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Financing Plan Did Not "Sweep" Away Sales Tax Liability

By: Joseph Lipari

Many business loan agreements contain provisions to protect the lender in the event the business of the debtor gets into trouble. Sometimes these arrangements involve a "lock box" under which all or a portion of the receipts of the business are deposited into a bank account controlled by the lender. Other loans contain "sweep" provisions under which the lender can move funds from a bank account controlled by the debtor to an account controlled by the lender. Such sweep provisions often are triggered by a default or other problem with the loan. Obviously loan agreements are drafted by lenders and their counsel and borrowers rarely are in a position to negotiate the terms. A recent Tax Appeals Tribunal decision, *Matter of Kieran*,[1] demonstrates the risks inherent in these arrangements.

'Matter of Kieran'

Patrick Kieran, was the president and 25%-owner of Bay Chevrolet, Inc. ("Bay Chevrolet"), a General Motors ("GM") car dealership in Douglaston, Queens. The dealership needed substantial financing to enable it to acquire needed inventory and to obtain working capital to operate the business. Bay Chevrolet entered into a financing arrangement with General Motors Acceptance Corporation ("GMAC"). Bay Chevrolet chose GMAC from a variety of GM-approved lenders. As part of the financing agreement, GMAC could "sweep" cash out Bay Chevrolet's general account bank in order to satisfy any payments that Bay Chevrolet owed to GMAC. Bay Chevrolet's general bank account held payments received from customers, including sales tax.

Bay Chevrolet filed for bankruptcy in 2007, and closed shortly thereafter. Approximately one month prior to the bankruptcy, GM terminated Bay Chevrolet's dealer agreement. Bay Chevrolet had failed to file sales tax returns or make payments thereon from about mid-2006 onward. Around the same time Bay Chevrolet stopped remitting sales tax, GMAC had begun to sweep funds from the general account, including amounts collected for sales tax, to satisfy its liabilities from Bay Chevrolet. Mr. Kieran argued that it was this sweeping that caused the dealership to not or partially pay sales tax due. The Tribunal noted that "[t]here is no evidence in the record that . . . Bay Chevrolet ever contacted in GMAC" to have GMAC pay over such sales tax to the Department of Taxation of Finance (the "Department"), nor is there evidence that Bay Chevrolet "took any other affirmative steps to protect sales tax collected."

Tax Law §1133(a) imposes personal liability upon "every person required to collect [sales] tax" for such tax. Under 20 N.Y.C.R.R. §532.2, a person required to collect sales tax is a "trustee," required to hold the tax on behalf of the Department until remittance. Tax Law §1131(1) defines such a person to include an "officer, director, employee[,] or manager" who had a "duty to act" in collection sales tax on behalf of business.

The Tribunal first determined that prior to GMAC's "control," Mr. Kieran was a "responsible person" (had to duty to act) with respect to Bay Chevrolet's collection of sales tax. The Tribunal stated that whether a person has a duty to act "depends on the facts of each case."[2] Specifically, the Tribunal determined that Mr. Kieran had a duty to act based on the fact that he "was president of Bay Chevrolet," was "in charge of the day-to-day management of the dealership," "oversaw all of the dealership's sales transactions pursuant to which the dealership collected sales tax," "signed checks and sales tax returns," "hired and fired employees," " had a "substantial economic interest" (25%) in the dealership, and maintained" "unquestioned control over [the dealership's] financial affairs," at least until the sweeping began.[3]

After determining that Mr. Kieran was a responsible person in first instance, the Tribunal further determined that Mr. Kieran's responsible person status persisted after GMAC began account sweeping (which Mr. Kieran characterized as a loss of financial control). The Tribunal tees up its argument by stating

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"that economic difficulties do not excuse" a responsible person's duty,[4] and that a responsible person "may not continue to operate a business 'at the expense of ensuring that sales tax was paid.'"[5] The Tribunal then puts forth its principal argument that Mr. Kieran "voluntarily" entered into the arrangement, and, thus, did not really lose control.[6] To support this argument, the Tribunal relies on its previous decision in *Matter of Button*.[7]

In *Button*, the taxpayers were officers and owners of a corporation that acted as a wholesaler for cigarettes (among other items). After the corporation's bank changed its collateral requirements, the corporation was in default of its obligations to the bank. In order continue its financing arrangement (and keep the business operating), the corporation agreed to give the bank a security interest in all of the corporation's accounts. After a subsequent default, the bank froze the corporation's accounts, and, as a result, the corporation's automatic payments to purchase cigarette sales tax stamps "bounced." The Tribunal in *Button* found that the taxpayers were liable for the sales tax due, despite the freeze in accounts.

The Tribunal found that the facts in *Kieran* were sufficiently analogous to impose the result of *Button* on Mr. Kieran. In the Tribunal's opinion, the taxpayers in *Button* and *Kieran* all caused their own inability to pay. The *Kieran* Tribunal further found that that taxpayer did "not show[] that the terms of the sweep agreement precluded him from taking any action to fulfill his duty as a responsible person."[8] The Tribunal went on to state that Mr. Kieran "ha[d] not shown that GMAC took legal control over the dealership's funds," and that specifically "there is no evidence that GMAC ever had check-signing authority for the dealership."[9] The Tribunal also dismissed as distinguishable or irrelevant several other cases that Mr. Kieran cited for support.[10]

Taxpayers such as Mr. Kieran are almost always unsuccessful in claiming relief from personal liability on the grounds that outside forces prevent them from making required sales tax payments. The most colorful of these cases involve businesses that are effectively controlled by organized crime. In one such case, *Matter of Marchello*,[11] the Tribunal, overturning an ALJ, found that the taxpayer therein was liable for sales tax although organized crime interests effectively ran the adult entertainment club that the taxpayer owned. Mr. Marchello, the taxpayer in that matter, hired a Mr. Aslan to operate Marchello's adult entertainment club. Marchello's involvement in the club was relatively passive. Aslan was supposed to pay all expenses of operating the club (including sales tax) out of club proceeds, and pay all profits to Marchello. Aslan was supposed to make himself available to Marchello for occasional meetings, and to furnish the quarterly sales tax returns to Marchello. Under Aslan's watch, the club kept a number of organized crime associates on the payroll and paid a number of personal expenses for Aslan and others. The Department eventually pursued the club for failure to remit sales tax. Despite Mr. Marchello's lack of day-to-day control, the Tribunal found him liable for the tax under a duty to act rationale, largely on the theory that Aslan was his agent.

The big question is whether there is anything Mr. Kieran could have done differently. Arguably, he would have been in his rights to segregate the sales tax payments on the grounds that such payments were not property of the dealership, although it is possible that GMAC would not have allowed that. The ability to sweep the account that included sales tax allowed GMAC to get paid before the Department,[12] even if the funds were technically held in trust. The Tribunal seems to go out of its way to point out that Bay Chevrolet had its choice of lenders and chose GMAC, underscoring that Mr. Kieran "volunteered" his way into his unfortunate position. However, there is no way of knowing whether another lender would have required (or not) a sweeping or similar arrangement to secure its financing.

A related question is whether GMAC, by sweeping all amounts in the account, including sales tax payments, could also be held responsible for the unpaid sales tax. (As a practical matter, this would likely only become an issue if the other potential responsible persons were unable to satisfy the sales tax claims.) The authorities are clear that sales tax is owed by the buyer. The seller simply collects the amounts on behalf of the Department, which is why these amounts are referred to as "trust fund liabilities." At least one advisory opinion indicates that where the seller's lender holds collected sales tax in trust (along with non-trust funds) in a lock box account, the lender is liable for the remittance of sales tax.[13]

Kieran contains an unrelated peculiarity worth mentioning: The Department attempted to argue that Mr. Kieran owed more sales tax than was reflected on the Department's statement of liabilities. In May 2008 (after the dealership had shut down), the Department issued several "notice[s] of estimated determination" to Kieran as "responsible officer." In May 2009, after Kieran (or others) filed late returns and partially paid certain amounts, the Department issued Kieran a "consolidated statement of tax liabilities," which showed no balance due for the quarter ending August 31, 2006. In its Answer to Mr. Kieran's Division of Tax Appeals Petition, the Department affirmed that the amounts due for that quarter had been "fully paid." Before the ALJ, however, relying on a printout from its records system, the Department argued that the consolidated statement and Answer were incorrect, and that a balance remained for the quarter ending August 31, 2006. The ALJ found that "[t]he fact that the [printout] bore a different amount, without further supporting proof, does not dictate the amount due,"[14] and held that no balance was due for the quarter ending August 31, 2006.[15] In affirming the ALJ's determination, the Tribunal stated that the "printout is not a statutory notice and is therefore not entitled to a presumption of correctness" and that, as the ALJ noted, the Department lacked sufficient evidence to otherwise support the printout.

About three quarters of the way through the decision, the Tribunal dispenses some advice: A taxpayer "cannot

relieve himself of his responsibility for operating his [business] and expect that he will be relieved of sales tax liability."[16] Business owners and managers should heed this warning, else they may find that even after their business assets are "swept" away, their sales tax liability remains.

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1 *Matter of Kieran*, DTA No. 823608 (N.Y. Tax App. Trib., Nov. 13, 2014).

2 Citing *Cohen v. State Tax Commission*, 128 A.D.2d 1022 (3rd Dep't 1987). The Tribunal curiously did not cite 20 N.Y.C.R.R. §526.11(b)(2), which also states this rule.

3 These factors are largely drawn from *Cohen*, *supra*, and 20 N.Y.C.R.R. §526.11(b)(2).

4 Citing to *Matter of Stafford*, DTA No. 811207 (N.Y. Tax App. Trib., May 11, 1995).

5 Citing to *Matter of Napoli*, DTA No. 808694 (N.Y. Tax App. Trib., July 13, 1995).

6 The Tribunal also held that the sweep arrangement was a "dereliction of [taxpayer's] duty" as a trustee of the sales tax funds.

7 DTA No. 817034 (N.Y. Tax App. Trib., Jan. 28, 2002) (later remanded, DTA No. 817034 (Mar. 14, 2002), then affirmed by the Tribunal, DTA No. 817034 (Oct. 20, 2005), on an issue unrelated to the one herein). The Tribunal also relied on persuasive authority from another "trust account" case dealing with federal withholding taxes. *See Kalb v. United States*, 505 F.2d 506 (2d Cir. 1974), *cert. denied*, 421 U.S. 979 (1975).

8 This was partially an evidentiary issue. Early in the decision, the Tribunal stated that the burden of proof is on the taxpayer to show in duty to act cases. Mr. Kieran failed to produce the actual sweep agreement.

9 At this point in the decision, the Tribunal was comparing the facts of *Kieran* to *United States v. Falino*, 441 F. Supp. 153 (E.D.N.Y. 1977), another federal withholding tax case. The Tribunal characterized *Falino* as a case where "a general contractor's president was found *not* responsible for the payment of withholding taxes because a surety company had . . . assumed legal control over the corporation's funds" (emphasis added).

10 *Chevlowe v. Koerner*, 95 Misc. 2d 388 (N.Y. St. Sup. Ct., July 19, 1978); Matter of Stern, DTA No. 801488 (N.Y. Tax App. Trib., Sept. 1, 1988); and *Matter of Muffoletto*, DTA Nos. 801567 and 802284 (N.Y. Tax App. Trib., June 19, 1997).

11 DTA No. 821443 (N.Y. Tax App. Trib., Apr. 14, 2011).

12 A point that the Tribunal makes in *Kieran.*

13 N.Y. STATE DEP'T OF TAX. AND FIN., ADVISORY OPINION, TILDEN COMMERCIAL ALLIANCE, INC., TSB-H-81(105)S (1981).

14 *Matter of Kieran*, DTA No. 823608 (N.Y. Div. Tax App., Sept. 12, 2013) (Conclusion of Law B).

15 Mr. Kieran, of course, still had a balance for the other quarters at issue.

16 Citing *Napoli*, *supra*.