NY Appellate Tribunal Upholds Passive Investor's Personal Liability for State Taxes, Journal of Taxation, Feb 2020

Journal of Taxation (WG&L)

SHOP TALK

NY Appellate Tribunal Upholds Passive Investor's Personal Liability for State Taxes

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. Readers are invited to write to the editors: Sheldon I. Banoff, Suite 1900, 525 West Monroe Street, Chicago, Illinois 60661-3693, Sheldon.Banoff@kattenlaw.com; Richard M. Lipton, Suite 5000, 300 East Randolph Street, Chicago, Illinois 60601, Richard.Lipton@bakermckenzie.com; and Adam M. Cohen , 555 17th Street, Suite 3200, Denver, Colorado 80202, ACohen@hollandhart.com.

[pg. 38]

Shop Talk has long been interested in cases imposing *per se* tax liability on a passive investor (e.g., a limited partner or non-manager member of an LLC) solely by reason of that person's status as a limited partner or LLC member without regard to any factors or willfulness. See, e.g., Shop Talk, "More on New York Tax Liability for Limited Partners and LLC Members," 115 JTAX 54 (July 2011); "Personal Liability of LLC Members and Limited Partners for New York Sales/Use Tax," 122 JTAX 91 (February 2015); and "NY Amends Personal Liability for Taxes Owed by LLC Members and Limited Partners," 129 JTAX 46 (July 2018). Our July 2018 Shop Talk column reported on two decisions by Administrative Law Judges of the New York Division of Tax Appeals imposing personal liability on an LLC owner for failure of the LLC to pay New York sales and use taxes. *In re Gregg M. Reuben,* 2018 WL 1902267 (N.Y. Div. of Tax App. 2/15/2018) and 2018 WL 4904370 (N.Y. Div. of Tax App. 4/19/2018).

Our friend, Allan Donn, a Norfolk, Virginia lawyer with Willcox & Savage, P.C., has regularly contributed to Shop Talk on this topic over the past decade. See Shop Talk, "Tax Liability Solely by Reason of Being a Limited Partner or LLC Member," 113 JTAX 317 (November 2010), and many of the articles cited in this update. Mr. Donn again writes us regarding further developments in *Reuben* involving potential personal liability of LLC members and limited partners for certain New York taxes:

The New York State Tax Appeals Tribunal has affirmed the determination of the Administrative Law Judges. *Gregg M. Reuben*, 2019 WL 4396906 and 2019 WL 4396907 (both N.Y. Tax App. Trib., 8/27/2019). In both cases, the issue stated by the Tribunal was whether Reuben was properly determined to be a person "under a duty" to collect and remit sales and use taxes. The Tribunal determined that even though he did not own a direct interest in the LLCs that were the "vendor" with respect to the taxes owed, he was nevertheless responsible.

Reuben owned a 99% membership interest in Alliance Parking Services, LLC (Alliance) with the remaining 1% held by an S corporation wholly owned by him. Alliance operated through 13 wholly owned LLCs that in turn owned and operated parking facilities. The Administrative Law Judges, as affirmed by the Tribunal, held that Reuben was *per se* personally liable for the sales and use tax due from the operating LLCs by virtue of his status as a member of Alliance with a 99% ownership interest. The Tribunal also said that he was liable for the taxes as a person under a duty

[pg. 39]

to act by virtue of his ownership and active management of Alliance and in turn the LLCs.

The New York Limited Liability Company law includes a member and manager liability protection provision generally found in LLC acts. Section 609(a) provides that neither a member nor a manager is liable for any debts, obligations or liabilities of the LLC "solely by reason of being" a member or manager. Section 609(c) contains an express exception to that liability protection rule, providing that the 10 LLC members with the largest percentage ownership interests are jointly and severally liable for all debts, wages, or salaries due to its employees for services performed by them for the LLC. Neither Section 609 nor any other provision of the LLC Act imposes personal liability for unpaid taxes solely by reason of being a member or manager. However, the New York tax laws do.

New York Consolidated Laws, Tax Law (NY Tax) Section 1133(a)(1) provides "every person required to collect any tax" (in this case sales and use tax) is personally liable for the unpaid tax. NY Tax Section 1131(1) defines a "person required to collect tax" to include any officer, director, or employee of a corporation, employee or manager of an LLC who as such is "under a duty to act for" the entity, and, without reference to "duty to act for" the entity, "any member of a partnership or limited liability company." In other words, unlike an officer, director or employee of a corporation or even an LLC manager, a limited partner or LLC member is subject to strict, joint and several liability, for any unpaid sales and use tax of the limited partnership or LLC. The strict liability of a limited partner or LLC member is not subject to the qualifier of being under a duty to act, which was the standard that the Tribunal said was the issue.

The Tribunal began with a recital of NY Tax Section 1133(a) that imposes personal liability for sales and use tax upon all individuals that may be considered persons required to collect those taxes and NY Tax Section 1131(1) that defines "persons required to collect tax" to include every vendor of tangible personal property or services, any officer of a corporation, and "any member of a partnership or limited liability company." Applying the statute, the Tribunal held that NY Tax Section 1131(1) imposes strict or *per se* liability for the collection of taxes on members of partnerships and members of LLCs. According to the Tribunal, the "critical question" was whether the tax liabilities of the parking facility LLCs were liabilities of Alliance, as the sole member, and, if so, whether Reuben, as a member and 99% owner of Alliance, was personally liable for the sales and use tax due by the parking facility LLCs.

Reuben contended that he could not be held strictly liable for the tax because he was not a member of

the parking facility LLCs. Reuben effectively was arguing that he could not have personal responsibility for the 13 LLCs because his ownership was organized in a tiered-ownership structure, and only Alliance was a member of those LLCs. Reuben owned an LLC membership interest in Alliance, but *not* in any of the operating LLCs that were non-compliant with their sales tax payment obligations.

The Tribunal rejected that argument and held that because Alliance was the sole member of the parking facility LLCs, Alliance was by statutory definition a person required to collect tax and was therefore liable for the tax due on behalf of the parking facility LLCs. Next, the Tribunal determined that Alliance's two members-Reuben, who owned a 99% share individually, and his wholly owned corporation, which owned 1%-were "persons required to collect tax" by virtue of their status as members of an LLC. Therefore, those two members shared joint and several liability for the tax due, first by the parking facility LLCs, which was passed through to Alliance, and then up the chain to the owners of Alliance.

The Tribunal further rejected the argument that a finding of strict liability would be contrary to the legislation that created the Limited Liability Company Act in 1994.

Having concluded that Reuben was a person required to collect tax of Alliance by virtue of Alliance having been held to be a person required to collect tax of the parking facility LLCs, the Tribunal then proceeded with dictum. After stating, "[a]lthough it is not necessary for the purposes of determining petitioner's liability for the tax due" given its earlier conclusion (of strict liability), the Tribunal stated that it agreed with the determination of the Administrative Law Judges that Reuben was also a person responsible under the "duty to act" standard of NY Tax Section 1131(1). Having decided the strict liability question, the Tribunal did not explain why it proceeded to address the unnecessary issue. Its determination of who was responsible under the standard was based upon factors relevant in determining whether an individual was a person under a duty to act. It then recited those factors and determined that Reuben owned and managed Alliance, which, as the sole member, owned and managed the affairs of the parking facility LLCs. In addition to having established the parking facility LLCs, Reuben played a significant, active and ongoing role in the business, was responsible for maintaining the financial books and records of Alliance, was the sole authorized signatory on the bank accounts for Alliance and the parking facility LLCs, hired and fired employees, and hired and engaged outside vendors for goods and services.

Reuben contended that he could not be deemed a responsible person under a duty to act because the person whom he had hired as Alliance's comptroller and chief financial officer "thwarted his ability to know, or learn, of the nonfiling of returns and nonpayment of sales and use taxes, among other liabilities." The Tribunal rejected that argument, explaining that "one cannot absolve himself of liability by simply delegating authority to a subordinate, or by disregarding his duty and leaving it to someone else to discharge (citation omitted)."

The Tribunal also rejected Reuben's contention that he should not have been subject to the penalties imposed upon him for the nonfiling of returns and underpayment of tax. It determined that he failed to carry his burden of establishing that the failure to pay tax "was due to reasonable cause and not due to

willful neglect."

[pg. 40]

Although the imposition of personal liability on an LLC member is harsh (even though in the *Reuben* case the taxpayer owned 99% of the parent LLC), the 2018 New York Budget Bill (reported in the July 2018 Shop Talk column) codified some of the relief provisions that had been included in the New York State Tax Commissioner's Policy (TSB-M-11(17)(S)). The relief provided by the Policy was that a member of an LLC or a limited partner whose ownership interest and distributive shares of profits and losses were less than 50% was held not to be under a duty to act for the LLC. (Reuben would not have qualified for relief under the Budget Bill, even if it were applicable to tax liabilities arising in the years in question, because, inter alia, Reuben had effective ownership of the parking facility LLCs that was not less than 50%.) The relief granted by the Budget Bill was to reduce the partner's or member's *per se* liability to that portion of the total based upon that person's share of the entity even though the partner or member eligible for relief was not completely exonerated from *per se* liability. The Policy was revoked after the Budget Bill and the New York State Tax Commissioner announced that new guidance would be issued regarding the Budget Bill legislation. See TSB-M-18(1)(S) (5/25/18). As of November 30, 2019, the Department had not yet issued guidance under the new statute.

We thank Mr. Donn once again for his analysis and keeping our readers apprised of these tax liability developments. As we stated in our July 2018 Shop Talk article, we agree with the recommendation of a New York State Bar Association (NYSBA) Report that the NY Tax Law should be reworded to remove entirely the unique liability language for LLC members and limited partners. See NYSBA Tax Section Comments on 2018-2019 New York State Executive Budget, Report No. 1391 (3/9/2018), pg. 33. As a matter of good tax policy and administration, holding minority, passive investors responsible for entity level sales and use tax debts should be mitigated, as the NYSBA Report urges.

We intend to keep our readers apprised of further developments in the NY Tax Law that impose joint and several liability on the passive investors in limited partnerships and LLCs.