

THE *ACTION MARINE* CASE: WHEN OFFICERS AND DIRECTORS CAN BE HELD PERSONALLY LIABLE FOR THE CORPORATION'S SALES TAX

The Arizona Supreme Court Decided that Corporate Officers and Directors May Be Held Personally Liable for a Business' Sales Tax Under Certain Circumstances

On April 9, 2008 the Arizona Supreme Court decided by a 3-2 margin that the Arizona Department of Revenue may hold corporate officers or directors personally liable for failing to remit money collected from the corporation's customers to pay transaction privilege tax.

Arizona's Statutory Framework Contains Language that the Department Has Recently Begun Using to Assert Personal Liability on Corporate Officers and Directors

In 1980 the Arizona Legislature enacted Arizona Revised Statute ("A.R.S.") § 42-5028. This law provides as follows:

A **person** who fails to remit any **additional charge** made to cover the tax or truthfully account for and pay over any such amount is, in addition to other penalties provided by law, personally liable for the total amount of the **additional charge** so made and not accounted for or paid over.

A.R.S. § 42-5028 (*emphasis added*)

In recent years, the Department has used this section to hold officers and directors of a corporation personally liable for the sales tax collected from customers but not remitted to the Department. In many of these cases, the Tax Court upheld the Department's position. However, when the Tax Court held against Action Marine, Inc. on this issue, it appealed to the Arizona Court of Appeals. The Court of Appeals reversed the Tax Court, reasoning that officers and directors did not fit into the definition of "person" as used in the statute. To resolve the issue definitively the Arizona Supreme Court accepted review.

The Supreme Court's *Action Marine* Decision Upheld the Department's Interpretation of A.R.S. § 42-5028

Upon review the Arizona Supreme Court overturned the Court of Appeals and held that A.R.S. § 42-5028 allows the Department to hold officers and directors of a corporation personally liable for unpaid transaction privilege tax in certain circumstances. See *Arizona Dept. of Revenue v. Action Marine, Inc.*, 181 P.3d 188 (April 9, 2008).

The case involved Action Marine, Inc., a corporation involved in the sale of boats and boating equipment. The company had gone belly up and was undergoing liquidation in Bankruptcy court. The Randalls owned the business as shareholders and also acted as officers and directors of

the corporation. At the time of the case, Action Marine, Inc. owed \$51,174.52 in transaction privilege tax, which the Department sought to collect from the Randalls personally.

The Arizona Supreme Court's conclusion turned on the definition of "person" in the statute. Furthermore, the Court determined the scope of the personal liability by clarifying the definition of the "additional charge."

Background on Arizona's Transaction Privilege Tax

The Supreme Court, in *Action Marine*, first noted the nature of Arizona's privilege tax. Arizona does not assert a true sales tax; rather, it taxes the privilege of engaging in business in Arizona. *Action Marine*, 181 P.3d at 189. The liability for this tax falls on the taxpayer (i.e. Action Marine, Inc.), not the customers who engage in transactions with the taxpayer. However, the taxpayer may pass the tax on to its customers by charging them a separately listed amount to cover the tax. *Id.* If the taxpayer elects to pass the tax on to its customers in this manner, it must remit to the Department all the money it collects even if it collects more from its customers than it owes in tax. *Id.* The reason for this is that the money collected from customers to cover the tax does not belong to the taxpayer, but to the state, and the taxpayer essentially holds the funds in trust for the state. *Id.*

The "Person" in A.R.S. § 42-5028 Includes Officers and Directors, Not Merely the Corporate Taxpayer

In *Action Marine*, the two sides disagreed as to whom A.R.S. § 42-5028 applied. The taxpayer argued that the "person" liable under the statute only included the taxpaying entity, while the Department asserted that the "person" must

encompass any person, including an officer or director of the company. Ultimately, the Supreme Court sided with Department.

The applicable definition of "person" found in A.R.S. § 42-5001(8) includes both corporations and individuals. Overturning the Court of Appeals, the Supreme Court found this language broad enough to encompass individuals in a managerial position with a corporation, and not just a taxpayer. Additionally, if the Arizona Legislature intended to limit A.R.S. §42-5028 to the taxpaying entity, it would have used the word "taxpayer" instead of the word "person." *Id.* at 190.

In addition, if the statute only applied to taxpaying entities, reasoned the court, the statute would duplicate the law found in A.R.S. § 42-5002(A) (1) and A.R.S. § 42-5024, which obligate the taxpayer to collect and remit the tax or suffer liability for failing to do so. Generally, courts "construe statutes to avoid rendering provisions duplicative." *Action Marine*, 181 P.3d at 191; *See also City of Tucson v. Clear Channel Outdoor, Inc.*, 105 P.3d 1163, 1171 (2005). Since the position advanced by the Randalls would render A.R.S. § 42-5028 duplicative of other statutes, the court rejected it in favor of an interpretation that gave it a separate meaning by extending personal liability to entities other than the taxpayer.

At the same time the legislature enacted A.R.S. § 42-5028, it also enacted § 43-435, which "extended liability beyond the employer" in the context of withholding tax and made "any person required to collect, account for and pay over income taxes to ADOR personally liable." *Action Marine*, 181 P.3d at 191. This "concurrent enactment . . . indicates that the legislature similarly intended the word 'person' in § 42-5028 to extend personal liability to persons other than the taxpayer." *Id.*

Finally, the Supreme Court interpreted “person” the way it did to advance the public interest. Its decision advances the public interest because “interpreting ‘person’ to include corporate officers or directors assuages concerns that such persons might abuse the privilege of limited liability protection by collecting money from customers under the guise of a state-imposed tax, using such monies for other purposes, forcing the taxpayer into bankruptcy, and later claiming limited liability protection.” *Id.*

The Arizona Supreme Court Has Set Forth a Test to Determine When a Corporate Officer or Director May Be Personally Liable for Delinquent Transaction Privilege Tax

Since corporate officers and directors fit within A.R.S. § 42-5028, the Supreme Court set forth a narrow test to determine when the officers or directors might have to pay the corporation’s transaction privilege tax themselves. The test involves a three-part inquiry: (1) Does the corporation collect a separate transaction privilege tax from customers?; (2) Does the officer or director have a duty to remit money collected from customers? and (3) Did the officer or director fail to remit the money collected or engage in untruthful accounting of the additional charge? *Id.* at 192. Affirmative answers to all three questions would result in personal liability for an officer or director.

Taxpayers may choose to pay the tax themselves or collect the tax from customers and remit it to the Department. Under the test, the officers and directors will only bear personal liability if the corporation elects to collect the tax from customers.

The directors and officers of a corporation make the decision to pay the tax directly or to collect the tax from customers as a separately stated tax charge. If they elect to col-

lect the tax from customers, “an officer or director who holds, maintains control over, or has responsibility for the money collected . . . assumes a duty to remit” the tax. *Id.*

Finally, the third element of the test merely requires a factual inquiry to see if the officer remitted the tax and engaged in truthful accounting of the tax. If he or she did so, then there is no issue because the Department will already have the money and there will be no deficiency for which to hold officers or directors personally liable.

Justice Hurwitz, In His Dissenting Opinion, Would Not Extend Personal Liability to Officers and Directors

Justice Hurwitz, joined by one other justice, wrote a dissenting opinion in which he sided with the Court of Appeals and argued against personal liability for officers and directors. In his view, “person” as used in A.R.S. § 42-5028 could only refer to the taxpaying entity, and not the officers and directors. At the same time, Justice Hurwitz recognized that this was a close case and that the majority arrived at a plausible reading of the statute.

The legislature enacted A.R.S. § 42-5002(A)(1), which states that a “person who imposes an added charge to cover the tax levied by this article . . . shall not remit less than the amount so collected.” A.R.S. § 42-5002(A)(1). This statute refers only to a “person who imposes an added charge,” and in the context of a business transaction the only person who can impose the charge is the taxpayer – not the officers or directors. *Action Marine*, 181 P.3d at 195. The dissent states that A.R.S. § 42-5028 imposes a penalty for failing to remit the added charge as required by A.R.S. § 42-5002(A)(1). Since officers and directors cannot impose the added charge, and have no duty to remit the amount collected, they cannot violate the rule. Therefore the penalty provision cannot apply to them and they cannot be held personally liable.

Thus “person” in A.R.S. § 42-5028 can only refer to the taxpaying entity.

Furthermore, such a reading results in no redundancy. A.R.S. § 42-5024, relied upon by the majority, provides that if a taxpayer does not remit its transaction privilege tax as required by A.R.S. § 42-5014, the tax owed, as well as interest and penalties, become a personal debt of the taxpayer. *Action Marine*, 181 P.3d at 194. Since the legislature had to enact a statute to create this liability it “seemed to recognize that a taxpayer’s failure to perform his statutory duty of remitting [transaction privilege tax] . . . did not itself create an actionable liability to the state.” *Id.* Based upon this reasoning, the legislature enacted A.R.S. § 42-5028 because “it logically follows that a statute . . . also was needed to impose personal liability on a taxpayer who failed to perform his statutory duty to remit **added charges**” under A.R.S. § 42-5002(A)(1). *Id.* at 196 (emphasis added). Therefore, the two statutes do not duplicate each other even if “person” refers only to the taxpayer.

Finally, the dissent rejected the majority’s reliance on A.R.S. § 43-435. That statute only imposes liability on a party “required to collect, truthfully account for and pay over” withholding tax. *Action Marine*, 181 P.3d at 196 (citing A.R.S. § 43-435). Applying that logic to A.R.S. § 42-5028, the only party *required* to collect or account for the tax is the taxpaying entity itself, and not its officers and directors.

If Officers and Directors Bear Personal Liability Under A.R.S. § 42-5028, the Amount of Their Personal Liability Turns on the Language of the Statute

Since the Supreme Court majority found in favor of personal liability, A.R.S. § 42-5028 asserts personal liability on a person who “fails to remit any additional charge made to cover the tax.”

The statute limits the amount of personal liability to “the total amount of the additional charge so made.” See A.R.S. § 42-5028. Therefore, the Supreme Court majority in *Action Marine* ruled on the definition of “additional charge” to determine the amount of personal liability.

The language of the statute modifies additional charge with the words “made to cover the tax.” See A.R.S. § 42-5028. Based on this language, the Arizona Supreme Court determined that “additional charge” included all money collected by a taxpayer from customers to cover the transaction privilege tax. Therefore a person held personally liable for the corporation’s delinquent transaction privilege tax under A.R.S. § 42-5028 may be required to personally pay the total amount the corporation collected from customers to cover the tax. *Action Marine*, 181 P.3d at 192-193.

The amount of personal liability contains an important limitation: the statute does not state that personal liability extends to penalties, interest or any other costs. See A.R.S. § 42-5028; *Action Marine*, 181 P.3d at 193-194. As a result, officers and directors would not have to personally pay anything other than the actual amount collected from customers. They would not have to personally pay any penalties, interest or other costs even if the corporation owed the Department such fees.

It merits note that the foregoing summaries are not intended as legal advice on any particular question of law. If you have any questions about these or related developments, please contact Pat Derdenger.

Steptoe's State & Local Tax Practice

Our Washington, Phoenix, Los Angeles and Century City attorneys represent business clients of many types and sizes in state and local tax matters, including high-technology businesses, electric utilities, telecommunications companies, mining and railroad companies, a steel mill, semi-conductor, aerospace and other manufacturers, retailers, banks, printers, mail order businesses, tax-exempt organizations, and resorts.

On behalf of these clients, our attorneys litigate complex and varied income, sales and use, and property tax issues in administrative proceedings and state and federal courts, and they also seek legislative solutions to industry-wide concerns that affect firm clients.

In addition, our attorneys counsel the firm's clients on the multi-state tax implications of their business transactions. For example, the firm advises its E-commerce industry clients on their complex multi-state income tax responsibilities and their sales and use tax collection obligations.

STATE AND LOCAL TAX LITIGATION

Steptoe's State and Local Tax Group includes experienced tax litigators who have broad commercial litigation and tax litigation experience. Their practice is national in scope, including practice in many states. Pat Derdenger served as a Justice Department trial attorney in the honors program representing the IRS in numerous trials during his time there. He has over thirty years of tax litigation experience. Dawn Gabel began her career as a commercial litigator, litigating a broad range of commercial disputes including banking litigation, CERCLA litigation, toxic torts, bad faith insurance disputes and general contract disputes. She is approaching her twentieth year of litigation practice. For the last fifteen years she has focused on tax litigation, primarily property tax litigation. We combine trial-tested litigation skills with up-to-date substantive tax experience. This combination enables us to take on the most challenging cases and achieve outstanding results for our clients.

Our attorneys have proven skills and extensive experience in all aspects of tax controversy and litigation:

- Managing audits
- Prosecuting property tax valuation and classification appeals through the administrative hearing and review process
- Filing appeals of administrative actions in tax or superior court and bringing original actions in court
- Negotiating litigation settlements

- Trying cases in court
- Arguing appeals in state appellate courts

Our active controversy and litigation docket keeps us at the cutting edge of evolving administrative and judicial practice and procedures, strategy and tactics.

In addition to our litigation skills, we are widely recognized for our substantive tax knowledge and experience. Many members have LL.M. degrees in taxation from, and teach classes at, top law schools, and are constantly researching, writing, and speaking to professional audiences on a broad range of substantive tax issues.

Pre-controversy Advice and Counsel. Our tax lawyers combine litigation and substantive tax experience to assist clients in effectively anticipating and planning for future controversies. Often, when the tax treatment of an item or transaction is challenged, the ultimate resolution is influenced significantly by actions taken or not taken when the transaction was planned, implemented, or first reported. With this in mind, we provide experience-based advice on reporting, document retention, and other pre-controversy matters.

Settlement Efforts. We fashion creative and effective approaches to settlement. Our experience encompasses not only direct negotiations for single clients, but also group representations of taxpayers with the same or similar issues. We work hard to achieve favorable results for our clients and to identify the most effective approach to resolve the matter, which in many cases may be a favorable settlement for the client rather than prolonged litigation.

DEEP AND CURRENT TRIAL AND APPELLATE EXPERIENCE

Settlement of Cases in Litigation. Many cases, when not settled administratively, can be favorably settled in litigation. We have a history of achieving such settlements, drawing on our litigation skills and our experience as litigators.

Actual Trial Experience. Relying on our courtroom experience, we develop and implement efficient, effective, and thorough trial strategies. Whether the case is presented by dispositive motion, or by trial, we have the required skill and experience, including intricate discovery and evidentiary disputes, the preparation and examination of fact and expert witnesses, and utilization of the most sophisticated electronic trial presentation and briefing techniques. Our experience enables us to be prepared for all the twists, turns, and surprises of trial advocacy.

Effective Appellate Advocacy. Steptoe tax lawyers have argued cases in state courts and every major federal Court of Appeals, as well as before the US Supreme Court. Our brief writing and appellate advocacy skills are recognized as leading in the bar.

Step-in Litigation Ability. We have successfully litigated cases in which we were not involved in the administrative process. These clients sought the highest level of litigation experience, and chose us for our premier tax litigation talent.

UNRIVALED TALENT

Substantive Tax Experience. Attorneys in our Tax Department have experience in ad valorem property tax matters, constitutional property tax matters, corporate tax, partnership tax, consolidated returns, international tax, transfer pricing, financial instruments and products, ERISA, employee benefits, tax-exempt organizations, sales and use tax, and other areas of tax law.

Litigation Experience. Our state and local tax attorneys litigate tax matters on a daily basis from the administrative level, through state tax or superior court, the court of appeals and the Supreme Court. Attorneys in our Litigation Department litigate across the United States and in other countries, and are available to assist our tax litigation attorneys with complex and innovative litigation strategies.

Our specific experience and particular skills, as well as backup provided by our colleagues in other practice disciplines, provide Steptoe's tax litigation lawyers with a valuable resource readily available as necessary to effectively represent our clients.

PROPERTY TAX

Our real and personal property tax representation spans the full administrative process, including state tax boards of review, state superior courts, and appellate courts of appeals.

TELECOMMUNICATION INDUSTRY TAX LAW

Our attorneys have considerable experience in dealing with federal and state and local telecommunications excise tax matters, including issues relating to the Mobile Telecommunications Sourcing Act (sources cell phone calls for purposes of local taxation). We have represented telecommunications clients on real and personal property tax matters, including valuation issues. Of note, our attorneys have represented a start-up international telecommunications carrier in structuring their state and

local telecommunications excise tax reporting requirements, including nexus issues. Our Telecommunications clients in the tax area have included local, long distance, cell phone and satellite carriers.

ELECTRIC UTILITIES AND PIPELINES

The firm's state and local tax practice has considerable experience in representing electric utilities and pipelines in a wide range of state tax issues. We have represented electric utilities on property tax valuation matters, both generation and transmission and distribution facilities, including a nuclear generation station. [See *ADOR v. SRP and APS*, 212 Ariz. 35, 126 P.3d 1063 (App. 2006).] We have also advised electric utilities on corporate income tax issues, including the sourcing of sales of electricity when generated in one state and sold in another (particularly the costs of performance and market tests dealing with the sales factor), nexus and Public Law 86-272 questions, as well as research and development tax credit issues. Our attorneys have also advised electric utilities on sales tax issues dealing with the construction of generation plants and the applicability of various sales tax exemptions to the construction of those facilities and operation of generation plants, including sales tax issues on the sale of the electricity both in-state and out-of-state. In addition to electric utilities, we have represented natural gas pipelines on sales tax, income tax and property tax matters.

CONSTITUTIONAL TAX ISSUES

Steptoe's state and local tax attorneys have considerable experience with federal commerce clause, due process clause and equal protection clause issues, as well as state-specific constitutional provisions such as the uniformity clause, which deals with property taxes and requires that property taxes as imposed on a class of property be uniformly applied.

Commerce clause issues handled include not only income, sales and use tax nexus issues but also issues dealing with discriminatory treatment of interstate commerce. Equal protection clause matters have included challenges to a state's unequal treatment of a taxpayer vis-à-vis the more favorable treatment provided to competitors. Additionally, Steptoe's attorneys in the DC office have represented insurance companies in actions before the US Supreme Court involving constitutional issues relating to state premium taxes.

CORPORATE INCOME TAX

- Advised and represented corporations in controversies over “unitary” combination issues—i.e., whether a particular affiliate is a member of the unitary group or not under the various tests the states use for determining unitary combination (such as operational integration or functional integration)
- Advised and represented corporations on income tax nexus issues, particularly with respect to the application of the protection from state income tax afforded by Public Law 86-272 (which prohibits a state from imposing a net income tax where the company’s only contact with the state is the solicitation of orders where those orders are sent back to the home office for approval and filing)
- Advised and represented companies on business income vs. non-business income issues (business income is apportioned to the various states the company does business in using factor apportionment while non-business income is allocated entirely to the source state). Some examples include gain on the sale of stock of a foreign subsidiary, the sale of a plant that had been closed for a number of years, the sale of land that had been acquired to build a new facility but where plans changed, royalty income from patents, income from court-awarded judgments

TAX CONSEQUENCES OF MERGERS & ACQUISITIONS

Our attorneys counsel clients on the state and local tax consequences of mergers and acquisitions, both income tax and sales tax, including whether an asset sale is a casual sale for state sales tax purposes. They also work with corporate counsel to draft tax provisions for merger and acquisition agreements.

MULTI-STATE TAXATION

Income Taxation

Advising multi-state businesses on state corporate income tax issues, including unitary combination issues, consolidated return elections, allocation and apportionment issues, business/non-business income questions, Public Law 86-272 nexus issues, throw-back rule issues, Appeal of Joyce types of issues, intangible holding company issues and voluntary compliance and amnesty filings.

Counseling clients on the multi-state taxation of flow-through entities such as partnerships, S-corporations, and limited liability companies, including nexus issues, composite return filings, and combined return issues.

Sales and Use Taxation

Advising clients on nexus issues: when remote vendors will be required to collect the destination state’s sales and use tax on sales made into the state, voluntary compliance and amnesty filings, Streamlined Sales Tax Project issues and registration.

SALES & USE TAXES, PRIVILEGE TAXES, & EXCISE TAXES

- Advised high-technology businesses, telecommunication companies, and manufacturers on gross receipts and other privilege taxes imposed by various jurisdictions
- Advised an international telecommunications company on nexus issues and state and local tax collection obligations on international calls
- Advised airlines and other air transportation companies on whether their sale or purchase of aircraft is subject to sales or use tax

CONSTRUCTION & HOMEBUILDING TAX ISSUES

Our attorneys represent construction contractors, both general and subcontractors, and homebuilders on a wide array of federal, state and local tax issues, including construction manager tax issues, hospital construction projects and issues dealing with the installation of exempt machinery and equipment.

They also advise and work with homebuilders on the marketing arm-contracting arm structure used in Arizona for state transaction privilege tax purposes, as well as assisting real estate developers deal with the Arizona “speculative builder” tax.

STATE & LOCAL TAX GROUP

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