

DUBOSE CORPORATION AND
DUBOSE CONSTRUCTION LLC
P.O. BOX 117
MOUNT MEIGS, AL 36057-0117,

Taxpayer,

v.

STATE OF ALABAMA
DEPARTMENT OF REVENUE.

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STATE OF ALABAMA
DEPARTMENT OF REVENUE
ADMINISTRATIVE LAW DIVISION

DOCKET NO. S. 05-917

FINAL ORDER

The Revenue Department assessed Dubose Construction, LLC for contractors gross receipts tax, penalties, and interest for November 1999 through March 2002. It also assessed the LLC's parent company, Dubose Corporation, for income tax, penalties, and interest for the fiscal years ending May 31, 2001 and May 31, 2002. The corporations paid the tax, penalties and interest, and then petitioned for a refund of the penalties.¹ The Department denied the petitions. The corporations appealed to the Administrative Law Division pursuant to Code of Ala. 1975, §40-2A-7(c)(5)a. The appeals were consolidated and a hearing was conducted on October 27, 2005. Robert Walthall represented the Taxpayer. Assistant Counsel Ron Bowden represented the Department.

The issue is whether the penalties paid by the two corporations should be waived for reasonable cause. Code of Ala. 1975, §40-2A-11(h). As discussed below, §40-2A-

¹ The contractors gross receipts tax petition includes penalties due but unpaid for periods after December 31, 2002. The income tax petition includes penalties due but unpaid for the year ending May 31, 2003. Those amounts are not properly before the Administrative Law Division because only the denial of a refund of tax, penalties, or interest actually paid can be appealed to the Administrative Law Division pursuant to §40-2A-7(c)(5)a.

11(h) defines “reasonable cause” to include instances in which the taxpayer has acted in good faith.

Flynn Dubose owns Dubose Construction, LLC, the Dubose Corporation, and several other corporations, all of which perform highway construction, subdivision development, and other heavy construction projects in Alabama. Dubose has been in the construction business in Alabama since the 1950's.

Dubose hired Tom Mills as the corporations' treasurer/comptroller in 1996. Mills is a CPA that had previously worked for Wilson, Price, Barranco, Blankenship, and Billingsley (“Wilson, Price”), a respected CPA firm in Montgomery, Alabama. Wilson, Price has always done the outside tax work for Dubose's corporations. Dubose hired Mills because he was well-qualified and familiar with Dubose's businesses.

As treasurer/comptroller, Mills paid the corporations' bills, maintained the corporations' books and records, and prepared and filed the corporations' monthly and quarterly tax returns. Wilson, Price prepared the corporations' annual returns, and also conducted an annual audit of the corporations' books and records.

In the Fall of 2003, Dubose began suspecting that something was wrong concerning the corporations' finances. Dubose discussed various book entry inconsistencies with Mills on several occasions, but his concerns were not satisfied. CPA Carl Barranco of the Wilson, Price firm sat in on some of the meetings.

In early 2004, Dubose found numerous tax lien notices and certified mail envelopes hidden in Mills' desk. Dubose confronted Mills, but again his concerns were not satisfied. Dubose temporarily assigned Mills to other duties, and asked Barranco to conduct a full fact-finding audit of his books. Wilson, Price subsequently spent

approximately 1,500 man hours analyzing the corporations' books. It was eventually determined that Mills had embezzled hundreds of thousands of dollars from the corporations by making false book entries, forging checks, etc. Dubose fired Mills when his illegal activities were discovered.

Mills had also failed to timely file and pay some of the corporations' Alabama taxes going back to at least 1999. Dubose hired another comptroller after Mills was fired, and his corporations have since filed all applicable returns and paid all tax and interest due.

Dubose claims that the late penalties in issue should be waived for reasonable cause because they directly resulted from Mills' illegal activities. He claims that he trusted Mills, and was unaware that Mills had not timely filed and paid the corporations' taxes until Mills' illegal activities were discovered in 2004.

The Department contends that deceptive conduct by a corporate employee that caused the corporation to fail to timely file and pay its taxes does not constitute reasonable cause to waive the related late penalties. The Department cites two federal cases in support of its position, *Atlas Therapy, Inc. v. U.S.*, 66 F.Supp.2d 1203 (N.D. Ala. 2003) and *United States v. Boyle*, 105 S.Ct. 687 (1985).

In *Boyle*, the U.S. Supreme Court held that for federal purposes, a taxpayer's reliance on a tax preparer to prepare and timely file the taxpayer's tax return did not constitute reasonable cause under 26 U.S.C. §6651(a)(1). *Boyle* involved an individual taxpayer, but the same rule was applied to corporations in *Atlas Therapy*. In that case, an employee of the corporation failed to timely file and pay the corporation's payroll taxes. The employee hid his malfeasance from his superiors, but was eventually

discovered and fired. The Court applied the general rule in *Boyle* in holding that the negligent failure of a corporate employee to timely file and pay the corporation's taxes was not sufficient cause to abate the resulting penalties.

Dubose argues that *Boyle* and *Atlas Therapy* are not controlling because the Alabama penalty waiver provision at §40-2A-11(h) employs a "good faith" standard, and thus is more lenient or broader than the federal provision.

Reasonable cause is present for federal purposes only if the taxpayer exercises "ordinary business care and prudence." *Boyle*, 105 S.Ct. at 689. The Administrative Law Division held in *Compaq Computer v. State of Alabama*, F. 95-435 (Admin. Law Div. 2/12/06), that because the Alabama waiver provision is similar in substance to the federal provision, federal authority should be considered as a general guideline in construing the Alabama waiver statute. The Administrative Law Division also stated, however, that "[t]he 'good faith' standard set out in §40-2A-11(h) is perhaps more lenient than the federal standard of ordinary business care and prudence." *Compaq Computer* at 7. The Administrative Law Division was not required in *Compaq Computer* to determine if the good faith standard in §40-2A-11(h) was, in fact, more lenient than the federal standard because under the facts of the case, reasonable cause was not present in either case. This case requires that the determination must be made. Based on the language of §40-2A-11(h), as interpreted by Department Reg. 810-14-1-33.01 and Rev. Proc. 97-003, I find that the Alabama provision is broader than the federal statute.

"Good faith" is not defined in Alabama's Revenue Code, Title 40, Code 1975. In such cases, the commonly understood meaning of the term should apply. *State v.*

American Brass, 628 So.2d 920 (Ala. Civ. App. 1993). “Good faith” is generally defined as “compliance with what is decent and honest.” *American College Heritage Dictionary* 597 (4th ed. 2002).

Mills did not act in good faith when he knowingly failed to file and pay the corporations’ taxes as part of his embezzlement scheme. It is clear, however, that Dubose, the owner and president of the closely held corporations, at all time acted honestly and in good faith. Mills was a competent CPA that had always performed the duties assigned to him. Dubose trusted Mills and reasonably believed in good faith that Mills was timely filing and paying the corporations’ taxes.

The Department argues that Dubose is at fault because he did not have sufficient internal controls in place. Specifically, the Department contends that Dubose should not have allowed Mills to pay the corporations’ creditors and also keep the corporations’ books and records. But it is not uncommon for the same employee to perform both functions in a relatively small, closely held business, especially if the employee is a competent, trusted friend of the owner.²

Dubose also reasonably believed that he had sufficient internal controls in place. He held weekly staff meetings with Mills and others. He received weekly financial balances and monthly financial statements concerning each of his corporations. Importantly, Dubose had an independent CPA firm, Wilson, Price, conduct full annual audits of his books and records. The fact that Dubose did not readily discover Mills’ illegal activities was not due to his lack of oversight, but rather to the complicated accounting methods Mills used to hide his wrongdoing. The above is confirmed by the

² An IRS Appeals Officer also determined that Dubose had sufficient internal controls in place. See below at 7.

fact that it took a team of seasoned CPAs from Wilson, Price over 1,500 man hours to fully uncover what Mills had hidden.

The Department has interpreted reasonable cause for penalty waiver purposes to include the "reliance on the advice of a competent tax advisor." See, Reg. 810-14-1-.3301(3)(a)(1)(v) and Rev. Proc. 97-003. Consequently, the fact that Dubose relied on Mills, a competent CPA, to handle the corporations' taxes technically constitutes reasonable cause. The Department's Taxpayer Advocate also cited Dubose's reliance on Mills as reasonable cause to waive the penalties assessed against Dubose Construction for the late filing of withholding returns in 2003. "The corporation's reliance on the advice of competent tax advisors is reasonable cause." Interoffice Memorandum from Taxpayer Advocate dated April 22, 2005.

Also, an IRS Appeals Officer determined that even under the stricter federal penalty waiver standard, the federal late penalties assessed against Dubose Corporation for the year ending May 31, 2003 should be waived for cause. The February 10, 2005 letter from the Appeals Officer reads in part as follows:

Your representative's argument for abatement of the subject penalties is that this is a case where the taxpayer reasonably relied on the tax compliance services of its long term trusted and qualified in-house tax accountant who was responsible for filing all of the Taxpayer's tax returns on a timely basis. The Taxpayer's in-house tax accountant, Tom Mills, served as the Taxpayer's accounting, tax and financial executive and was directly responsible for ensuring that all tax filings were made on a timely basis. Your representative states that the relevant federal tax cases clearly establish that a taxpayer's business is not vicariously responsible for the penalties resulting from the criminal acts, willful misconduct or fraud committed by an officer of the business who was qualified and responsible for filing returns and paying taxes due to the IRS. The willful and deceitful acts of misconduct by Mr. Mills against the Taxpayer were the cause of the Taxpayer's failure to fulfill its duties to timely file the returns and pay the subject taxes due in this case. Accordingly, the Taxpayer cannot be vicariously responsible for the penalties resulting from

these failures. Your representative states that the court held in the case of *Matter of American Biomaterials*, 954 F.2d 919 (3rd Cir. 1992) that if an employee or officer's misconduct or crimes prove to be the reason for the corporation's failure to meet its obligations under the tax code, then the corporation is not automatically responsible for the resulting penalties. This fact plus the fact that the taxpayer had established internal controls in place and competent external auditors further substantiate reasonable cause in this case. It is also stated that the Taxpayer for many years, since its organization, timely filed its tax returns and paid the tax due. Further, the Taxpayer employs accounting personnel that have instituted a system of responsibilities and oversight to ensure that its obligation to prepare and timely file its tax returns and pay its tax dutifully executed.

* * *

Based on the facts and circumstances of this case, in combination with the law and its interpretations, I do feel you warrant relief from the Failure to File and Failure to Pay penalties. I will sustain the Estimated Tax penalty based on the fact that your defense of reasonable cause does not apply to this penalty on corporation tax returns.

In *American Biomaterials*, the case cited by the IRS Appeals Officer, the corporation's officers had embezzled large sums of money from the corporation. The Court held that because the officers controlled the corporation, the corporation was in effect "disabled" by the officers' illegal acts, and thus should not be held vicariously liable for failing to timely file and pay its taxes.

I find it ironic that a corporation may be held vicariously liable for the illegal acts of an underling employee, but not so if the offending party controls the corporation. Applying that rationale, if Dubose instead of Mills had engaged in illegal acts which caused his corporations not to timely file and pay their taxes, the corporations, and thus Dubose, would not be penalized. In any case, the IRS Appeals Officer construed *American Biomaterials* to hold that if the illegal acts of an employee are the reason why the corporation failed to timely file and/or pay its taxes, the corporation should not be held vicariously liable for the resulting penalties. That rationale applies in this case.

The U.S. Supreme Court stated in *Boyle* that given the large number of taxpayers that file returns, “our system of self-assessment . . . simply cannot work on any basis other than one of strict filing standards.” *Boyle*, 105 S.Ct. at 691. But also essential to the system is that it be perceived as fair. Penalizing Dubose’s closely held corporations would in effect be penalizing Dubose. Dubose lost hundreds of thousands of dollars because a trusted employee embezzled from his companies. Dubose could not have reasonably expected or foreseen Mills’ illegal acts, and further penalizing him would be considered unfair by the vast majority of Alabamians. Under the extraordinary circumstances in this case, and the broad definition of reasonable cause in Reg. 810-14-1-.33.01 and Rev. Proc. 97-003, the penalties in issue are waived for reasonable cause.

The above finding of reasonable cause applies only to the narrow facts of this case. The general rule in *Boyle* still applies that the negligent failure of an employee, tax preparer, etc. to timely file a taxpayer’s return will not constitute reasonable cause to waive the resulting penalties, absent extraordinary circumstances such as are present in this case.

The Department is directed to refund to the Dubose Corporation the late penalties paid for the fiscal year ending May 31, 2001 in the amount of \$4,132, and for the fiscal year ending May 31, 2002 in the amount of \$5,850.10, plus applicable interest. The Department should also refund the late penalties paid by Dubose Construction, LLC for November 1999 through November 2002 in the amount of \$31,768.15, plus applicable interest.

This Final Order may be appealed to circuit court within 30 days pursuant to Code of Ala. 1975, §40-2A-9(g).

Entered March 2, 2006.

BILL THOMPSON
Chief Administrative Law Judge