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The Continuing Saga of Unlimited Liability Companies in New York

by Timothy P. Noonan

Limited liability companies have historically had an important feature: Their members had limited liability for the debts and obligations of the company. You probably could glean that much from the name. But an interesting issue has been brewing over the past several years in New York that calls into question the suitability of this moniker.

In New York, as in most other states, responsibility for unpaid sales and use taxes not only lies with the legal entity running the business, but it also extends to some responsible persons of the entity.[1] "Responsible person" provisions like that are common for flow-through taxes like sales and withholding taxes, and are designed to ensure that the taxes collected by the business are remitted to the governmental entity charged with administering those taxes. The rationale for these provisions is basic and straightforward: Persons who are in a position within the business to ensure that the taxes are collected and remitted, and who have a duty to act on behalf of the business, should be held responsible if the business fails to meet its collection or remittance obligations.

New York state, however, has taken those rules one step further. As noted by my colleagues in a 2005 article in this publication, New York law appears to create an additional category of responsible persons that extends far beyond traditional notions of this term.[2] Under this definition of responsible person, liability for unpaid sales taxes extends to any member of a partnership *or any member of a limited liability company*.[3] In that 2005 article, Jack Trachtenberg and Mark S. Klein pointed out that while at one point the New York State Department of Finance and Taxation had taken the position (following the issuance of a New York State Bar Association report on the issue) that the provisions of Tax Law section 1131 did *not* call for unlimited liability for partners and LLC members, more recent evidence had suggested a change in policy. Indeed, at that time our firm was litigating several matters in which the department was seeking to hold that passive investors in partnerships or LLCs were responsible persons.

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And while those cases eventually settled, the issue has not gone away. On the contrary, it is now clearer than ever that the tax department takes the position that the law enables auditors to hold any partner or any LLC member responsible for sales tax regardless of whether that person was involved in the business. Once again, the issue appears to be coming to a head as more taxpayers are getting hit with these types of assessments and more practitioners are pressing the issue.[4]

In this article, I'll review this issue in more detail, talk about some of the current developments, and address what's likely to happen in the future.

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[1]Tax Law section 1131(1).

[2]*See* Jack Trachtenberg and Mark S. Klein, "The Imposition of Unlimited Liability on Limited Partners and Members of LLCs in New York," *State Tax Notes*, Dec. 5, 2005, p. 863, *Doc 2005-22739*, or *2005 STT 232-20*.

[3]Tax Law section 1131(1).

[4]*See, e.g.*, Joseph Lipari and Debra Silverman Herman, "Undue Hardship Under Sales Tax and Offer-in-Compromise Program," *New York Law Journal*, Mar. 12, 2010.

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The Statute

Under Tax Law section 1133(a), any person who is required to collect and pay over the sales tax faces personal liability if taxes are not paid.[5] In turn, New York Tax Law section 1131(1) defines a person required to collect tax as including vendors as well as any officer, director, or employee of a corporation; any employee of a partnership; any employee or manager of a limited liability company; or any employee of an individual proprietorship who as such officer, director, employee, or manager is under a duty to act for that entity in complying with any requirement of this article of the law.[6]

Also, before 1994 the law included "any member of a partnership" in the category of responsible person. And as relevant here, in 1994 the law was amended to also include "*any member of a limited liability company.*"[7]

Problems With the Statute

Where Do I Start?

I guess we can start with a basic tax policy issue. It is understandable and rational to hold individuals personally liable for the sales tax deficiencies of a business when those individuals are responsible for the business's operations. Once a business gets its hands on a state's money, a state should have every right to aggressively ensure that the business pays that money over. And if the state must enforce the liability against those who are in the position to see that taxes are paid, so be it. No one should have a problem with that. But holding passive investors liable for the unpaid sales taxes of a business makes no sense and is unfair. They can't manage the affairs of the business or see to it that taxes are paid. So why hold them personally liable?

Next, it's not as though the law change in 1994 was a deliberate and well-thought-out attempt by the Legislature to expand the category of responsible persons in New York. Instead, it appears this whole issue came about because of a mistake. When LLCs came into existence, wholesale changes had to be made to the tax law (as well as many other provisions in New York law) to cover situations regarding those new entities. Those changes occurred in 1994.[8] For tax purposes, because LLCs were generally going to be treated as partnerships, several changes needed to be made to the tax law. And to do so, the Legislature appears to have done what most of us using Microsoft Word would call a "find and replace." Wherever the tax law referred to a partnership, the Legislature also added a reference to LLCs. And wherever the tax law referred to partners, the Legislature added a reference to members of LLCs.

Generally, that "find and replace" worked fine, because the tax law is supposed to treat LLCs and partnerships in a similar fashion — as flow-though entities for tax purposes. But in the context of personal liability, the difference between the entities is drastic. Indeed, the whole point of LLCs was to provide *limited* liability to members. That is unlike the *unlimited* liability applicable to general partners of a partnership, because partners (at least general partners) are always liable for the debts and obligations of the partnership regardless of their involvement. So you can't do a "find and replace" to Tax Law section 1131 without drastically changing the nature of the provision. That section of the tax law has nothing to do with the flow-through tax treatment of partnerships or LLCs, or any aspect of a taxpayer's tax calculation. It has to do with liability. And one of the most important aspects of LLCs — if not the most important — was that they gave their owners *limited liability*. Tax Law section 1131 completely negates the primary benefit of using an LLC.

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Interestingly, though, that "legislative intent" issue has never arisen in any litigated cases. I also suspect the tax department would argue that mistake or not, the law on the books allows it to assert tax against passive LLC members, so the department is going to do it. However, if the law is unconstitutional, defective, or inconsistent with other aspects of New York LLC or partnership law, the department would be prohibited from enforcing it. And I believe — based on many of the arguments presented by Trachtenberg and Klein in their 2005 article — that the law suffers from all three of those problems. That's undoubtedly why our firm was able to settle several of those cases back around the time the 2005 Trachtenberg and Klein article came out. And that's precisely why we believe taxpayers will ultimately be successful in combating assessments issued on those grounds.

Case Law

Other taxpayers, though, haven't been so lucky. And in one recent case, the tax department prevailed over a pro se taxpayer in the tax appeals

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[5] N.Y. Tax Law section 1133(a).
[6] N.Y. Tax Law section 1131(1).
[7] *Id.* (emphasis added).
[8] 1994 N.Y. Laws 576.

tribunal.[9] In *Matter of Santo*, the taxpayer was a member of an LLC that ran a restaurant business. It was clear from the facts of the case that he was not at all involved in the operations of the business. Thus, using a traditional responsible person analysis (looking to whether the taxpayer had a duty to act on behalf of the LLC, whether he could hire and fire people, whether he had access to bank accounts and other financial information, and so forth), an administrative law judge in the Division of Tax Appeals held that the taxpayer was not a responsible person under Tax Law section 1131. In that decision, the ALJ did not refer to the per se liability provisions contained in the statute.

The victory for the taxpayer, however, was short-lived, because the tax department appealed. And on appeal, the Tax Appeals Tribunal — citing Tax Law section 1131(1) — held that regardless of how involved the taxpayer was in the operations of the business, the "petitioner was a member of a limited liability company and, as with members of a partnership, such members are subject to *per se liability* for the taxes due from the limited liability company."[10]

So the glimmer of hope taxpayers had after the initial decision in *Santo* was quickly extinguished by the tax appeals tribunal. And the tribunal decision confirms what Trachtenberg and Klein said in their 2005 article — namely that challenges to the application of Tax Law section 1131 in the Division of Tax Appeals would probably be fruitless. Absent some forbearance on the part of the tax department or a reversion to its pre-2005 policy, a taxpayer's best (and perhaps only) chance of success is either through the legislative process or through an Article 78 proceeding in the New York Supreme Court.

Combating the Tax Department Position

For any taxpayer to successfully challenge the tax department's position on this issue, however, we have to know where the tax department stands and why it believes enforcement of the law is proper.

So let's start with some of the history. As noted above, in a 2003 report issued by the New York State Bar Association, the bar took issue with efforts by some auditors within the tax department to enforce responsible person status on passive investors in partnerships and LLCs. Shortly after, under the leadership of former tax commissioner Arthur Roth, the tax department had, at least informally, decided that the provisions of the law were not enforceable against passive members of LLCs or limited partners.

As noted in the Trachtenberg and Klein article, however, at some point following Roth's departure, a change in policy occurred. From what we can tell, that occurred at the audit level, with audit personnel deciding to step up their enforcement efforts and start going after passive investors on a case-by-case basis. It doesn't appear that there was any official change in policy from the commissioner or that there was any other formal policy change. Whatever the case, for about the last five years, passive LLC members and limited partners have been getting hit with huge assessments for unpaid sales tax due from delinquent companies. Some of those taxpayers probably just paid the bill. Some did not, but had their bank accounts levied — and the bill was paid for them. Some, like Santo, fought the issue and lost. But others, including several of our clients, continue the fight.

Obviously, auditors within the tax department are showing no signs of backing down on the issue. In fact, even as some legislators are considering a change in the law to address this problem, it is unclear whether the tax department would support such a change. Apparently there are some within the department who are arguing that without this provision of the law, taxpayers would be able to hide behind various levels of LLCs or partnerships to avoid being hit with tax as responsible persons. Without the power to assess *all* members of LLCs, the argument goes, the tax department enforcement efforts could be hamstrung by those improper tiered structures.

But there are many flaws in that argument. First, there's no indication that the existence of that problem led to the imposition of this law in the first place. Instead, as noted above, it appears that the additional language arose from a drafting error — there was no indication that there was a deliberate attempt by the Legislature or tax department to correct what was viewed as tax evasion. Also, it's silly to suggest that taxpayers layer together LLCs to hide their involvement in a business entity for the very purpose of avoiding a potential assessment for unpaid sales taxes years in the future. Most cases in this area involve situations in which individual entrepreneurs or investors come together to form an LLC to operate a restaurant, car dealership, software company, or other type of business. An LLC is chosen as a vehicle of choice in that situation because of the favorable tax treatment it provides and because of the limited liability it offers. And while I'm sure there are exceptions to that, taxpayers generally aren't setting up various layers of entities to hide themselves from view.

Whatever the case, if the tax department believes the per se provisions of the law are there to allow them to assess those officers who are "really responsible," why did it go after Santo — who the department agreed wasn't responsible? And why has it

[9]*Matter of Santo*, Tax Appeals Tribunal (Dec. 23, 2009). (For the decision, see *Doc 2009-28559* or *2010 STT 3-18*.)
[10]*Id*. (emphasis added).

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gone after so many other taxpayers, including many of our clients, who didn't participate at all in any sort of layered or tiered structure, but merely were passive investors in an LLC that ran a business? I suspect no one would complain if the tax department implicated the per se liability provisions of Tax Law section 1131 only in those situations in which it needed the statute to find those who were "really responsible." But that's not what is happening. Instead, the per se provisions are being used against any and all LLC members regardless of their investment, level of involvement, or scope of responsibility. Blanket assessments are being issued on a widespread basis.

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But the tax department is in a Catch-22. Its justification for the law's strict enforcement demonstrates that the law itself is unnecessary. For example, auditors say they need the law to assist them in taxing those LLC members who are really responsible. In doing so, though, the department personnel effectively are admitting that only those who are really responsible should be on the hook for taxes! Moreover, despite that supposed justification, the department continues to use the law to go after a much larger subset of taxpayers — those, like Santo, who the auditors knew weren't responsible. And no justification has ever been provided for that.

Next Steps

As I noted initially, this issue is back in the forefront. It has been raised at the commissioner level, and legislation has already been proposed by one legislator to fix the problem. Also, Trachtenberg — the author of the 2005 article previously mentioned and New York state's new taxpayer rights advocate — has also taken up the issue for study and review.[11] So it is to be hoped that a fix could be on the way.

What remains to be seen, however, is what form that fix is going to take. Could it be a policy decision? Or a legislative change? Or is this going to play out in the courts? The answer at this point could be all of the above. Whatever happens, though, I hope that the next time this column reports on this issue, a fix will be in place. ✰

Noonan's Notes on Tax Practice is a column by Timothy P. Noonan, a partner with Hodgson Russ LLP, Buffalo, N.Y.

[11] *See* Lipari and Herman, *supra* note 4.

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