

## TAX LAW

# New York State Sales Tax

## Civil tax fraud penalty update

By Eric L. Morgenthal

As a lifelong Met fan, I've never been a big admirer of Roger Clemens. However, I must admit he was typically skilled in demonstrating a particular aspect of baseball...the brushback pitch. For those who don't follow baseball, pitchers throw a "brushback" pitch intentionally close to the batter to keep them from crowding home plate. It's a way to prevent the batter from reducing the strike zone by overreaching and dominating the area. Recently, the New York State Department of Taxation and Finance was thrown a brushback pitch because it seemed like they too were beginning to overreach.

New York State Sales Taxes are trust fund deficiencies. This means that the Responsible Persons (officers and those with certain authority within the entity), are personally liable for the taxes withheld if not remitted at the business level. This basic principle was relatively longstanding. However, I began to hear information to the contrary.

Last year, a representative from New York State had indicated to me that the state operates differently than the IRS on the issue of trust fund taxes. He stated that the 'Responsible Person' owing New York State trust fund taxes stands side-by-side with the entity and not behind it. Moreover, he had indicated that the state could assert its rights against the individual owner, even if not first sought from the entity. It seemed to me like the batter was slowly inching toward the plate.

In a recent case before the New York State Division of Tax Appeals, (*In the Matter of the Petition of Dong Ming Li, In the Matter of the*

*Petition of Xiu Ying Zheng, In the Matter of the Petition of Yi Bao Zheng*), the entity had paid the trust fund taxes owed under the NYS Tax Amnesty Program in effect during the end of 2003. The Department had concluded that although the business owner was being prosecuted personally, the business was submitting the amnesty application and therefore the two should be viewed as mutually exclusive. NYS had held that the acts of the owner should not preclude amnesty acceptance from the entity. However, in the context of the subsequent litigation, the argument set forth by NYS was that tax fraud prosecutions were undertaken against the individual owners and as a result, any resulting individual civil fraud penalties owed did not first require an entity level assessment. The NYS Tax Department had issued separate Notices of Determination against the officers after the entity level deficiencies were extinguished under amnesty.

The primary issue before the court was "whether the Division of Taxation's cancellation of sales tax fraud penalty assessed against a corporation also requires cancellation of such a penalty assessed against an officer of the corporation under a duty to act for that corporation pursuant to Tax Law §1131(1) and §1133(a)."

The Division of Tax Appeals held in favor of the taxpayer. The corporate amnesty precluded the Department from collecting against the individual officers of the corporation. The court validated the taxpayer's argument when it concluded with citing the *Matter of Halperin v. Chu*<sup>1</sup> in saying that:

"It is critical to focus on the fact that it is from the corporate entity that the person's

individual liability is derived. That is, without such corporate liability, there is no liability on which the person under a duty to act would be obligated. It follows, then, that relief of the corporate obligation, in whole or in part, must necessarily result in like relief of the individual's derivative personal obligation." The court further stated that "any re-determination decreasing the corporation's tax liability will result in a decrease in a petitioner (owner's) personal liability".

The Tax Department then attempted to argue that the word "tax" as indicated in the statute was not intended to mean "penalties" as well. New York State's argument was that even if taxes paid at the entity level reduced the taxes owed by the individual owners, the explicit addition of the word penalty in other parts of the statute<sup>2</sup> meant that penalties were intended to be considered separately. As a result, penalties could first be imposed at the individual level, even without previous imposition at the entity level. The state was seeking to impose individual civil fraud penalties even without any entity tax remaining. (Here goes the batter, inching forward again.)

Again, the court brushed the Tax Department back indicating that "to isolate and focus on the word "tax" overlooks the statutory framework under which interest and penalty (including fraud penalty) are determined simply as a mathematical function of the amount of the tax involved." In short, the owner's personal liability is derived from the taxes, penalties and interest of the corporation. Individual trust fund penalties are derivative in nature. Taxes carried through to the owners would first

require an assessment at the entity level. Likewise, the court held that there shouldn't have been an individual tax fraud penalty because the absence of the individual/entity tax to base it on.

If you have an individual client charged with NYS Civil Tax Fraud Penalties, it may be worth considering the impact of this case upon your client matter, particularly if the trust fund taxes were already paid by the entity under amnesty or were never imposed against the entity at all.

Move back Tax Department...it looks like you're crowding the plate.

*Note: The author is a tax attorney in Smithtown, NY and an Officer in the Academy of Law. He had formerly served as Chair of the SCBA Taxation Law Committee and is a member of the New York State, Nassau and Suffolk County Bar Associations, the American Institute of Certified Public Accountants and the American Association of Attorney-CPA's.*

<sup>1</sup> *Matter of Halperin v. Chu* (134 Misc 2d 105, 509 NYS 2d 692, 695, aff'd 138 AD2d 915, 526 NYS2d 660)

<sup>2</sup> "The Division argued that the explicit addition of the words "penalty" in sections 1138(a)(3)(C)&(D) and 1138(a)(4) and 1138(b) and the omission from the subdivision 1138(a)(3)(B) clearly indicates that penalties and interest are not to be included when tax is referred to." (*In the Matter of the Petition of Dong Ming Li, In the Matter of the Petition of Xiu Ying Zheng, In the Matter of the Petition of Yi Bao Zheng*).



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