



# Don't You (Forget About Sales and Use Tax)

09.12.2019 | By **Douglas W. Schwartz**

Some recent California Office of Tax Appeals (“**OTA**”) decisions highlight the importance of being, simply, mindful of sales and use tax requirements. Businesses often plan to reduce income taxes or avoid a Proposition 13 reassessment, but then completely forget about sales and use taxes – which is unfortunate, because while compliance need not result in the business coming out-of-pocket for tax payments, non-compliance can later result in huge out-of-pocket costs (and even personal liability by officers!).

## **A one-minute sales and use tax primer**

A business selling or leasing tangible personal property in California at “retail” (*i.e.*, to the end consumer) must pay sales tax and file sales tax returns unless the goods are exempt (*e.g.*, prescription medicines, or food not served at a counter or restaurant). Contrary to popular belief it is the *retailer* – not the *customer* – that pays this tax, though the retailer can have the customer *reimburse* it for sales tax (that is the “sales tax” line appearing on your store or restaurant receipt). With reimbursement, the seller need not be out-of-pocket for sales tax. If the sale is outside California but the goods are destined for “use” in California (as is often the case with Amazon.com, Chewy.com, or other “e-tail”), the retailer may be required to collect “use” tax from the consumer (the use tax complements the sales tax that would have been paid had the sale taken place in California).

The California Department of Tax and Fee Administration (“**CDTFA**”) administers sales and use taxes, having taken over this function from the California State Board of Equalization a few years ago. Anyone selling non-exempt tangible personal property in California, whether or not at retail, must obtain a seller’s permit from the CDTFA. A wholesaler (unlike a retailer) need not actually pay sales tax if the goods are sold for resale, and the wholesaler should obtain “resale certificates” from its customers to that effect. The CDTFA will advise a permit holder when to file returns (*e.g.*, annually, quarterly, monthly) based on the anticipated volume of sales.

Sales and use taxes are one of the few areas (another being California payroll taxes) where a person buying *assets* of a business (as opposed to stock or other equity ownership of the business) can get tagged with the sales and use tax liabilities of the seller. To avoid that result, the buyer can get a tax clearance from the CDTFA. Sales taxes are also one of the few areas where there can be *personal liability* (not just corporate) to the government: If the asset sale closes with the seller having liability for back sales taxes and if the seller had collected sales tax reimbursement, then the person “responsible” for the seller’s finances can have direct liability for the unpaid sales taxes. (If that concept sounds familiar it should, because the IRS similarly can impose “trust fund” personal liability on “responsible” persons who do not turn over wage withholdings to the government, and California has similar rules.) A business may also face a prohibitive 40% penalty – not just a 10% negligence penalty – for back sales taxes if it collects sales tax reimbursement but does not pay such amounts over to the CDTFA.

## The OTA Decisions

Some recent OTA decisions – almost all of them against the taxpayer – involved the foregoing issues in one way or another:

- The OTA upheld the CDTFA’s determination in *Appeal of Guistomangia, Inc.*, where the CDTFA found that a California restaurant underreported its sales by more than \$2 million. The judge held that, because the restaurant had failed to provide any sales records during a CDTFA audit, the CDTFA properly determined an additional \$258,745 sales tax liability based on the best records and estimates available. The OTA also upheld the CDTFA’s determinations where the taxpayer failed to present meaningful records to the contrary in *Appeal of Surf City Hookah Lounge, Inc.* (tobacco lounge); *Appeal of Roberto Hernandez d/b/a Raliberto’s Taco Shop* (restaurant); *Appeal of SRN, Inc.* (restaurant); *Appeal of Noel Herrera Laurel and Luz Maria Ibarra Herrera* (restaurant); and *Appeal of Hamdiah Saleh Aldahebi d/b/a Golden 7 Food Store* (liquor store). As these cases illustrate, restaurant and similar hospitality businesses are frequent targets for audits because they have high customer volumes and tend not to be able to afford sophisticated accounting systems.
- In *Appeal of Richard S. Weiss*, the OTA agreed with the CDTFA that a corporate officer was personally liable for the unpaid tax liabilities of the corporation. In that case, the corporation had collected sales tax reimbursement, but the officer caused (or allowed) the funds to be used for other purposes (including employee wages, rent, and loan repayments) rather than to be remitted to the CDTFA. The OTA also upheld personal liability on officers who used sales tax reimbursements from customers for other purposes in *Appeal of Mohammed Bagher Bahour* and *Appeal of Gholamreza Shafazand*. A rare loss for the government occurred in *Appeal of William Blaine Riggie*, where a CFO of a gasoline station and mini-market business convinced the OTA that he did not have sufficient control over finances to make him “responsible” (though in doing so he had to point the blame at the owners). While a business owner may try to avoid unpaid sales tax liability by dissolving the business, ceasing the operations of a business with unpaid sales tax liability opens the door for the CDTFA to hold an officer personally liable for the corporate liability.
- In *Appeal of Ruzbehjon Inc.*, the OTA upheld the CDTFA’s determination that the purchaser of a restaurant business was responsible for the seller’s unpaid sales taxes. The purchaser did not request, and so the seller did not furnish, a tax clearance certificate which might otherwise have cut off the liability, and because the purchaser was unaware of the sales tax liability it also failed to withhold the sales tax liability amount. The OTA similarly upheld successor liability in *Appeal of Sonic Lighting, Inc.*

## Some lessons

California taxpayers can take away a few lessons from these OTA decisions:

- **Keep good records.** *Guistomangia* highlights the importance of keeping thorough, accurate, and up-to-date records to back up sales and use tax returns. Without such records the CDTFA can and often will assess taxes

based on the best information available to it.

- **Don't dip into the cookie jar.** Persons in charge of finances might be tempted to use readily-available cash from sales tax reimbursements to pay other expenses. They absolutely should not do this, however, as they then run the risk of becoming personally liable for these amounts. As *Weiss* shows, the officer can be liable even if he or she uses the funds for perfectly valid and pressing business needs (e.g., wages) and not a trip to Vegas.
- **Stay clear.** As a part of every M&A transaction, purchasers of businesses should either require a seller to obtain a certificate that the business's tax liabilities have been paid in full or, alternatively, obtain a certificate from the CDTFA stating that no taxes, interest, or penalties are due. A purchaser can also protect itself through the usual representations, warranties, indemnities, and hold-backs or escrows, but a CDTFA "get out of jail free card" is usually the most straightforward protection.
- **Get a check-up.** A business should get regular "check-ups" from accountants or other experts to ensure that it is in compliance with California and other states' sales and use tax laws. If there are any missteps, the outside professional can help correct them and take advantage of any tax amnesty programs – which, while expensive, can avoid much greater liability later on. A business in particular should get a check-up if the owners are contemplating selling – why have proceeds tied up in escrows and indemnity claims for back sales taxes when the owners could have taken the proceeds and enjoyed their retirement?

### **How Nossaman Can Help**

Nossaman is experienced in navigating complex sales and use tax laws; advising on sales and use tax compliance; and representing businesses in the process of winding up; and representing sellers and buyers in M&A transactions, where sales and use taxes may be at issue. Please contact us if you would like further information or assistance regarding sales and use tax matters.