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Glenwal-Schmidt v. U.S.

42 AFTR.2d 78-5817

Memorandum And Opinion

This matter came on for nonjury trial before United States Magistrate Jean F. Dwyer by consent of both parties on May 29, 30 and 31st, 1978. The suit was brought by plaintiff against the United States for the recovery of certain penalties which had been assessed against plaintiff as a result of its failure to make timely payments to the Internal Revenue Service for employee taxes withheld by plaintiff.

Plaintiff asserts that under the relevant U.S. Code of the C.F.R. its failure to pay was with reasonable cause and accordingly the penalties should be refunded.

After hearing all the evidence for both parties and reviewing the documents submitted, the Court makes the following,

Findings Of Fact

(1.) Plaintiff is a joint venture consisting of the Glenwal Company, a New Jersey corporation, and the Albert P. Schmidt Company, also a New Jersey corporation. At all times relevant to this action the joint venture was engaged in the construction business.

(2.) On September 29, 1972, Glenwal-Schmidt (hereinafter "Glenwal") entered into a contract with the United States Navy. Under the terms of this contract, Glenwal agreed to design and construct three groups of family housing in Roosevelt Roads, Puerto Rico. For its part, the Navy agreed to pay Glenwal a lump sum of \$7,400,000.00. The work was to be financed by monthly progress payments to Glenwal as the work progressed. The contract documents contained the general conditions found on federal Standard Form 23A as well as additional general conditions found on a Navy form identified as NAVFAC Form 4-4330/5. These clauses are numbered 1 through 23 and 23 through 101, respectively.

(4.) Glenwal began work on October 14, 1972, and completed the project on November 6, 1975. During the course of the work, various disputes arose between Glenwal and the Navy. These disputes centered around the Navy's allegations of defective work and Glenwal's failure to complete certain phases of the work by the contract completion date. Glenwal disputed the allegations of defective work and also argued that the contract time should be extended to compensate for certain excusable delays. Throughout the contract period, negotiations were carried on between Glenwal and the Navy with respect to these disputes. In many of these instances during the contract period, agreements were reached, which were reflected in change orders, [pg. 78-5818]signed by both Glenwal and the Navy, which granted to Glenwal additional money and additional extensions of time.

(5.) As a result of these disputes, the Navy began withholding portions of the progress payments otherwise due and owing to the taxpayer. These withholdings were made in accordance with the Navy's interpretation of Clauses 5 and 35 of the general conditions

described in paragraph 3 above. The amounts withheld were in addition to the contract retention required to be withheld under the terms of Clause 7.

(6.) During the same period, Glenwal claimed additional amounts above and beyond the progress payments. These additional monies were claimed as compensation for various changes and delays in the work which Glenwal alleged were caused by the Navy. With respect to certain of these claims, Glenwal was compensated with additional money or with additional extensions of time by virtue of various change orders issued at various times throughout the project.

(7.) Under the terms of the contract, disputes between the contractor and the Navy were to be resolved according to the procedures set out in Clause 6 of the general conditions. This clause required the Navy's Contracting Officer to render a final decision, in writing, on disputed matters of fact. Once the final decision was rendered, the contractor could begin his administrative and judicial appeals. At no time during the contract period did the Contracting Officer render a final decision on these disputed matters. Glenwal was obligated to continue performance on the work pending resolution of the disputes.

(8.) By the end of June, 1975, the Navy was withholding \$64,000.00 as an offset to liquidated damages and defective work. By the end of September, 1975, the Navy was withholding \$162,025.00. As a result of the Navy's withholding and the increased costs resulting from the extra work and delays, Glenwal's cash flow was severely restricted.

(9.) To avoid defaulting on the contract, Glenwal elected to use its limited cash to pay only those subcontractors and suppliers which were essential to complete the work. During this period, many of Glenwal's vendors were not paid. In addition, Glenwal failed to deposit certain withholding taxes for the quarters ending June, 1975, and September, 1975. The amounts due for those quarters were \$44,857.73 and \$31,791.58, respectively. At the time it entered into the Navy contract, Glenwal knew that it would have a tax liability. Glenwal also knew that the Navy had the right to withhold money for liquidated damages and defective work, and furthermore, that any such withholding might affect Glenwal's ability to deposit and pay its tax liabilities.

(10.) On February 3, 1977, the various disputes between Glenwal and the Navy were resolved by negotiation. This resolution was reflected in a document signed by Glenwal and by the Navy, which listed all claims each party had against the other. On April 15, 1977, pursuant to the February 3 agreement, the Navy paid Glenwal a lump sum settlement of \$968,494.53, consisting of the outstanding contract balance due as of February 3, 1977, supplemented by the net contract price adjustment agreed to on that date.

(11.) Prior to its settlement with the Navy, Glenwal paid the withholdings due for the two quarters in question. In addition, Glenwal paid penalties and interest on the penalties totaling \$7,414.46.

(12.) After exhausting its administrative remedies, Glenwal filed this action to recover the penalties on the grounds that its failure to timely pay and deposit the withholding was due to "reasonable cause" within the meaning of 26 C.F.R. §301.6641-1(c)(1).

(13.) The court has jurisdiction of this action pursuant to 28 U.S.C. §1346(a)(1).

Conclusions Of Law

(1.) Penalties assessed for failure to pay and failure to deposit taxes can be excused upon a showing of "reasonable cause and [lack of] willful neglect" 26 U.S.C. §6651(a)(2) and §6656, respectively.

(2.) Whether the elements which constitute reasonable cause are present in a particular case is a question of fact; what elements must be present to constitute reasonable cause is a question of law. *Hatfield, Inc. v. Commissioner of Internal Revenue Service*, 162 F.2d 628, 635 [35 AFTR 1496] (3d CCA, 1947).

(3.) Reasonable cause means nothing more than the exercise of ordinary business care and prudence. *Orient Investment and Finance Co. v. Commissioner of Internal Revenue Service*, 166 F.2d 601, 503-604 [36 AFTR 818] (D.C. CCA, 1947).

(4.) A failure to pay will be considered to be due to reasonable cause to the extent that the taxpayer has made a satisfactory showing that he exercised ordinary business care and prudence in providing for [pg. 78-5819] payment of his tax liability and was nevertheless either unable to pay the tax or would suffer an undue hardship if he paid on the due date. 26 C.F.R. §301.6651-1(c).

(5.) "Undue hardship" means that the taxpayer will suffer a substantial financial loss if he pays the taxes on the due date. 26 C.F.R. §1.6161-1(b).

(6.) In determining whether the taxpayer was unable to pay the tax in spite of the exercise of ordinary business care and prudence in providing for payment of his tax liability, consideration will be given to all the facts and circumstances of the taxpayer's financial situation, including the amount and nature of the taxpayer's expenditures in light of the income (or other amounts) he could, at the time of such expenditures, reasonably expect to receive prior to the date prescribed for the payment of the tax. 26 C.F.R. §301.6651-1(c)(1).

(7.) The Armed Services Procurement Regulations ("ASPR") provide that before demanding money from a contractor within the meaning of Appendix E-608, 32 C.F.R. §1-39, III, Appendix E-608, the Contracting Officer shall make an appropriate decision under the Disputes clause of the contract and shall give notice of the opportunity to appeal. 32 C.F.R. §1-39, III, Appendix E-606.2. These regulations further provide that in determining an amount due to the Government under a contract, full and fair consideration will be given to the merits of the Government's claim and of all known claims of the contractor that may serve to reduce the amount to which the Government is entitled. 32 C.F.R. §1-39, III, Appendix E-605. Finally, the regulations provide that negotiations to determine indebtedness must not be unduly prolonged. 32 C.F.R. §1-39, III, Appendix E-606.

(8.) Money withheld from employees' wages for employment taxes are required to be held in a special fund in trust for the United States. 26 U.S.C. §7501.

(9.) Glenwal had a right to rely on all the contract clauses and on the Armed Services Procurement Regulations. Both the contract disputes clause (Clause 6) and the regulations contemplate a speedy and orderly resolution of any dispute beginning with a final decision in writing by the Contracting Officer.

(10.) The amounts withheld by the Navy during the quarters in question (June and September, 1975) were more than adequate to pay the taxes due. Despite the fact that Glenwal disputed the withholding, the Contracting Officer never rendered a final decision on these matters. Almost two years later, in April, 1977, the Navy concluded a settlement with Glenwal whereby all of the monies withheld were released and Glenwal was paid additional money for changes made and delays caused by the Navy. The lump sum payment to Glenwal was almost a million dollars. Throughout the period of the construction project, active negotiations were constantly going on with respect to all disputes between Glenwal and the Navy. Many of these negotiations resulted in agreements which were reflected in change orders signed by both Glenwal and the Navy.

(11.) Glenwal could not have foreseen that the Navy would not comply with the requirements of the Disputes clause and of the Armed Services Procurement Regulations. Considering all the facts and circumstances, Glenwal exercised ordinary business care and prudence in providing for its tax liability and was nonetheless unable to pay on time without incurring a severe financial hardship (viz, default and forfeiture of its bond). Glenwal thus had reasonable cause for its failure to timely deposit and the penalties should be forgiven.

Accordingly, judgment will be entered for the plaintiff in conformity with the foregoing findings of fact and conclusions of law.

An order in conformity will be entered on even date with this memorandum and opinion.