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Undue Hardship Under New York's Sales Tax and Offer-in-Compromise Program

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A ticking time bomb. That phrase is occasionally used to add a dash of hyperbole to an otherwise dry article. However, the phrase is particularly relevant to the disasters potentially faced by many members of Limited Liability Companies ("LLC's") in New York. By reason of what appears to be a simple mistake in legislative drafting years ago, under current law *all members of LLC'S* are personally liable for the entire amount of unpaid sales tax of the LLC regardless of how small an interest in the LLC owned by the investor and despite the fact that the investor had no involvement in the operations of the LLC. In other words, the protections against unlimited personal liability for members of LLC's have largely been eliminated.

For the last several years, many tax practitioners have been aware of this trap for the unwary but have tried to convince themselves that the provision was "too bad to be true" and that, one way or another, the New York State Department of Taxation and Finance (the "Tax Department") would not be able to enforce such a rule. Practitioners also took some solace from an Administrative Law Judge ("ALJ") Determination last year that, without discussion, refused to enforce personal liability against a non-controlling member of an LLC. In *Matter of Santo*,[1] the New York State Tax Appeals Tribunal however, overturned the ALJ Determination and upheld the provision of the New York sales and use tax law[2] that imposes absolute personal liability on any member of a partnership or limited liability company for all of the unpaid liabilities of the partnership or LLC in which they hold an interest.[3]

Moreover, despite the widespread hope among tax practitioners that the Tax Department would decline to exercise such authority, the Tax Department has issued numerous assessments against individuals who invested small amounts of money (often $50,000 or less) to LLC's formed to operate restaurants, bars or similar ventures in exchange for small minority interests in the LLC's with absolutely no rights or ability to oversee their operations. Often these businesses fail and in connection therewith, the businesses are unable to pay all of its bills including sales tax. The problem is often compounded by the fact that LLC's that operate failing businesses do not have adequate books and records and the sales tax assessed is based on estimates that often are greatly in excess of the actual liability. In many cases, the LLC is unable to contest the sales tax due to the cost of professional fees. The Tax Department's position is that each individual member of the LLC (as well as individual members of upper-tier LLC's) is jointly and severally liable for the full amount of tax, penalties and interest. In our experience, the potential sales tax due from each member of the LLC can run into several hundreds of thousands of dollars including interest and penalties. This treatment of limited partners and LLC members is inconsistent with the personal liability standard applied to corporate officers and employees of corporations under the sales tax, and more notably, New York's Partnership[4] and LLC laws,[5] which expressly provide limited liability for limited partners and members with respect to the debts of the entity. The Tax Department has indicated that a legislative fix is necessary to correct the inequities caused by the statute, but has refused to recommend that such a fix be included in the Governor's Executive Budget.

Absolute Liability v. Duty to Act

To understand the background of this issue it is necessary to recognize that the sales tax is what is known as "a trust fund tax". In other words, the sales tax is *imposed* on the purchaser of a taxable good or service, but is collected from the purchaser by the vendor "in trust" for the government and remitted thereto. Other types of trust fund taxes are Federal and state payroll withholding taxes; income tax is imposed on the employee, but is collected and remitted

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by the employer in "trust" for the government. Since legal liability for the tax is on the purchaser or employee, and the vendor or employer acts as a fiduciary in collecting and remitting the tax to the government there is a longstanding history of imposing penalties on the fiduciary for failure to properly collect and remit the tax to the government.

These penalties are often imposed on individuals involved in the operation of a business. For example, the Federal[6] and New York State[7] payroll withholding tax responsible person provisions generally impose personal liability when any person required to collect, truthfully account for, and pay over any tax willfully fails to do so, or when the person willfully attempts to evade or defeat it or its payment to the government. Under Federal and New York law, a "person" for this purpose includes an officer or employee of any corporation, or a member or employee of a partnership, who as such officer, employee or member "*is under a duty to perform the act in respect of which the violation occurs"* (emphasis added).[8] Thus, the question of whether someone is a responsible person for withholding tax purposes is factual and twofold: (1) whether the individual is a person under a duty to act, and (2) whether the individual's failure to withhold and pay over such taxes was willful. Under the duty to act standard the question to be resolved is whether the individual had or could have had sufficient authority and control over the affairs of the entity to be considered a responsible person.[9] The rationale of this approach is simple, persons who are involved in a business, will have knowledge, responsibility and control over any decision to not comply, and therefore should be personally liable for noncompliance.

With respect to New York's sales tax, section 1133(a) of the Tax Law authorizes the Tax Department to impose personal liability on "any person required to collect [sales] tax." Section 1131(1) enumerates certain categories of persons who constitute a "person required to collect tax" including every vendor of property and services, recipients of amusement charges, and hotel operators (i.e. the "business"). In addition to the business itself, officers, directors or employees of a corporation (dissolved or active), employees of a partnership or individual proprietorship and employees or managers of an LLC may be assessed unpaid sales tax only if they were "under a duty to act . . in complying with [the sales tax law]" on behalf of the business (the "Duty to Act Standard"). The fact based inquiry of whether a person is a responsible person under the sales tax Duty to Act Standard is basically identical to that cited above for New York withholding tax, including the variety of factors the Tax Department, courts and administrative tribunals examine when making their determination, such as: status as an officer, director, or shareholder; knowledge of and control over the financial affairs of the business; authorization to hire and fire employees. In addition the courts consider whether the individual signed the tax returns and whether the individual had a significant economic interest in the entity.[10] Holding corporate office or owning an equity interest in the entity, does not, in and of itself, warrant the imposition of liability.[11]

In contrast, any member of a limited liability company is a "person required to collect tax" for sales tax responsible person purposes (the "Absolute Liability Standard"). This provision was added to the sales tax law in 1994 in connection with various amendments to New York statutes to deal with the introduction of Limited Liability Companies. There is no legislative history explaining the sales tax provision and, due to the striking difference between the treatment of corporate stockholders and LLC Members, the most likely explanation is that the provision is a result of sloppy drafting. In 2003, the New York State Bar Association issued a report (the "NYSBA Report")[12] expressing concern about the Absolute Liability Standard, citing in particular the disconnect between the treatment of liability under the sales tax and New York's LLC and Partnership law.[13] It is the authors' understanding that as a result of the NYSBA Report, the Tax Department placed a temporary moratorium on sales tax assessments based solely on the Absolute Liability Standard, but as reported by other practitioners in an article in 2005, the moratorium ended at some time.[14] Now, five years later, the Department continues to apply the Absolute Liability Standard.

Santo Decision[15]

Mr. Santo entered into a business venture, structured in the form of an LLC, with others to open a Red Robin restaurant. Initially, Mr. Santo contributed no capital to the LLC, but at a later date loaned the LLC, all of his savings, $15,000. Another Member ("Scotti") was in charge of all of the financial operations of the LLC. In 2005, the restaurant opened, but had difficulty paying its construction creditors. In May of 2006, the Tax Department issued Notices of Determination to Mr. Santo finding him liable for almost $200,000 of the LLC's unpaid sales tax. The ALJ applied the Duty to Act Standard and determined that Mr. Santo was not responsible for the financial management of the LLC and was not involved in the day-to-day operation of the restaurant.[16] Ultimately, the ALJ concluded that Santo was not a responsible person because he "lacked the power to exercise the tax collection responsibilities on behalf of the LLC."

In December, however, the Tribunal reversed the ALJ decision, holding that it was an error for the ALJ to treat Santo as if he were an officer or employee of a corporation. The Tribunal stated that Santo was a member of an LLC, and as with members of a partnership, such members are subject to the Absolute Liability Standard and "subject to per se liability for the taxes due from the LLC." Furthermore, the Tribunal held that when a case involves a manager of a partnership or LLC, the Tax Department need only show "the person's status as a member," to satisfy the Duty to Act Standard "[s]ince Tax Law §1131(1) imposes strict liability upon members of partnership or LLC".

The Tax Department's Position

Officials of the Tax Department, particularly Jack Trachtenberg, the newly appointed Deputy Commissioner and Taxpayer Rights Advocate, have discussed the ramifications of *Santo* at various meetings of accounting and bar groups. As the Taxpayer Rights Advocate, Mr. Trachtenberg has placed reform of the responsible person assessments on his list for future initiatives due to the Tax Department's current audit position.

Although the Tax Department recognizes that collecting taxes from passive investors in LLC's is inconsistent with the rules governing LLC Members generally, many officials in the Tax Department are unwilling to change the rules. The issue, stated simply, is that individuals in charge of the operation of failed businesses are often themselves insolvent. Thus, the Tax Department is forced to choose between collecting from innocent investors or not collecting at all. Although the Tax Department does not have the option to go after passive investors in corporations, it does not want to give up the ability to collect against LLC members. It is extremely unlikely that the New York State Legislature would be willing to amend the law in the absence of Department consent.

Offers in Compromise

It appears that Tax Department officials may be looking to mitigate some of the impact of *Santo* in connection with amendments to the State's Offer in Compromise Program (the "Program")[17]. The current Program authorizes the Tax Department to compromise fixed and final liabilities (not subject to administrative review), only if (1) the taxpayer has been discharged in bankruptcy or insolvent ("Eligible Taxpayers"), and (2) the amount payable in compromise equals or exceeds the amount the Tax Department could recover through legal proceedings (i.e. levies, income executions and seizures (the "Amount Payable"). In general sales and other trust fund taxes will not be compromised for an amount less than the full amount of the tax (without interest and penalties).

Recognizing that the current Program is "outdated," "overly restrictive" and "ineffective" section 1 of Part L of Governor David Paterson's 2010-11 Executive Budget Bill[18] allows the Tax Department to consider "an increased pool of applicants," by expanding the group of Eligible Taxpayers with fixed and final liabilities to include tax debtor's that can show proof that collection in full would cause the tax debtor undue economic hardship or proof that there are other exceptional mitigating circumstances that would render acceptance of the compromise just and appropriate.[19] Other proposed provisions add greater flexibility with respect to the Amount Payable under the Program for fixed and final liabilities, by allowing the Tax Department to compromise such liabilities based on the Tax Department's actual ability to collect (versus legal ability to collect—exhausting all legal means), or as otherwise justified by the tax debtor. Of significance, the Memorandum in Support of the legislation states that the changes are derived from the analogous federal program and the Tax Department intends to follow federal precedent.[20]

Conclusion

Although reform of the Offer in Compromise Program is overdue, it will provide no relief to individuals who, unaware of the Absolute Liability Standard, invest in LLC's and find themselves liable for sales tax assessments they had nothing to do with but are financially able to pay off. Eventually most tax practitioners will be aware of this rule and advise their clients not to invest in LLC's if there is a risk of sales tax. Consequently, the liability falls on those individuals who are not well represented. The position of many in the Tax Department that the State should be allowed to seize money from ignorant but innocent investors because the statute was improperly drafted is offensive. It should be hoped by tax practitioners, business persons and most government officials that the Absolute Liability Standard needs to be repealed.

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1 *Matter of Joseph P. Santo*, DTA No. 821797, N.Y.S. Tax App. Trib., Dec. 23, 2009; *Matter of Joseph P. Santo*, DTA No. 821797, N.Y.S. Div. Tax Appeals, Mar. 12, 2009.

2 In the interest *of* simplification, the term "sales tax" will be used to refer to both sales and use taxes.

3 N.Y. Tax Law §1131.

4 Section 96 of the New York State Partnership Law provides that "a limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business . . "*See also* N.Y. Partnership Law §123-303. In contrast, a general partner in a partnership is jointly and severally liable for all debts and obligations of the partnership. Thus, the per se liability discussed above is reasonable with respect to general partners.

5 Section §609(a) of the New *York* State Limited Liability Company Law states "[n]either a member of a limited liability company managed by a manager or (including a person having more than one such capacity) is liable for any debts, obligations, or liabilities of the limited liability company or each other, whether arising in tort, contract or otherwise, solely by reason of being such a member, manager. . ."

6 IRC §*6672*.

7 N.Y. Tax Law §685(g).

8 IRC §6671; N.Y. Tax Law §685(g).

9 *Cohen v. State Tax Comm'n*, 128 AD.2d 1022, 513 NYS2d 564.

[10] See e.g., *Matter of Roncolato*, DTA No. 806017, N.Y. Tax App. Trib. (Aug. 15, 1991); *See also* 19 RCNY 526.11 (stating that "generally a person who is *authorized* to sign a corporation's tax returns or who is responsible for maintaining the corporate books, or who is responsible for the corporation's management is under a duty to act.").

[11] *Chevlowe v. Koerner*, 95 Misc 2d 388, 407 NYS2d 427; *Matter of O'Reilly*, DTA No. 818564, N.Y.S. Tax App. Trib. (May 17, 2004).

[12] N.Y.S. Bar Ass'n Tax Section, *Report on Trust Fund Liability for Collection of Sales Tax*, July 22, 2003.

[13] The NYSBA Report also discussed two cases where the ALJ, and the Tribunal in one case, strictly interpreted the statutory language and applied the Absolute Liability Standard, to find "any partner" liable for unpaid sales tax, irrespective of the partner's involvement in the management and affairs of the partnership. *See Matter of John P. Bartolomei*, DTA No. 812888, N.Y.S. Tax App. Trib. (Aug. 3, 1997); *Matter of Robin Pickett*, DTA No. 810045, N.Y. Div. of Tax App. (Nov. 18, 1993).

[14] *Mark* S. Klein and Jack Trachtenberg, *The Imposition of Unlimited Liability on Limited Partners and Members of LLCs in New York*, State Tax Notes, Dec. 5, 2005.

[15] *Matter of Joseph P. Santo*, DTA No. 821797, N.Y.S. Tax App. Trib., Dec. 23, 2009.

[16] *Matter of Joseph P. Santo*, DTA No. 821797, N.Y.S. Div. Tax Appeals, Mar. 12, 2009. The record shows that Mr. Santo was not involved in the day-to-day operation of the restaurant, visiting only twice a week.

[17] N.Y. Tax Law §171, subdiv. Fifteenth (applying to fixed and final liabilities) & Eighteenth-a (applying to liabilities that are not fixed and final, such as those matters currently under administrative review).

[18] S. 6610/A. 9710.

[19] 2010-11 N.Y.S. Executive Budget, Revenue Article VII Legislation, Memorandum in Support, Part L.

[20] *Id.*