

BEFORE THE
CALIFORNIA UNEMPLOYMENT INSURANCE APPEALS BOARD

In the Matter of:

ROBERT LAKE JOHNSTON
(Petitioner)

EMPLOYMENT DEVELOPMENT DEPARTMENT

PRECEDENT
TAX DECISION
NO. P-T-446
Case No. T-85-205

Office of Appeals No. UPL-T-17812

The petitioner appealed from that portion of the decision of the administrative law judge in Case No. UPL-T-17812 which denied his petition for reassessment of an assessment levied under the provisions of section 1735 of the Unemployment Insurance Code.

STATEMENT OF FACTS

On April 11, 1984, the Department levied an assessment against the petitioner under the provisions of section 1735 of the Unemployment Insurance Code. The assessment covered the three calendar quarters ended December 31, 1981, March 31, 1982, and June 30, 1982, and was in the amount of \$4,702.83 unemployment and disability insurance contributions, \$1,734.91 California personal income taxes, \$2,277.33 penalty, plus interest as provided by law.

The petitioner was the president, chief financial officer, and a director of Tool and Machine Industries, Inc., a tool and die shop and machining and welding shop catering to the aerospace industry. The corporation was formed by the petitioner and five others who were the only stockholders and members of the board of directors.

The petitioner had a majority of the voting shares of the corporation. While he may not be entitled to outvote the other shareholders, he claimed it would enable him to "fire the board of directors and hire a new one that would hopefully vote with you." The petitioner alleged, "We never had a vote that -- that everybody didn't agree"

The corporation began manufacturing operations about July 1, 1980. The petitioner was the only person who could bring in work (sales) and the only one who could "quote it." In July 1981 the petitioner and his wife were seriously injured. The petitioner returned to work on a part-time basis in November 1981. However, as a result of his absence due to injuries at various times during the period from July 1981 through December 1981, and the lack of profitable sales or orders, it was necessary to cease operations.

Prior to closing the business, on approximately January 1, 1982 the petitioner and the other five directors of the corporation entered into a financing arrangement with Heller Credit Corporation to complete all orders on hand. Heller took charge of all receivables and advanced funds to the corporation to continue operating. Without this financing the petitioner alleged the corporation inventory and receivables would have been worthless.

The petitioner planned to complete the unfinished inventory, and then sell the equipment at auction to pay off the corporation's debts and the personal liabilities of the directors. The petitioner assumed there would be sufficient funds to pay some or all of the state and federal taxes.

The petitioner completed a typewritten narrative introduced as Exhibit No. 17 at the hearing in which he stated that if the company had shut down rather than complete all orders on hand, "we would be in enormous personal debt and could never have paid any taxes." The petitioner also stated he was the only one who was doing all the work to try to save the corporation and pay its bills.

Three other directors testified the petitioner generally ran the corporation and made the decisions. The Vice President alleged he left in March 1982 because the petitioner would not teach him his duties. These persons indicated a general lack of knowledge of the fiscal affairs of the corporation, even though they attended board meetings. They generally went along with the petitioner's wishes.

When orders were being completed, the corporation continued to employ the persons whose services formed the basis for this assessment. These employees were paid their net wages after deductions although no employee withholdings were placed in the trust account. The petitioner

nevertheless filed quarterly returns for the three quarters ending June 30, 1982 but failed to pay over any employer taxes or withholdings, because the credit corporation allegedly would only advance enough funds to pay the net payroll despite his request for additional funds.

The problem relating to employment taxes was first brought to light in a board meeting in February 1982. The petitioner requested the other directors to loan money to the corporation to keep going and make the payroll. Only the petitioner and one other director/shareholder loaned any additional funds. No evidence was presented that these additional funds were placed in the trust account or retained for the payment of any taxes due from the corporation.

The orders on hand were completed in the corporation shops or sent to other shops. The corporation then ceased total operations in May 1982. After the sale of the corporation equipment and payment to Heller Credit Corporation and other corporate debts, the corporation received approximately \$18,000. Of this \$18,000, \$14,000 was paid to the Internal Revenue Service and \$4501.72 to the Employment Development Department as partial payment of the amounts due.

REASONS FOR DECISION

Section 1735 of the Unemployment Insurance Code provides in pertinent part:

"Any officer, major stockholder, or other person, having charge of the affairs of a corporate or association employing unit, who willfully fails to pay contributions required by this division or withholdings required by Division 6 (commencing with Section 13000) on the date on which they become delinquent, shall be personally liable for the amount of the contributions, withholdings, penalties, and interest due and unpaid by such employing unit. The director may assess such officer, stockholder, or other person for the amount of such contributions, withholdings, penalties, and interest."

Section 13020 of the Unemployment Insurance Code provides in pertinent part:

"(a) Every employer who pays wages to a resident employee for services performed either within or without this state, or to a nonresident employee for services performed in this state, shall deduct and withhold from such wages, except as provided in Sections 13025 and 13026, for each payroll period, a tax computed in such manner as to produce, so far as practicable, with due regard to the credits for personal exemptions allowable under Section 17054 of the Revenue and Taxation Code, a sum which is substantially equivalent to the amount of tax reasonably estimated to be due under Part 10 (commencing with Section 17001) of Division 2 of the Revenue and Taxation Code resulting from the inclusion in the gross income of the employee of the wages which were subject to withholding. . . ."

The Unemployment Insurance Code requires an employing unit to make contributions to the Unemployment Fund and to withhold from the wages of workers certain worker contributions, including personal income tax, in trust and pay over to the Department these contributions and withholdings quarterly along with the proper returns. If such contributions and withholdings are not paid over as required, the director may make an assessment of the amount due. Any corporate officer who is (1) a person having charge of the affairs of the corporation, and (2) wilfully fails to pay the unpaid and owing contributions and withholdings of the corporation, is personally liable for the payment thereof plus penalty and interest as provided by law.

There is no dispute that the employer contributions and withholdings which form the basis of the assessment herein were not paid on time and became delinquent. However, the petitioner herein denies personal liability for the unpaid employer contributions and withholdings due from Tool and Machine Industries, Inc. The thrust of the petitioner's contentions, in written and oral argument, is that during all relevant periods the control of the financial decisions affecting the corporation was in the hands of an outside credit corporation, that the petitioner acted as a reasonable and prudent businessman, that there was no wilful failure to pay over any taxes owed, and that petitioner is being subjected to a 100 per cent penalty that is unfounded in any statutory authority. The petitioner argues that a failure to pay employer contributions should not be looked upon as involving the enforcement of a trust but simply a failure to pay. The petitioner makes a comparison of Federal and State law and cites Slodov v. United States (1978), 436 US 238, for the proposition that a violation of obligations to withhold does not per se invoke liability and that the only actionable basis for liability is a wilful failure to pay.

The Slodov case, supra, is distinguishable on its facts. The Slodov case involved an individual who purchased the stock and assumed management of three corporations, which were delinquent to the federal government for payroll taxes. After the petitioner assumed control, the corporation acquired sufficient funds to pay the taxes but those funds were used to pay other corporate expenses. The petitioner therein acknowledged liability for the taxes that accrued during her period of control, but denied liability for other periods. The court held where a person acquires and assumes control of a corporation at a time when taxes are delinquent and there are no funds to satisfy the tax obligations, and where funds thereafter acquired are not directly traceable to the withheld taxes, the acquirer is not liable under section 6672 of the Internal Revenue Code for willfully failing to pay over taxes. In the instant case this petitioner was president of the corporation since its formation and the taxes accrued during his tenure, not before he became associated with the corporation, as in Slodov.

We know of no court decisions interpreting or construing section 1735 of the code. The concept of a responsible person in a similar provision of federal law, section 6672 of the Internal Revenue Code, has been interpreted in numerous court decisions. A "responsible person" under section 6672 of the Internal Revenue Code is the federal counterpart of a person having charge of the affairs of a corporation under section 1735 of the Unemployment Insurance Code. Section 6672 of the Internal Revenue Code provides in part:

"(a) General Rule. 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."

Although section 6672 of the Internal Revenue Code and section 1735 are not identical, they are sufficiently similar so that the construction and interpretation of the federal statute by the courts should be considered in construing the similar state provision (Appeals Board Decision No. P-T-104).

In determining if this petitioner may be held personally liable we must first consider whether the petitioner falls within the class of persons who can be found as having charge of the affairs of the corporation within the meaning of section 1735 of the Unemployment Insurance Code.

Every corporation employing workers must have some person who has the duty or responsibility of withholding and paying over taxes to the government. A corporate officer may be deemed a responsible person if he has significant although not exclusive authority with respect to corporate decision making and action where taxes are due to the government (Hartman v. United States, 538 F2d 1336 (8th Cir. 1976)). Similarly, a corporate officer who possesses significant authority in the general management and fiscal decision making of the corporation is a responsible person (Kizzer v. United States, 598 F2d 1128 (8th Cir. 1979)).

A responsible person within the meaning of section 6672 of the Internal Revenue Code is one who has the final word as to which bills should or should not be paid (Wilson v. United States, 250 F2d 312 (9th Cir. 1958)). "Final," within the context of section 6672 means significant rather than exclusive control over the payment of bills (Turner v. United States, 423 F2d 448 (9th Cir. 1970)).

In Scherer v. United States (1963), 228 F.Supp. 168, the chief executives of a corporation, who were in reality running the corporation, and the board of directors were responsible persons within the meaning of section 6672 of the Internal Revenue Code where they knew taxes were due and unpaid yet kept the business going rather than pay over taxes.

The petitioner herein was the president, a director, and the chief financial officer of the corporation with signatory authority and the power to "fire" other directors. He was also the person who signed and submitted the employer quarterly returns without paying the employer contributions and employee withholdings for the period in question. There is no question that the petitioner had significant authority over the general management and decision-making process of the corporation. The petitioner was well aware that employee contributions were not being placed in the trust account or employer contributions made while the corporation continued to operate.

As one of the directors and chief financial officer of the corporation, the petitioner had a duty to participate in the management of the corporation and to do so in a manner that would assure the payment of all obligations of that corporation. The petitioner did not establish that any other corporate officer, director, or shareholder had ever prepared the employer quarterly returns or was expected to do so. The other directors generally agreed with and looked to the petitioner for guidance with respect to the fiscal affairs of the corporation. Accordingly, we conclude that the petitioner falls within that class of individuals envisioned in section 1735 of the Unemployment Insurance Code as having charge of the affairs of the corporation and, as such, is a responsible person.

The remaining issue is whether the petitioner's failure to pay over the required employer contributions and withholdings was willful.

The federal courts have held that an intent to defraud the government is not required for a finding of willfulness as that term is used in section 6672 of the Internal Revenue Code, Feist v. United States, 607 F.2d 954 (Ct.Cl.1979); Anderson v. United States, 561 F.2d 162 (8th Cir. 1977); Roth v. United States, 567 F.Supp. 496 (DCNY 1983).

In Feist v. United States supra, the court stated:

"Willfulness can be proved by showing that the responsible person recklessly disregarded his duty to collect, account for, and pay over the trust fund taxes or by showing that the responsible person ignored an obvious and known risk that the trust funds might not be remitted." (607 F.2d 954, 961)

In Garsky v. United States, 600 F.2d 86 (7th Cir. 1979), the court stated:

"A responsible person's use of funds, or his knowledge of the use of funds for payments to other creditors after he is aware of the failure to pay withholding taxes, is willful conduct within the scope of section 6672." (600 F.2d 86, 91)

In First National Bank in Palm Beach v. United States, 591 F.2d 1143 (5th Cir. 1982), the court stated:

". . . the determination of who is a responsible person and whether funds are in good faith paid on a preferred security are not matters to be determined either in a partial vacuum, filled only with legal theory, or solely on the basis of the paper relationships controlling stock holders create between themselves and the entities that are subject to their control. If individuals dominate a corporation, that relationship is relevant to whether they are 'responsible persons' within the meaning of section 6672. We are concerned with actual control and economic reality, not paper facade. An officer's control of corporate purse strings is relevant to whether or not that officer is a responsible person. [citations omitted] Moreover, the fact that a dominate stock holder cast his advances to the controlled corporation in the form of a secured loan transaction may be relevant in determining whether or not he 'willfully' failed to ensure that withholding taxes were paid; it may indicate that the corporation was under-capitalized, and that he in essence made the United States an involuntary and unwilling creditor of the corporation by placing on the government alone the risk that funds would be available for the payment of withholding taxes." (591 F.2d 1143, 1149, and 1150)

Wilfulness was found to exist where a corporate officer voluntarily and consciously allowed withheld taxes to be used for other corporate purposes even though the officer expected to have sufficient funds on hand on the due date to remit the taxes (Newsome v. United States, 431 F.2d 742 (5th Cir. 1970)).

The California Supreme Court in In Re Morales (1983), 35 Cal 3d, 196 Cal.Rptr. 353, reviewed a disciplinary proceeding against an attorney who had been an officer and employee of a law corporation which was dissolved and who became the sole officer of a new corporation to conduct his legal practice. The attorney and petitioner in that case had been convicted of, among other charges, failing to withhold and pay over to the state certain payroll taxes and unemployment compensation contributions. That petitioner had paid only the employees' "net wages" because of difficulties encountered in paying all of the corporate obligations.

The court stated that petitioner had made an illegal business decision concerning the allocation of available funds between competing obligations. Further, the court stated that the decision to allocate the available funds to other creditors was clearly wilful where that petitioner hired the staff, knew his tax obligations, borrowed money and earned fees to support his practice, but decided to pay other creditors instead of the state. The court also rejected that petitioner's argument that his obligation to pay taxes was "vicarious" because the law corporations were the actual employers.

In the instant case, the payment of withholding taxes and employer contributions was not made at the time they became delinquent. The payment of any such withholdings and contributions at a later date depended entirely upon whether after satisfying all other debts by completing the inventory and selling the equipment, there would be sufficient funds remaining. The obvious risk was known to the petitioner. Further, the petitioner was aware of the use of funds and that funds would be used to keep the corporation operating when employment taxes and withholdings were not being paid.

The petitioner and the other directors entered into a financing agreement primarily to avoid what the petitioner termed as an enormous personal debt if the corporation did not complete all orders on hand, prevent its inventory from becoming worthless, and be able to obtain its accounts receivable. The plan was to finish everything in the shop and sell the equipment at auction to pay off the corporation's debts and personal liabilities of the directors, although the petitioner assumed the corporation might be able to pay only a part of the federal and state taxes that would be due.

In order to accomplish these goals, the corporation continued to employ individuals without funds for the necessary employee withholdings or employer contributions. The petitioner continued to file employer quarterly returns for the quarters in question without payment of withholdings and contributions. He did not assure the payment of any taxes when he and the other directors entered into the financing agreement. By continuing to operate under the financing arrangement, the petitioner made the state an unwilling creditor. The petitioner, as one of the corporation's directors and chief financial officer, had the duty of managing the affairs of the corporation to assure payment of all tax obligations. We conclude on this basis that the petitioner acted wilfully.

The fact that the petitioner may have acted as a prudent businessman with respect to the decision to save the inventory and avoid an enormous personal debt does not make his actions any less wilful or justify continuing a business by knowingly making the state an unwilling creditor. Therefore, the petitioner is personally liable for the unpaid contributions and withholdings assessed under the provisions of section 1735 of the Unemployment Insurance Code.

We recognize that the majority of the assessment herein is not the so-called trust fund portion. However we decline to find, as the petitioner has requested, that a "wilful failure to pay" employer contributions as opposed to employee withholdings or the trust fund portion requires a different standard of wilfulness to invoke personal liability. Accordingly, the concept of "wilfulness" as enumerated in the court decisions cited above with respect to section 6672 of the Internal Revenue Code, is equally applicable to a consideration of the wilfulness required in section 1735 of the Unemployment Insurance Code.

DECISION

The appealed portion of the decision of the administrative law judge is affirmed. The petitioner's petition for reassessment in Case No. UPL-T-17812 is denied.

Sacramento, California, May 22, 1986.

CALIFORNIA UNEMPLOYMENT INSURANCE APPEALS BOARD

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GEORGE E. MEESE

DISSENTING - Written Opinion Attached

CHET WRAY

DISSENTING OPINION

I dissent.

I cannot agree with my colleagues in their finding that the petitioner wilfully failed to pay the unpaid contributions and withholdings of the corporation and was thus personally liable for the payment thereof.

At the pertinent time in question control of all the corporation's cash flow was in the hands of a credit corporation. The petitioner made every reasonable effort to comply with the requirements of both state and federal law. His request for sufficient operating funds in order to pay the required contributions and withholdings was denied by the credit corporation. Without the petitioner's efforts it would probably not have been possible for the petitioner to pay the state and federal taxes he managed to pay by completing the inventory. Under these circumstances I cannot conclude that the petitioner acted wilfully to avoid the payment of any contributions or withholdings to the taxing authorities. Therefore, I would find the petitioner was not personally liable for the assessment herein.

CHET WRAY