

15-1108

TAX TYPE: PENALTY & INTEREST

TAX YEAR: 2007 & 2008

DATE SIGNED: 2-16-2016

COMMISSIONERS: J. VALENTINE, R. PERO, R. ROCKWELL

EXCUSED: M. CRAGUN

BEFORE THE UTAH STATE TAX COMMISSION

<p>TAXPAYER-1 dba TAXPAYER-2</p> <p style="text-align: center;">Petitioner,</p> <p>v.</p> <p>TAXPAYER SERVICES DIVISION OF THE UTAH STATE TAX COMMISSION,</p> <p style="text-align: center;">Respondent.</p>	<p style="text-align: center;">INITIAL HEARING ORDER</p> <p>Appeal No. 15-1108</p> <p>Account No. #####</p> <p>Tax Type: Penalties and Interest Waiver Periods: Various 2007 & 2008 Periods (see below)</p> <p>Judge: Chapman</p>
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Presiding:

Kerry Chapman, Administrative Law Judge

Appearances:

For Petitioner: REPRESENTATIVE-1 FOR TAXPAYER’S, Attorney
REPRESENTATIVE-2 FOR TAXPAYER’S, President and Owner
REPRESENTATIVE-3 FOR TAXPAYER’S, Accountant

For Respondent: RESPONDENT-1, from Taxpayer Services Division
RESPONDENT-2, from Taxpayer Services Division

STATEMENT OF THE CASE

This matter came before the Utah State Tax Commission on February 2, 2016 for an Initial Hearing in accordance with Utah Code Ann. §59-1-502.5.

On May 11, 2015, Taxpayer Services Division (“Respondent” or “Division”) issued a Waiver decision to TAXPAYER-1. dba TAXPAYER-2 (“Petitioner” or “taxpayer”), in which it addressed the taxpayer’s request for a waiver of penalties and interest associated with its withholding account for 15 non-consecutive monthly periods in 2007 and 2008. Specifically, the taxpayer’s waiver request concerns the following amounts of penalties and interest:

Period	Penalty Amount At Issue	Interest Amount At Issue	Month Return Filed	Month Taxes Paid
January 2007	\$\$\$\$\$	\$\$\$\$\$	04/07	10/08

Period	Penalty Amount At Issue	Interest Amount At Issue	Month Return Filed	Month Taxes Paid
February 2007	\$\$\$\$\$	\$\$\$\$\$	04/07	10/08
August 2007	\$\$\$\$\$	\$\$\$\$\$	10/08	11/14
September 2007	\$\$\$\$\$	\$\$\$\$\$	10/08	11/14
October 2007	\$\$\$\$\$	\$\$\$\$\$	10/08	12/12
November 2007	\$\$\$\$\$	\$\$\$\$\$	10/08	11/14
December 2007	\$\$\$\$\$	\$\$\$\$\$	10/08	07/12
January 2008	\$\$\$\$\$	\$\$\$\$\$	10/08	08/12
February 2008	\$\$\$\$\$	\$\$\$\$\$	10/08	08/12
March 2008	\$\$\$\$\$	\$\$\$\$\$	10/08	04/13
April 2008	\$\$\$\$\$	\$\$\$\$\$	10/08	10/12
May 2008	\$\$\$\$\$	\$\$\$\$\$	10/08	10/12
July 2008	\$\$\$\$\$	\$\$\$\$\$	10/08	02/13
August 2008	\$\$\$\$\$	\$\$\$\$\$	07/09	07/13
October 2008	\$\$\$\$\$	\$\$\$\$\$	12/08	04/13

In its Waiver Decision, the Division waived the penalties on the taxpayer’s withholding account for the first three periods at issue, specifically for the January 2007, February 2007, and August 2007 periods. The Division, however, denied the taxpayer’s request to waive the penalties for the other 12 periods. In addition, the Division denied the taxpayer’s request to waive the interest for all 15 periods at issue.

The taxpayer accepts the Division’s decision not to waive interest for the January 2007 and February 2007 periods. The taxpayer, however, asks the Commission to waive interest for the other 13 periods at issue. The taxpayer also asks the Commission to waive the penalties for the other 12 periods for which the Division did not waive penalties. The taxpayer believes that it should not be responsible for these penalties and interest because of the following circumstances.

The taxpayer is owned by a married couple, REPRESENTATIVE-2 FOR TAXPAYER and NAME-1. REPRESENTATIVE-2 FOR TAXPAYER’S is the taxpayer’s President and manages the business. The taxpayer explains that it had an employee who embezzled \$\$\$\$\$ of

withholding taxes that the taxpayer withheld from its employees' wages instead of remitting the taxes to the Internal Revenue Service ("IRS") and the Tax Commission in 2007 and 2008. The employee who embezzled the funds was the REPRESENTATIVE-2'S daughter-in-law, NAME-2, who had been employed as the taxpayer's controller since 2000 or 2001.

Because of their daughter-in-law's actions, the taxpayer incurred penalties and interest associated with its withholding tax accounts with both the IRS and the Tax Commission. Now that the taxpayer has paid all delinquent state withholding taxes, it asks for all penalties and interest to be waived for the 15 periods at issue because it was not responsible for its taxes being paid late. The taxpayer explains that it had no knowledge of its employee's actions until June 2008, when an annual external audit required by the United States Department of Education for the 2007 calendar year showed that the REPRESENTATIVE-2'S daughter-in-law had started to embezzle from the taxpayer in early 2007 and had continued until the auditor discovered her actions.

REPRESENTATIVE-2 FOR TAXPAYER'S explained that his daughter-in-law's duties included calculating the taxpayer's payroll and payroll tax obligations. Once the payroll was calculated, REPRESENTATIVE-2 FOR TAXPAYER'S would meet with his daughter-in-law to review the payroll. Once payroll was reviewed and deemed accurate, REPRESENTATIVE-2 FOR TAXPAYER'S would make arrangements to transfer funds from the taxpayer's operating account to its payroll account to cover its payroll obligations. REPRESENTATIVE-2 FOR TAXPAYER'S would also sign separate checks for the taxpayer's federal and state withholding tax deposits for his daughter-in-law to remit. Beginning in early 2007, however, the REPRESENTATIVE-2'S daughter-in-law began voiding these checks for many of the monthly periods, after which she would write additional checks to herself from the payroll account and use REPRESENTATIVE-2 FOR TAXPAYER'S's signature stamp to sign them. NAME-2 was authorized to use REPRESENTATIVE-2 FOR TAXPAYER'S's signature stamp when he was

out of town. Once she began to embezzle funds in early 2007, she intercepted all delinquency notices and destroyed them.

After discovering the embezzlement through the external audit, the taxpayer adjusted its internal control system by setting up accounts to electronically deposit its withholding tax obligations. The taxpayer also submitted a letter that its attorney filed with the IRS to appeal the IRS's denial of penalty abatement for the 4th quarter of 2007 and the 1st and 2nd quarters of 2008.¹ The taxpayer's attorney stated that the IRS denied the waiver request because the REPRESENTATIVE-2 FOR TAXPAYER decided not to have their daughter-in-law arrested and charged with embezzlement. The taxpayer has appealed the IRS's action, as well.²

REPRESENTATIVE-2 FOR TAXPAYER'S explained that he and his wife decided not to pursue charges against their daughter-in-law because it would have ruined their relationship with their son and their grandchildren. He stated that they also considered that their son and his family would have most likely lost their home had they pursued criminal charges against their daughter-in-law. After they discovered their daughter-in-law's actions, however, they fired her and made her resign a similar position she held with another, unrelated company. REPRESENTATIVE-2 FOR TAXPAYER'S stated that they also required her to receive counseling and made their son and her sign over their home. REPRESENTATIVE-2 FOR TAXPAYER'S fired his daughter-in-law on June 16, 2008.

REPRESENTATIVE-2 FOR TAXPAYER'S explained that he has had to use a line of credit to pay the taxes that the taxpayer owed the IRS and Tax Commission because of his daughter-in-law's actions. He stated that it has been difficult to pay the taxes because the taxpayer's education business suffered a decline in students during the recent recession of the late 2000's.

¹ It does not appear that the taxpayer asked the IRS to waive interest.

² Neither party indicated whether the laws that apply to IRS waiver decisions utilize the same criteria that apply to Commission waiver decisions.

The Division stated that it waived the penalties for the first three periods at issue on the basis of the taxpayer's good compliance history prior to 2007. The Division stated that it was aware of the embezzlement claim when they made its decision, but decided not to waive penalties for any additional periods because the taxpayer did not provide a police report showing that embezzlement occurred and because the taxpayer should have caught any embezzlement that occurred earlier than it did. The Division stated that without a police report, the embezzlement the taxpayer refers to is only a "claim" and not a "fact." However, the Division admitted that it would have waived more periods had the taxpayer provided a police report. In addition, the Division stated that the taxpayer would have been able to catch any embezzlement that occurred sooner than it did had proper checks and balances been in place. The Division contends that a business should have a reconciliation process in place to detect embezzlement within a month of its having occurred for a monthly filer and within a quarter of its having occurred for a quarterly filer. As a result, the Division asks the Commission not to waive any additional penalties. In addition, the Division asks the Commission not to waive any interest because the Tax Commission has not committed any error or given any erroneous advice.

To show that embezzlement occurred, the taxpayer proffered dozens of checks from 2007 and 2008 that all appear to have been signed with the same signature stamp and that were made out to NAME-2. The checks all indicate that they were paid to NAME-2 for a two-week pay period. The checks, however, suggest that something odd may have been occurring because, in a number of instances, more than one check was issued on the same date for the same pay period. For example, on July 9, 2007, three checks with different check numbers were issued to NAME-2, all in the same amount of \$\$\$\$ and all indicating that they were for the same pay period of June 25, 2007 through July 8, 2007.

In addition, REPRESENTATIVE-2 FOR TAXPAYER'S indicated that he could provide the audit report in which the embezzlement is mentioned to prove that the embezzlement occurred. Furthermore, he states that they could provide documents showing that he and his wife

made their son and daughter-in-law sign over their home after the embezzlement occurred. REPRESENTATIVE-2 FOR TAXPAYER'S believes that these circumstances should warrant a waiver of penalties and interest because the taxpayer was not responsible for the late filing and payments of returns and taxes for the periods at issue.

At the hearing, the taxpayer was asked why returns and payments were late for the May 2008, July 2008, August 2008, and October 2008 periods since the due dates for these periods occurred after the embezzlement was discovered and after NAME-2 was fired. REPRESENTATIVE-2 FOR TAXPAYER'S explained that once the taxpayer's controller was fired, it took months for the taxpayer to discover what had and what had not been paid and that it was difficult to catch up. REPRESENTATIVE-2 FOR TAXPAYER'S also stated that the Division's suggestion for a business to conduct an audit on a monthly basis is unreasonable. For these reasons, the taxpayer asks the Commission to waive penalties for all periods at issue and interest for all but the first two periods at issue.

At the hearing, the Division was asked if it was aware of any appeals where the Commission has considered a waiver of penalties and/or interest because of embezzlement. The Division stated that there have been appeals, but it could not remember any appeal numbers. The Division stated, however, that the Commission recently considered a case involving embezzlement and a large dollar amount outside of the appeals process and that the Commission waived penalties for a full year. The Division, however, stated that a police report existed in that case.

APPLICABLE LAW

The Commission has been granted the discretion to waive penalties and interest. Utah Code Ann. §59-1-401(13) provides, "Upon making a record of its actions, and upon reasonable cause shown, the commission may waive, reduce, or compromise any of the penalties or interest imposed under this part."

The Commission has promulgated Administrative Rule R861-1A-42 to provide additional guidance on the waiver of penalties and interest, as follows in pertinent part:

....

(2) Reasonable Cause for Waiver of Interest. Grounds for waiving interest are more stringent than for penalty. To be granted a waiver of interest, the taxpayer must prove that the commission gave the taxpayer erroneous information or took inappropriate action that contributed to the error.

(3) Reasonable Cause for Waiver of Penalty. The following clearly documented circumstances may constitute reasonable cause for a waiver of penalty:

- (a) Timely Mailing...
 - (b) Wrong Filing Place...
 - (c) Death or Serious Illness...
 - (d) Unavoidable Absence...
 - (e) Disaster Relief...
 - (f) Reliance on Erroneous Tax Commission Information. . . .
 - (g) Tax Commission Office Visit. . . .
 - (h) Unobtainable Records...
 - (i) Reliance on Competent Tax Advisor...
 - (j) First Time Filer...
 - (k) Bank Error...
 - (l) Compliance History:
 - (i) The commission will consider the taxpayer's recent history for payment, filing, and delinquencies in determining whether a penalty may be waived.
 - (ii) The commission will also consider whether other tax returns or reports are overdue at the time the waiver is requested.
 - (m) Employee Embezzlement. The taxpayer shows that failure to pay was due to employee embezzlement of the tax funds and the taxpayer was unable to obtain replacement funds from any other source.
 - (n) Recent Tax Law Change...
- (4) Other Considerations for Determining Reasonable Cause.
- (a) The commission allows for equitable considerations in determining whether reasonable cause exists to waive a penalty. Equitable considerations include:
 - (i) whether the commission had to take legal means to collect the taxes;
 - (ii) if the error is caught and corrected by the taxpayer;
 - (iii) the length of time between the event cited and the filing date;
 - (iv) typographical or other written errors; and
 - (v) other factors the commission deems appropriate.
 - (b) Other clearly supported extraordinary and unanticipated reasons for late filing or payment, which demonstrate reasonable cause and the inability to comply, may justify a waiver of the penalty.
 - (c) In most cases, ignorance of the law, carelessness, or forgetfulness does not constitute reasonable cause for waiver. Nonetheless, other supporting circumstances may indicate that reasonable cause for waiver exists.
 - (d) Intentional disregard, evasion, or fraud does not constitute reasonable cause for waiver under any circumstance.

UCA §59-1-1417(1) provides that the burden of proof is generally upon the petitioner in proceedings before the Commission, with limited exceptions as follows:

- (1) In a proceeding before the commission, the burden of proof is on the petitioner except for determining the following, in which the burden of proof is on the commission:
 - (a) whether the petitioner committed fraud with intent to evade a tax, fee, or charge;
 - (b) whether the petitioner is obligated as the transferee of property of the person that originally owes a liability or a preceding transferee, but not to show that the person that originally owes a liability is obligated for the liability; and
 - (c) whether the petitioner is liable for an increase in a deficiency if the increase is asserted initially after a notice of deficiency is mailed in accordance with Section 59-1-1405 and a petition under Part 5, Petitions for Redetermination of Deficiencies, is filed, unless the increase in the deficiency is the result of a change or correction of federal taxable income:
 - (i) required to be reported; and
 - (ii) of which the commission has no notice at the time the commission mails the notice of deficiency.

DISCUSSION

The taxpayer has the burden of proof in this matter pursuant to Subsection 59-1-1417(1). In accordance with Subsection 59-1-401(13), the Commission may waive penalties and interest upon a showing of “reasonable cause.” The Commission has adopted Rule 42 to provide guidance in determining whether “reasonable cause” exists for purposes of waiving penalties and interest.

Interest. In regards to the taxpayer’s request for a waiver of interest, Rule 42(2) provides that “[g]rounds for waiving interest are more stringent than for penalty. To be granted a waiver of interest, you must prove that the commission gave the taxpayer erroneous information or took inappropriate action that contributed to the error.” The grounds for waiving interest are more stringent because the State of Utah has not received taxes when they are due and because of the time value of money. In this case, the taxpayer does not assert that it paid its withholding taxes late for any of the periods at issue because of erroneous information given or inappropriate action taken by the Tax Commission. The fact that the taxpayer may not have been at fault

because of the embezzlement is not a determining factor. As a result, “reasonable cause” does not exist to waive any of the interest at issue.

Penalties. Rule 42(3)(m) provides that employee embezzlement constitutes reasonable cause to waive penalties if “[t]he taxpayer shows that failure to pay was due to employee embezzlement of the tax funds and the taxpayer was unable to obtain replacement funds from any other source.” While a police report may support a taxpayer’s claim that embezzlement has occurred, Rule 42 does not indicate that a police report must be filed before penalties can be waived because of employee embezzlement. By a preponderance of the evidence standard, the taxpayer has proffered sufficient information to show that employee embezzlement occurred from early 2007 through mid-June 2008.

Furthermore, the Division’s suggestion that a monthly taxpayer who experiences employee embezzlement should have sufficient checks and balances in place to discover the embezzlement within a month does not seem reasonable. The taxpayer had a plan in place where REPRESENTATIVE-2 FOR TAXPAYER’S would sign checks personally and where an external audit occurred once a year that would detect employee embezzlement. Had the embezzlement gone on for a longer period without detection, the Division’s checks and balances argument would be stronger. In this case, however, the penalties that accrued prior to the June 2008 discovery of the embezzlement should be waived because of employee embezzlement in accordance with Rule 42(3)(m). Accordingly, all penalties imposed for periods through and including the April 2008 period should be waived.

The penalties for the four periods beginning with May 2008 should not be waived. The return for May 2008 was due on July 1, 2008, which is after the embezzlement was discovered and after NAME-2 was fired. Furthermore, it appears the taxpayer was able to file returns and make payments in a timely manner for the June 2008 period (which had a due date of August 1, 2008) and for the September 2008 period (which had a due date of November 1, 2008). As a

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result, reasonable cause does not exist to waive the penalties associated with the May 2008, July 2008, August 2008, and October 2008 periods.

Summary. All penalties at issue should be waived with the exception of those imposed for the May 2008, July 2008, August 2008, and October 2008 periods. In addition, interest should not be waived for any of the periods at issue.

Kerry Chapman
Administrative Law Judge

DECISION AND ORDER

Based on the foregoing, the Commission waives all penalties at issue except for those imposed for the May 2008, July 2008, August 2008, and October 2008 periods. The Commission does not waive any interest imposed for any period. It is so ordered.

This decision does not limit a party's right to a Formal Hearing. However, this Decision and Order will become the Final Decision and Order of the Commission unless any party to this case files a written request within thirty (30) days of the date of this decision to proceed to a Formal Hearing. Such a request shall be mailed, or emailed, to the address listed below and must include the Petitioner's name, address, and appeal number:

Utah State Tax Commission
Appeals Division
210 North 1950 West
Salt Lake City, Utah 84134

or emailed to:
taxappeals@utah.gov

Failure to request a Formal Hearing will preclude any further appeal rights in this matter.

DATED this _____ day of _____, 2016.

John L. Valentine
Commission Chair

Michael J. Cragun
Commissioner

Robert P. Pero
Commissioner

Rebecca L. Rockwell
Commissioner