* court should have affirmed the district court's ruling, at least with respect to the trust fund portion of the tax liability. The *Brewery* court was correct in finding that financial difficulties cannot constitute reasonable cause. The Sixth Circuit's reasoning is correct because the withheld tax money is held in trust for the U.S. government and not remitting the tax when it is due is equivalent to making the government "an unwilling partner in a floundering business."⁴³ The money withheld from employee paychecks does not technically belong to the company and the courts should not allow business to use this money for operating expenses.

The *Van Camp* court fails to consider the language of the Treasury Regulations, which seem to differentiate between the failure to pay withholding taxes and the same act with regard to other taxes. The regulations state, "facts and circumstances which, because of the taxpayer's efforts to conserve assets in marketable form, may constitute reasonable cause for nonpayment of income taxes may not constitute reasonable cause for failure to pay over taxes described in § 7501 that are collected or withheld from any other person."⁴⁴ This regulation places a heavier burden on an employer who fails to pay over withheld taxes. Because the monies withheld from employees do not technically belong to the employer, it is reasonable to conclude that the employer has no claim to those funds and no right to use them for operating expenses.

The *Van Camp* court committed its second error by concluding that the disallowance of financial difficulties as reasonable cause would "effectively read out of the statute the 'reasonable cause' exception to the mandatory penalties in many employment tax cases."⁴⁵ This conclusion seems to ignore a point made earlier in its own opinion that the IRS has

38. *Van Camp*, 251 F.3d at 868.

39. *Id.*

40. Treas. Reg. § 301.6651-1(c)(1) (2000).

41. *Van Camp*, 251 F.3d at 867.

42. *Id.* at 868.

43. *Brewery*, 33 F.3d at 593 (citing *Thibodeau v. United States*, 828 F.2d 1499, 1506 (11th Cir. 1987)).

44. Treas. Reg. § 301.6651-1(c)(2).

45. *Van Camp*, 251 F.3d at 868 (quoting *Fran*, 164 F.3d at 819).

given eight circumstances that constitute reasonable cause.⁴⁶ The court discounts these circumstances by stating that consideration of financial difficulties is necessary for reasonable cause to exist in the context of employment tax. This contradicts the court's own opinion because just before its discussion of financial problems, the court found that the district court's "failure to examine whether Van Camp's illness was serious enough to establish reasonable cause was clearly erroneous."⁴⁷ By its own admission, even this case proves that in the employment tax context, reasonable cause can exist without consideration of financial difficulties.

When considering the non-trust fund portion of employment taxes, the argument in favor of the bright-line rule of *Brewery* is not nearly as strong, and the logic of *Van Camp* seems more reasonable. With this portion of the taxes, the government is essentially in line for payment along with all of the employer's other creditors. This tax is not one that the employer is required to pay on behalf of someone else, but is simply another debt of the employer. The *Brewery* court concluded that the rule should be the same for both portions of the tax.⁴⁸ The court reached this conclusion because the tax is for the employees' benefit and because economists have concluded that employees bear the cost of the employer's share of employment tax in the form of lower wages.⁴⁹ On this issue, the court's reasoning is not as persuasive as it is with the trust fund portion of the tax. First, the United State's tax definition of income does not always follow the economic definition. Therefore, economists' conclusions should hold little weight in tax law. Secondly, these payments are made out of the employer's operating funds. Because these funds belong completely to the employer, it is reasonable to conclude that a prudent businessman may logically choose to pay rent or an electric bill before a tax bill when funds are low and a choice must be made.

As evidenced by the split in the courts, there are supportable arguments on both sides of the issue of whether financial difficulties may constitute reasonable cause. Because it ignored the trust fund properties of withholding tax, the *Van Camp* court mistakenly concluded that the employer's financial strain can constitute reasonable cause. *Van Camp*'s logic, however, is quite persuasive when considering an employer's failure to pay its own share of employment taxes. Judges dealing with this issue should look at these portions of the tax separately. Penalties for the non-

46. *Id.* at 867. The court cites *Boyle*, 469 U.S. at 243-44 n.1. The *Boyle* court lists eight circumstances that constitute reasonable cause in failing to file a return, they include "unavoidable postal delays," "the taxpayer's reliance on the erroneous advice of an IRS officer or employee, the death or serious illness of the taxpayer or a member of his immediate family, the taxpayer's unavoidable absence, [and] destruction by casualty of the taxpayer's records or place of business" (citing Internal Revenue Manual (CCH) § 4350, (24) ¶ 22.2(2)). See also *Defining Reasonableness Before the Internal Revenue Service*, which identifies other events that may constitute reasonable cause, including an electronic funds transfer that is delayed by the financial institution. *Id.* at 24 (citing Rev. Rul. 94-46, 1994-2 C.B. 278).

47. *Van Camp*, 251 F.3d at 867.

48. *Brewery*, 33 F.3d at 593-94.

49. *Id.*

payment of the trust fund portion should never be excused because of financial difficulties. However, the rule for the employer's portion of employment taxes should not be so harsh and should allow a consideration of the financial standing of the employer.

Tribute





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