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Passive Investor Held Liable For Unpaid Sales Tax? *In Re Leal* Bankruptcy Appellate Panel Holding Defused

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The Bankruptcy Appellate Panel for the Ninth Circuit recently held that passive investor partners who merely contributed capital to their California retail shoe business could be liable for unpaid sales tax.¹ Although an attention-getting holding, a closer look at the case reveals that only if the bankruptcy court on remand finds that the passive investors were general partners in the business would they be liable for sales tax under California law. The case serves as a reminder that passive investors can be held liable for failing to pay state sales taxes under certain circumstances.

Background

Ernest and Maria Leal (the “Debtors”) were approached by long-time acquaintances (the “Stanleys”) to provide what the Debtors characterized as a “loan/investment” in a new retail shoe store located in California. Mr. Stanley, who had retail shoe experience, would handle all operational and business management. The Debtors and the Stanleys signed a lease identifying all of them collectively as the tenant doing business as Desert Shoes. Maria Leal and Ms. Stanley signed a Business License Tax Application on which Maria Leal apparently identified herself as “co-owner.” Maria Leal alleged that she visited the store three times after it opened in 2002, but that the Debtors were not involved in any operational aspects of the business and did not sign checks from the store's accounts.

Several months after the store opened, the Stanleys started to avoid contact with the Debtors. The Debtors eventually learned that the Stanleys closed the store because its lease was in default. Various creditors of Desert Shoes brought actions against Maria Leal as a partner of Desert Shoes. The Debtors filed a voluntary chapter 7 petition in 2004. The Debtors did not list the California State Board of Equalization (“SBE”) as a creditor. After the Debtors received their discharge and the bankruptcy case was closed, the SBE contacted the Debtors regarding Desert Shoes’ unpaid sales tax in the amount of \$20,000. The bankruptcy court granted the Debtors’ motion to reopen their Chapter 7 case and held a hearing to determine the validity of the alleged sales tax debts and tax liens.

¹ *In re Leal*, 366 B.R. 77 (9th Cir. B.A.P. Mar. 16, 2007).

The Issue

The SBE argued that if the Debtors were in a general partnership with the Stanleys, they would have joint and several liability for unpaid sales taxes. Under California Corporations Code § 16306(a), “all partners are liable jointly and severally for all obligations of the partnership unless otherwise agreed by the claimant or provided by law.”

The Debtors argued that Cal. Rev. & Tax Code § 6829(a) protected them from liability for the taxes because there was no evidence that the Debtors were responsible for or willfully failed to pay the sales taxes. That section provides in relevant part:

Notwithstanding Section 16306 . . . of the Corporations Code, upon termination, dissolution, or abandonment of a partnership, . . . any . . . partner, or other person having control or supervision of, or who is charged with the responsibility for the filing of returns or the payment of tax, or who is under a duty to act for the . . . partnership, in complying with any requirement of this part, shall be personally liable for any unpaid taxes and interest and penalties on those taxes, if the officer, member, manager, or other person willfully fails to pay or to cause to be paid any taxes due from the . . . partnership . . . pursuant to this part.

The parties’ disagreement centered on the meaning of the phrase “notwithstanding Section 16306” in relation to the two sections. The Debtors argued that even though general partners are jointly and severally liable for all obligations under § 16306, § 6829 overrode § 16306 and provided that in order for a general partner to be personally liable for the nonpayment of taxes, a general partner must (1) be charged with the responsibility of filing the returns or paying the tax or is under a duty to act for the partnership, and (2) willfully fail to pay or cause to be paid any taxes due.

The Outcome

The lower bankruptcy court agreed with the Debtors, thereby making an evidentiary hearing on whether a general partnership existed unnecessary. The Bankruptcy Appellate Panel reversed, holding that § 6829 did not operate as a shield against joint and several liability of general partners under § 16306, and remanded for a determination of whether the Debtors were general partners in the business. The practical application of the Panel’s decision is that § 6829 does not apply to general partners because general partners are always responsible for filing returns and paying tax. A general partner is by definition personally and jointly and severally liable for all debts of the partnership, including taxes. According to the Panel, the language “notwithstanding Section 16306” accomplished a different purpose: ensuring that persons such as limited partners who have *actual* responsibility to pay taxes would not escape liability under § 6829 because partners in a limited partnership are not personally liable for the limited partnership’s debts by statute.

The Panel pointed to the statute of limitations on general partners' personal liability for sales tax obligations as support for its conclusion. The Panel noted that a statute of limitations section would be unnecessary if general partners were not personally liable for sales tax obligations. The Panel also pointed to legislative history, which demonstrated the legislature's choice to preserve the ability of the SBE to pursue either the partnership or the general partners for unpaid sales tax liabilities.

The Panel expressed no opinion as to whether the Debtors actually were general partners in Desert Shoes and remanded to the bankruptcy court for resolution of that issue. The Panel simply held that the Debtors could not use § 6829 as a shield against liability if in fact they were general partners.

The Bottom Line — A Cautionary Tale

While it may come as no surprise that general partners in a business may be liable for unpaid sales taxes, the case serves as a reminder that even limited partners can be liable for sales taxes in some circumstances. From the cautionary tale of Desert Shoes, there are several pearls of wisdom:

- If you are a general partner, being "passive" is unwise. Lack of actual knowledge or of personal responsibility does not protect a general partner.
- If you are a limited partner, being "passive" is critical. Being responsible for filing returns or paying taxes can lead to personal liability for unpaid taxes.
- Whether you are a general or limited partner, be careful who you do business with.
- If you end up in bankruptcy, list all creditors. Had the Debtors listed SBE as a creditor and the SBE failed to file a proof of claim, the Debtors may have had their sales tax debts expunged.
- Remit your sales taxes!■



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