

CORPORATE MATTERS: COVERING YOUR PARTNER'S TAX TAB

Authors

Simon H. Prisk
Sheryl Shah

Tags

Joint and Several
Partnerships
Secondary Liability
Withholding Tax

A district court, affirming a bankruptcy court decision, recently held that a partner can be secondarily liable for a partnership's unpaid employment taxes and that the I.R.S. could proceed with collection without having commenced specific individual action against the partner.

Case History

In *Pitts v. U.S.*,⁷⁵ Wendy K. Pitts, a California resident, was a general partner of DIR Waterproofing ("DIR"), a California general partnership. On March 1, 2012, Pitts filed a Chapter 7 bankruptcy petition in the U.S. Bankruptcy Court for the Central District of California. As of that date, DIR had unpaid Federal Insurance Contribution Act taxes and unpaid Federal Unemployment Tax Act taxes for various quarters in 2005, 2006, and 2007. It also had unpaid penalties.

Commencing in 2007, the I.R.S. recorded a number of tax liens naming DIR and Pitts as the taxpayers for the unpaid amounts. The I.R.S. identified Pitts as a DIR partner on the liens. At the time of the district court proceeding, the liens still encumbered the property of Pitts.

On June 21, 2007 and August 7, 2007, the I.R.S. issued Notices of Federal Taxes Due naming DIR as the taxpayer and Pitts as a partner.

As of the time of the summary judgment proceeding in June 2013, DIR still owed at least \$114,859 in tax debt, plus unassessed interest. However, the I.R.S. never assessed DIR's taxes against Pitts or brought a judicial action against her.

On May 31, 2012, Pitts filed an adversary proceeding against the government to determine the dischargability of debts; the nature, extent, and validity of liens; and whether the I.R.S. violated the discharge injunction under applicable bankruptcy provisions.

On June 11, 2012, Pitts received a bankruptcy discharge. On June 26, 2013, she and the government filed cross-summary-judgment motions. After a hearing, the bankruptcy court denied her motion and granted the government's motion. On

⁷⁵ *Pitts v. U.S.*, (DC CA 08/12/2014) 114 AFTR 2d, ¶ 2014-5171.

October 23, 2013, the bankruptcy court issued a judgment in favor of the U.S. The court determined, *inter alia*, that the liens filed by the I.R.S. against Pitt's property were valid and perfected, and that the I.R.S. did not violate the discharge injunction.

Pitts appealed the bankruptcy court's ruling to the district court.

Background

Under Code §3402, an employer must deduct and withhold certain tax amounts from the wages it pays its employees. The employer is then liable for paying those withholdings to the I.R.S. under Code §3403.

Under Code §6672(a), if an employer fails to properly pay over its payroll taxes, the I.R.S. can seek to collect a trust fund recovery penalty equal to 100% of the unpaid taxes from a "responsible person," *i.e.*, a person who (i) is responsible for collecting, accounting for, and paying over payroll taxes; and (ii) willfully fails to perform this responsibility.

Pitts Liable for DIR's Unpaid Tax Debts

Pitts admitted that she was liable for DIR's obligations as a general partner, per California partnership law, but argued that under *U.S. v. Galletti*⁷⁶ a general partner is not a "taxpayer" with respect to the payroll tax withholding liabilities of his or her general partnership under Code §3403. She therefore contended that the I.R.S. could not rely on §3403 to support her liability for DIR's tax debts.

She further asserted that the I.R.S. had two main avenues for making her liable for such debts: either under federal or state law. To establish her liability as a responsible party under §6672, Pitts said that the I.R.S. had to separately assess her within the applicable three year statute of limitations. Since the I.R.S. never assessed Pitts' tax liability, she claimed that she was not responsible for DIR's tax debt under federal law. Additionally, she argued that since general partners are not "taxpayers" under Code §3403, the I.R.S. cannot separately assess them when it assesses the partnership for those tax withholdings. Pitts also contended that, although she was jointly and severally liable for DIR's obligations under California law, she was merely liable for DIR's debt and not its "tax" liability under the Code.

The I.R.S. argued that once it assesses a tax against a general partnership, it need not separately assess the general partners in order to make them liable. The I.R.S. asserted that since Pitts is liable for DIR's debts under California law, the tax assessment against DIR for its unpaid employment tax withholdings suffices to create a tax debt owed by Pitts to the I.R.S. Furthermore, I.R.S. stated that it did not have to proceed against Pitts under §6672 but rather could separately pursue her under state law.

The district court noted that the Supreme Court, in *Galletti*, had already weighed in on many issues relevant to the current appeal. Interpreting Code §3403, the Supreme Court held that the "employer" liable for paying the tax withholdings to the

⁷⁶

U.S. v. Galletti, (S Ct, 3/23/2004) 93 AFTR 2d 2004-142593 AFTR 2d 2004-1425 (See: Weekly Alert ¶ 1 03/25/2004).

"A partner can be secondarily liable for a partnership's unpaid employment taxes."

I.R.S. is the general partnership. It specifically rejected the argument that imposing a tax on the general partnership is equivalent to imposing a tax directly on the general partners because, under California law, a general partnership is an entity distinct from its partners. However, the Supreme Court went on to hold that the general partners may be secondarily liable for the general partnership's Code §3403 tax debts by operation of state law – all without a separate tax-liability assessment. Otherwise stated, under *Galletti*, once the I.R.S. assesses a general partnership for employment tax-withholding liability under Code §3403, the ten year statute of limitations for collection runs against the partners without separate assessment.

The district court thus found that when the I.R.S. seeks to hold a general partner liable via state law for a general partnership's Code §3403 tax liability, the general partner is liable for a federal tax obligation. Since the underlying obligation at issue in this action – employment tax withholdings under Code §3403 – arose under federal law, Pitts was therefore liable under federal law. The means by which the I.R.S. had chosen to hold her accountable for that obligation – state law – did not change that result.

Other Issues

After examining and rejecting arguments put forth by Pitts, the district court also found that the I.R.S. could properly employ administrative-collection procedures set forth in Code §6321 (lien for taxes) through Code §6326 (administrative appeal of liens) against a general partner to collect employment tax withholdings due from a general partnership under Code §3403, where the general partner is secondarily liable under state law for those obligations. It also found that the I.R.S. did not have to obtain a judgment against Pitts in order to hold her liable for DIR's tax debts.

Pitts also put forth a statute of limitations argument, which was not successful. The Court found that the liens were valid against Pitts. In addition, it agreed with the bankruptcy court's non-dischargability findings and found that the bankruptcy court did not err in determining that the I.R.S. did not violate the discharge.

New York Partnership Law

Under New York Partnership law,⁷⁷ the same outcome would have been reached. Although no partner has been held secondarily liable for unpaid partnership taxes, in New York the rule of “joint and several liability” would apply to recover the unpaid obligations from the general partner(s).

Unless provided, all partners are jointly and severally liable for all the debts and obligations of the partnership. What can be recovered from one is recoverable from all and vice versa. This means that the I.R.S. would be able to claim unpaid taxes and penalties from a general partner based on the argument that he is jointly and severally liable for all the debts and obligations of the partnership. Furthermore, the Court also held that the I.R.S. was neither obligated to furnish notice that it was

⁷⁷ N.Y. PTR LAW §26.

going to levy the taxes upon the plaintiff's personal assets nor was the Secretary of the Treasury required to enter into an installment agreement for the taxes.⁷⁸

In *Young v. United States I.R.S.*,⁷⁹ the I.R.S. was allowed to levy taxes upon the personal individual retirement account of Sidney Young, a New York resident, for the payment of outstanding federal taxes from a dissolved California partnership. The Court held that under both New York and California law, Mr. Young was jointly and severally liable as a general partner for the partnership's liabilities.

Furthermore, the I.R.S. has specifically passed that Trust Fund Recovery Penalty ("T.F.R.P.") taxes⁸⁰ (i.e., withheld income, employment taxes, social security taxes, railroad retirement taxes, and collected excise taxes) may be assessed against anyone who is a responsible or willful person, including a member of a partnership. The term "responsible person" is what links the partners in a partnership to a duty to pay partnership taxes. When examining whether a particular person is a responsible person, the I.R.S. will consider access, control, and authority, among other factors. A general partner will be considered "responsible" unless he can show otherwise. For example, a general partner who is not directly involved in the business or who does not have control over the bank account or the person who maintains the account may not be responsible because he does not have power over paying creditors.

CONCLUSION

In New York, general partners would also be held liable for the unpaid taxes of a partnership because they are considered accountable under the state rule of joint and several liability.



78

26 U.S.C.S. §6159.

79

Young v. U.S. I.R.S., 387 F. Supp.2d 143 (E.D.N.Y. 2005).

80

<http://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Employment-Taxes-and-the-Trust-Fund-Recovery-Penalty-TFRP>.