Your Business Owes Sales Tax: Are You Personally Liable?

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Recent Legal Updates That May Surprise You

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As we have discussed in prior columns, sales taxes are "trust taxes." That means, under the wrong circumstances, certain individuals can be held personally liable for a business's outstanding sales tax debts. This can include owners, operators, and even investors or employees. Often, this comes as an unwelcome surprise and for good reason.

Most restaurant sales are taxable. The sales tax is collected, or should be collected, from customers by the restaurant as a fiduciary of the state. As such, not only is the business responsible, but certain individuals who are owners or active in the restaurant's management may be deemed a "responsible person" and can be, and often are, held personally liable for the taxes owed by the business. Let's take a brief look at New York's rules regarding personal liability for sales taxes.[1]

A. Who Can Be A Responsible Person?

First, let's consider the following scenario: John is a chef with a passion for food. Paul is an entrepreneur who dabbles in the hospitality industry. Together they form an LLC and open a trendy bar and grill in Brooklyn. Their friend George, a software engineer who lives in California, invests some start-up capital in exchange for an ownership stake. Ringo is an experienced restaurant manager, and he's hired to run the day-to-day operations. The restaurant opens to big crowds and rave reviews.

Three years later, the restaurant is selected by the New York Department of Taxation and Finance ("Tax Department") for a routine sales tax audit. It turns out the company didn't file any sales tax

returns for the first year. In years two and three, the restaurant had begun filing returns, but many of the returns were filed late and it turns out many of the returns contained errors. The auditor has a field day!

John, a 50% owner, loves working in the kitchen, but he has stayed out of the accounting. Paul, a 40% owner, hangs around the restaurant and likes to invite business associates over to "his bar," but he hasn't focused too much on the day-to-day operations. George, a 10% owner, has never even been to the restaurant and has nothing whatsoever to do with management of the business other than his initial investment and ownership stake. Ringo, who had originally been the person who was supposed to actually run the place, quit after the first year over creative differences.

After a few months, the auditor completes his audit and drops off an audit bill assessing $200,000.00 in tax, penalties, and interest for the three-year period. Who can the Tax Department hold responsible for this liability? Here's the important point: The auditor can probably go after John, Paul, George, *and* Ringo. All four probably have some exposure, but how could that be?

B. What Does It Mean To Be A Responsible Person?

As mentioned above, New York's Tax Law imposes personal liability for sales taxes upon all individuals who qualify as "responsible persons."[2] A responsible person, in turn, is jointly and severally liable for the tax owed along with the business entity or any of the business's other responsible persons. This means that a responsible person's personal assets could be seized by the Tax Department to satisfy the sales tax liability of the business.

The rationale behind making certain individuals responsible for the business's trust tax liabilities is two-fold: First, the Tax Department wants to encourage key stakeholders to ensure that the business is complying with its tax obligations. Second, the Tax Department wants a fallback plan to collect the tax from those responsible persons if it turns out that the business was noncompliant.[3]

In general, whether an individual qualifies as a responsible person turns upon various factors including the type of business entity involved; the individual's ownership percentage; and the individual's status and involvement with the business.[4] For example, the following factors may weigh in favor of personal liability: active involvement in operating the business on a daily-basis; decision-making authority over which financial obligations are paid; involvement in hiring and firing of employees; check signing authority; involvement with preparation of tax returns; and/or authority over business decisions. In short, management-level involvement may likely trigger personal liability.

However, the rules are different for LLCs. In New York, mere membership in an LLC is sufficient to create "per se" personal liability for unpaid sales tax debts. Yes, you read that correctly! Unfortunately, this rule can yield some pretty harsh results, in particular for passive investors. As a result, in 2011 the Tax Department began to provide some measure of relief for members who could demonstrate, essentially, that (a) they owned less than 50% of the entity and (b) they were not in a management-level position.[5] LLC members who can make the required showing are eligible to have their liability reduced, essentially, to their pro rata investment. So, under this policy, a ten-percent passive investor would owe, essentially, ten percent of the liability.

Significantly, and hot off the press, this administrative policy was just codified into law in March as part of New York's 2019 Fiscal Year Budget Bill. Unfortunately, the legislature did not align the rules for LLCs with other business types, but at least this relief is now mandated by statute. The Tax Department is expected to issue new guidance shortly.

C. A Closer Look At Personal Liability

How do these various rules play out in the real world, and how will they impact our foursome from the illustration above? First-of-all, we are told that John and Paul operated their bar and grill through an LLC. This brings the special LLC rules into play.

John is the chef. He has a passion for food, but he has stayed in the kitchen and out of the finance and accounting. Unfortunately for John, he's a 50% owner of the LLC. It doesn't matter that he wasn't responsible for the financial aspects of the restaurant. The auditor can assess John for the full $200,000 liability.

Paul is the entrepreneur. He hangs around the restaurant, but he hasn't focused much on the day-to-day operations. Paul is a 40% owner of the LLC. Since he owns less than 50%, if Paul can establish that he does not hold a management-level position, then he may be able to seek to reduce his liability to somewhere around $80,000 (40% of the tax bill).[6] But that's a big if. Paul is certainly representing himself to the public as an owner. Does he have authority to hire and fire staff? Does Paul sign tax returns or make decisions over which creditors to pay or not pay? Was Paul aware the business wasn't keeping up with its tax obligations? This will require a facts and circumstances analysis. Either way, though, Paul is looking at either a $200,000 or $80,000 tax bill.

George is the software engineer who lives in California. He invested the initial capital to help get the restaurant off the ground. He's never been to the restaurant and has no involvement with the management of the business. Nonetheless, George is a 10% owner of the LLC. Even under the new law passed in March, George is stuck. The best that he can do is seek to have his liability reduced to somewhere around $20,000 (10%).

Ringo was the experienced restaurant manager. He was hired, as an employee, to run the restaurant on a daily-basis. He's not an owner of the LLC, but we can assume he was heavily involved in the financial decisions of the business, because neither John nor Paul wanted to be in charge and they hired Ringo to handle those types of decisions. Unfortunately, it seems that Ringo didn't do a very good job. But, he quit after the first year. Nonetheless, assuming the auditor could locate Ringo, the auditor could likely assess 100% of the sales tax liability for that first year against Ringo. For sake of simplicity, let's call that 33% of the total liability for all three years, or $66,000.

Consequently, the Tax Department can attempt to collect against the restaurant, John, Paul, George, and Ringo, up to their respective assessed amounts. The Tax Department cannot collect more than $200,000 (plus accruals) in total, but it likely has up to five different taxpayers from which it may attempt to collect. Yikes!

D. New York's Tax Court Just Analyzed These Rules

In April, New York's tax court just examined the fate of a restauranteur who was a 50% owner of an LLC that ended up owing $121,543 in additional tax as the result of a routine sales tax audit.[7] The taxpayer, Mr. Bitton, operated a restaurant in New York. In summary, the restaurant went through several different iterations and various partners and managers came and left. At trial, Mr. Bitton testified that he was not actively involved in the business at all times, although he conceded that he had check signing authority, received mail, the lease was in his name, and he spent time frequently at the restaurant. He further testified that he had been precluded from taking an active role in the business due to a chronic illness, and that moreover another individual was the general manager during the relevant time period.

Nonetheless, the court summarily concluded that he was a responsible person merely by virtue of his ownership of 50% of the LLC, irrespective of any other facts. Poor Mr. Bitton was held personally liable for the full assessment (just like John in our example above). This is not an uncommon outcome.

The moral of the story is that a sales tax audit can present significant challenges to any business, but also to a variety of owners, operators, investors and even certain employees depending upon the facts and circumstances. Consequently, it's crucial to familiarize yourself with proper bookkeeping, accounting, and tax compliance rules and requirements in order to minimize risk and better appreciate possible exposure. The best defense to an audit is to set up and operate the business the correct way before the auditor comes knocking. Once an auditor arrives, however, handling the audit seriously, professionally, and quickly will best serve any business.

If you are reviewing your company's sales tax practices, are considering whether you may have exposure for sales tax liabilities, or if you are facing a tax audit or dispute, you can email me at lrothenberg@litaxattorney.com.

Disclaimer: The information contained in this article does not constitute tax advice and is for informational purposes only.

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[1] Many states have similar rules. For example, New Jersey also imposes personal liability for trust taxes upon individuals who qualify as responsible persons. *See generally, Cooperstein v. Director*, 13 N.J. Tax 68 (1993).

[2] *See* Tax Law §§ 1133 and 1131.

[3] As an aside, federal and state payroll taxes are also trust taxes, but that's a subject for a different article!

[4] *See* Tax Department Form DTF-17.1.

[5] *See* TSB-M-11(17)S (2011).

[6] We are using round numbers to demonstrate the general application of these rules. In reality, if an eligible LLC member is granted relief, he may also qualify for penalty abatement in addition to a reduction in liability. For sake of simplicity, penalty abatement is not reflected in these numbers.

[7] *Matter of Bitton*, DTA No. 827184 (Division of Tax Appeals, ALJ Unit) (04/19/2018).

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