Understanding Sales and Use Tax Personal Liability

By Jesse W McClellan J.D.
McClellan Davis, LLC

Business failures are all too common in today's economic climate. Although many people assume that unpaid tax liabilities die with a business liquidation, this assumption is generally incorrect. With revenues down, states have become ever more vigilant in their efforts to collect the unpaid tax liabilities of closed out businesses. This article provides a discussion on who may be held personally responsible for an outstanding sales and/or use tax liability of a business organization such as a corporation, limited liability company or limited liability partnership.

Sales and use tax laws vary significantly from state to state, and personal liability rules are no exception. Some states may only pursue officers, members or partners of an organization, while others will pursue any "responsible person." Some states may pursue "responsible persons" within an entity only if they can establish that there was a willful failure to pay collected taxes; others merely require that a tax liability exist. The differences may sound subtle, but their impact on a state's ability to hold an individual personally responsible is significant.

Because California law includes many of the various elements present in other states, personal liability for sales and use tax in California is addressed in more detail below.

California's Revenue and Taxation Code provides that a "responsible person" of a closed-out business may be held personally responsible for the willful failure to pay collected tax, or use tax owed, of the former entity. The burden is upon the state to prove each element set forth under the law by a preponderance of the evidence. (Rev. & Tax. Code, § 6829; Evid. Code, § 115)

When is a business closed out for personal liability purposes?

Under prior law, it was necessary for the business entity to terminate, dissolve or to be abandoned before the state could pursue a "responsible" individual for the entity's unpaid tax obligations. However, recent law changes have broadened the triggering act. Now, a responsible person of the business entity may be pursued upon the close-out of "the business of" the organization. Under the more recent law, the mere closure of a California seller's permit opens the door for personal liability. For example, if a retail business incorporated and headquartered in New York closes its California store locations along with its California seller's permit, it's open game for collection efforts. Individuals of the corporation can be pursued even though the corporate entity remains intact and business operations continue in other States.

What individuals can be held personally responsible?

California law does not limit personal liability to officers, members or partners. Rather, any person of the entity that is responsible for the filing of returns, payment of tax, or who is charged with the duty to act on behalf of the business for sales and use tax purposes may be held personally responsible. Generally, California will pursue the individual that signs the sales and use tax returns and/or the person that authorizes or directs the payment of taxes. The legal provisions in this regard seem to provide the potential for a professional tax preparer to be held personally responsible, but there is no known case in California where that has been done. Moreover, as discussed in more detail below, an individual must also *willfully* fail to pay, as defined under the law, before he or she can be held personally responsible.

To what extent can a responsible person be held liable?

It is important to note that filing bankruptcy in any form, either by the business or individual, does not generally result in the discharge of an outstanding tax liability. Most laymen, and even some tax professionals and bankruptcy attorneys mistakenly believe that filing bankruptcy will relieve past or current sales and use tax obligations. Unfortunately, this is rarely the case.

There are two basic categories that the state may pursue: 1) collected tax, and 2) use tax owed for the consumption of goods purchased without the payment of tax.

The first category includes only sales or use taxes which were collected but not remitted to the state. The state cannot hold an individual responsible for a tax liability stemming from an entity's disallowed claimed exempt sales, such as disallowed claimed sales for resale or sales in interstate commerce, because tax generally would not have been collected on such sales.

Note that when a business is audited, the descriptions assigned by the auditor to asserted errors can often be misleading. For example, disallowed sales for resale may be described in an audit report as "additional taxable sales." Technically the description is correct, but it may be easily misinterpreted to mean that sales *on which tax was collected* were underreported, when in reality no tax was even charged on these sales. Because the state employees who actually collect unpaid taxes generally lack an audit background, such misleading descriptions can result in the erroneous assessment against "responsible" individuals.

The second category is a little less obvious. When a business purchases goods from out of state that are subject to use tax, and the business uses those goods without reporting the requisite use tax, an individual can be held responsible for the unpaid tax. This is true even if the business was never registered as a seller with the state and even if no tax was ever collected by the business. Further, if a business purchases goods from an in-state retailer under a resale certificate, but uses the goods prior to reselling to them, an individual can be held responsible for the applicable tax.

If the State can establish the above elements, is personal liability automatically assessed against the responsible individual(s)?

No. In addition to the above three elements, the state must also demonstrate that the responsible person *willfully* failed to pay collected sales taxes or use tax owed. The law specifically defines the meaning of a willful failure as an "intentional, conscious, and voluntary course of action." Although the definition is similar to the definition assigned to fraud, the two are distinct. A willful failure does not require evil or malicious motive and it does not have to result in unjust enrichment.

For example, if the controller of an organization elects to pay employee salaries with the remaining funds of a closing business in preference over a known sales tax obligation, the controller will likely be found to have willfully failed to pay the tax. On the other hand, if at the time of close-out of the business there are no funds available whatsoever, the state generally will not succeed in asserting willful failure.

The foregoing discussion is intended to be general in nature and is by no means exhaustive on the subject. It goes without saying that the facts of each case must be viewed in detail to determine whether or not the legal elements are present and have been satisfied. If you or your client believes there is risk of being held personally responsible for the liability of a closed-out business, it is advisable that you contact a qualified professional immediately.