BANKRUPTCY INSIGHT

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DISCHARGING 'RESPONSIBLE PERSON' LIABILITY FOR CALIFORNIA SALES TAXES

In Ilko v. California State Board of Equalization, 2011 WL 2520271 (9th Cir, 2011) the Ninth Circuit Court of Appeals affirmed the Bankruptcy Appellate Panel's ruling that an owner's personal liability for sales taxes incurred by his wholly-owned company eight (8) years prior to the filing of the owner's personal bankruptcy case were not discharged. This is a key ruling because it discusses precisely what must be done in order to discharge an owner's liability for sales tax liabilities incurred by his company.

Under California law (as of Sept. 2011), sales taxes are no longer assessable against the individual owner of a corporation or limited liability company (and therefore are potentially dischargeable in bankruptcy) approximately three and a half years after a business closes if the "business or its representative" gave prompt written notice to the State Board of Equalization of the business' closure. However, if no notice is given to the State Board, the taxes remain assessable against the individual owner (and other 'responsible persons') for at least eight (8) years. This is critical because if the taxes are still assessable against an individual when his or her bankruptcy case is filed, such taxes are not dischargeable.

So, giving notice to the State Board of Equalization of the closure of a business, and in fact terminating that business years before a personal bankruptcy case is filed, are key strategies in attempting to discharge any 'responsible person' sales tax liability imposed upon the owner of a business. However, in order for the tax to be dischargeable in bankruptcy it is *also* required that a tax return actually have been filed by the individual responsible person in his or her own personal name at least two years pre-bankruptcy. The business' sales tax return does not suffice even if signed by the individual in his/her corporate capacity. To add a further technicality, three years must elapse from the date the return was due (including extensions if any).

So, how does an individual owner of a business file a return for sales taxes incurred by their business years earlier? The California State Board of Equalization has opined as to just what such a return might look like:

> "... any person who is potentially liable under section 6829 may file a return .... Such a return should clearly state its purpose, and include all relevant information (such as that it is filed to report an amount due under section 6829, ..., the identity and seller's permit number of the applicable corporation, and the period for which the return is filed)."

In the Matter of the Petition for Redetermination Under the Sales and Use Tax Law of Hosmer Chandler McKoon 2007 WL 1932801 (5/31/2007) (Cal. St. Bd. Eq.)

In Depth Analysis

The Debtor in Ilko was the president and majority shareholder of Executive Auto Sales, Inc. ("EAS"). The California State Board of Equalization audited the sales tax returns of EAS for the period of October 1, 1993 through September 30, 1996. As a result, EAS became indebted to the State through a final assessment in the amount of $85,376.58 that became due and payable on June 20, 1997.

On July 3, 2001 the debtor - - i.e, the owner of EAS - - filed his chapter 7 bankruptcy. The debtor received his discharge on October 3, 2001. On March 31, 2003 EAS ceased operations without paying the full amount of the audit assessment. On November 10, 2005 the Board issued a dual determination for responsible person liability to debtor under Tax Code § 6829 for the unpaid portion of the audit assessment against EAS.

It is important to note that throughout the bankruptcy of its owner EAS continued to operate as a going concern. It is not unusual for a wholly owned business to continue operating during the Chapter 7 bankruptcy of its owner, since many businesses have no value for the creditors of their owner's bankruptcy estate.

The Bankruptcy Appellate Panel held that such taxes were not dischargeable based on the following reasoning:

1. The Debtor's responsible person liability to the Board was a "tax" for purposes of dischargeability under § 523 (a) (1);

2. The California sales tax at issue was determined to be a tax "on or measured by gross receipts" under § 507 (a) (8) (A) (in addition to being an excise tax).

3. The court determined that the debtor's tax liability was not assessed before, but was still assessable under California law after the commencement of the bankruptcy case.

The Debtor argued that the statute of limitations for assessment of his tax liability had expired prior to his bankruptcy filing. The State of California successfully countered that the statute of limitations for assessing the tax did not even begin until EAS stopped operating in March 2003, after the debtor had filed his bankruptcy case based on the provisions of California Revenue and Taxation Code §6829. This is an important distinction because taxes that remain assessable post-bankruptcy can never be discharged in that bankruptcy case. §507(a)(8)(A)(iii). The Debtor argued that this requirement did not apply to him because he was not personally required to file a sales tax return as he was neither a retailer nor held himself out to be a retailer.

The Court ruled that:

A. Debtor's personal liability for the unpaid sales taxes of EAS under Tax Code § 6829 cannot be imposed until the corporation terminates or abandons its business or dissolves; and

B. There is no indication in the statutory scheme that debtor can bootstrap himself into a more favorable limitations period by attributing EAS's filed tax returns to himself, especially when EAS and debtor are viewed as separate persons under Tax Code §6005.18.

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As noted by the Court: "in California the legislature has chosen, for whatever reason, to limit personal liability to when the corporation terminates, is abandoned or dissolves."

Generally, the Bankruptcy Code treats taxes as of one of three types:

1. Taxes on or measured by income or gross receipts (e.g., income taxes);
2. A tax required to be collected or withheld and for which the debtor is liable in whatever capacity (e.g., the Trust Fund portion of payroll taxes); and
3. An excise tax.

Category 1 taxes may be discharged if they are at least 3 years old when the case is filed and several other criteria are met. Category 2 taxes are never discharged. Category 3 taxes are generally dischargeable if they are at least three years "old" by the time a bankruptcy case is filed. Under Category 1, taxes which were not assessed before the bankruptcy (but which are still assessable after the bankruptcy filing) are never discharged.

The Ilko court concluded that California Sales Taxes fit both categories 1 and 3, and that therefore the more restrictive requirements of Category 1 apply.

The State successfully argued that because responsible person liability does not arise under Tax Code § 6829 until a corporation dissolves, terminates or abandons its business, the statute of limitations for issuing a notice of dual determination to a responsible person begins to run when the liability arises (i.e., only after the business ceases). Since the debtor was not liable for the taxes until EAS ceased operations on March 31, 2003, which was after the July 3, 2001 filing of his bankruptcy case, the taxes were still assessable.

The lessons of this care are clear. If 'responsible person' sales tax liabilities are very large (such that it is critical to discharge them), a multi-year strategy must be employed to do so. This involves:

A. Terminating the business;
B. Timely notifying the State Board of Equalization that the business has terminated;
C. Filing a custom personal tax return for the sales tax liability; and
D. Waiting at least 3-1/2 to 4 years before filing a personal bankruptcy case.

Naturally, filing a return could result in collection activity, which may make waiting up to 4 years quite difficult. Further, the State could file a tax lien, which would result in a lien upon assets of the business' owner (if there are any such assets). This is critical because tax liens survive bankruptcy, even if the underlying tax debt can be personally discharged. In re Isom 901 F.2d 744 (9th Cir., 1990). Despite these obstacles, the opportunity to discharge these tax liabilities and thus free up future income assets exists.