Outside Counsel

Personal Liability of LLC Members For Unpaid Sales Taxes

By **Timothy Lewis**

One of the most significant benefits of a Limited Liability Company (LLC) is limited liability for its members, so long as proper formalities and similar requirements are followed. However, New York Tax Law §1131(1) provides an exception for certain "persons required to collect tax" pursuant to which personal liability can be imposed for New York sales taxes that were or should have been collected by an LLC but are not paid over to the state.

The statute's treatment of corporate officers and employees generally follows the federal "responsible person" guidelines. However, the definition in §1131(1) also refers to "any member of a partnership or limited liability company," without explicitly stating any requirements concerning the person's involvement (or lack thereof) similar to those listed for corporate officers and employees. A strict reading of the statute would conclude that any member of an LLC or partnership is per se liable for unpaid sales tax plus interest and penalties.[1]

Limited Partners

Prior decisions have interpreted §1131(1) and the scope of liability to apply to all partners of a limited partnership. In *Matter of Robin Pickett* (New York Division of Tax Appeals, Nov. 18, 1993), an administrative law judge concluded that the tax law "explicitly places liability on all members of a partnership [and] does not distinguish between limited and general partners."

Similarly, in *Matter of John P. Bartolomei* (New York Tax Appeals Tribunal, April 3, 1997), the tribunal concluded that a limited partner, "regardless of the partner's involvement in the operation and management of the business," is liable as a person required to collect tax. These cases approved the Department of Taxation and Finance's strict interpretation that asserts personal liability regardless of degree of ownership or control.

The Department continues to routinely assess limited partners and LLC members based on that interpretation, and it is not uncommon for a minority limited partner or LLC member who made a minimal investment in the entity and had no significant involvement with the entity or the sales taxes at issue to be assessed for an amount that is ten or twenty times the amount that they initially invested in the entity (and presumably lost as well).

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However, in the LLC context, a recent administrative law judge decision in *Matter of Joseph P. Santo* (New York Division of Tax Appeals, March 12, 2009) did not follow those decisions. The court cited earlier decisions regarding personal liability for individuals affiliated with corporations and applied the corporate principles to the particular LLC member at issue.[2]

In *Santo*, the court distinguished between active and passive LLC members, considering factors such as degree of management, responsibility over financial and tax returns, and authorization to sign tax returns. The key factors were the "power to exercise tax collection" and the degree of investment and ownership. The petitioner had previous experience in the restaurant business, so his role was to oversee the managers of the restaurant operated by the LLC. He visited the restaurant once or twice weekly in the course of supervising the managers. The petitioner had no role in the collection or remittance of sales tax or the preparation or filing of sales tax returns. He had check signing authority on behalf of the LLC; however, he only signed six to ten checks in total, when the LLC member who handled all financial matters for the LLC was on vacation.

After an investigation and analysis of the facts, the court concluded that the petitioner was not an active member, but a minority investor with no control over the management of the LLC. The court concluded that the petitioner "lacked the power to exercise the tax collection responsibilities on behalf of the LLC and, therefore, cannot be held to have been a person responsible for the collection and payment of sales tax on behalf of the LLC."

Legislative Purpose

New York's Limited Liability Company Law protects LLC members from personal liability for the debts and obligations of the business based on membership alone. No member "is liable for any debts, obligations or liabilities... whether arising in tort, contract or otherwise, solely by reason of being such member."[3] The legislative purpose suggests that LLC members should not be personally liable for tax obligations only because they are members, absent other circumstances and reasons.

It is also questionable whether an assessment of an LLC member who had minimal if any involvement with the LLC or its tax compliance, derived no significant benefit from the LLC, and clearly does not meet the responsible person criteria outlined in §1131(1) and the corresponding regulation,[4] such as the taxpayer in *Santo*, passes constitutional muster.

The implications of potential personal liability of tax »» Page 7

TIMOTHY LEWIS *is a member of T.W. Lewis & Co., a boutique tax law firm.* TREYTON MOY, *an accounting student at Cornell University, contributed to this article.*

Taxes

« Continued from page 4

obligations on LLC members are relevant to potential and current investors. Passive members who have no control over taxation and management decisions should be aware of their potential liabilities. Passive investment in an LLC without any degree of management is riskier since it may be difficult and expensive to prevent and/or contest personal assessments for possible unpaid sales tax obligations.

Limited liability is an attractive and significant factor in a potential investor's initial decision to make an investment in a particular venture. A strict interpretation of section 1131(1) may follow the letter of the law, but certainly ignores the spirit and purpose of allowing the formation of LLCs. It weakens limited liability for LLCs and may defeat their primary purpose of encouraging investment and new businesses throughout the state.

The choice of a particular business entity is also crucial in light of these decisions. Owners and members need to consider tax liability implications, since the degree of limited liability for minority and passive LLC members is not entirely clear and subject to change depending on future decisions and possible legislative amendment of the statute.

1. This aspect of the New York law differs from the computation of the federal trust fund penalty amount, which only includes interest in some cases and never includes a personal assessment for penalties assessed against the entity relating to the unpaid taxes or unfiled returns.

2. See, e.g. *Matter of Constantino*, Tax Appeals Tribunal, Sept. 27, 1990 (Petitioner held not to be a person required to collect tax since his role was essentially a minority investor and supervising employee; his formal status as an officer was offset by circumstances relating to lack of control of the corporation and its tax matters).

3. NY Limited Liability Company Law §609(a).

4. NYCRR §526.11.