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# Case at a Glance

The IRS's practice in collecting delinquent employment taxes owed by a partnership is to assess the partnership but not the general partners. After assessing the partnership, the IRS files tax liens and levies against the general partners. The IRS maintains that notice to the partnership is notice to the general partners. The Ninth Circuit held that the general partners are entitled to be individually assessed and notified.

## Must the IRS Individually Assess the General Partners to Collect the Partnership's Delinquent Employment Taxes?

by Ralph C. Anzivino

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### ISSUE

Is the Internal Revenue Service required to assess the general partners of a partnership individually in order to collect the partnership's delinquent employment taxes from the general partners, or is assessment against only the partnership sufficient?

### FACTS

Respondents are general partners of a partnership. The partnership filed federal employment tax returns showing balances owed at various times between 1992 and 1995. The Internal Revenue Service (IRS) made timely assessments (within the three-year time limit) of the taxes shown on those returns against the partnership between 1992 and 1996. The IRS did not make any assessments against the partners individually, nor did it provide any notice to or demand for payment from the partners. The IRS did, however, file notices of federal tax liens against the general partners.

The Galletti respondents filed their joint voluntary chapter 13 petition on October 20, 1999, and Briguglio respondents filed a joint voluntary chapter 13 petition on February 4, 2000. The IRS filed proof of claims in both respondents' bankruptcy cases after the three-year statute of limitations expired. The IRS's claim against the Gallettis, in the amount of \$395,006, consisted of more than \$240,000 in penalties and interest that had accumulated in the five- to six-year period between the date the partnership taxes were first due and the date of the Gallettis' bankruptcy petition. The IRS's claim against the Briguglios, in the amount of \$403,264, consisted of more than \$265,000 in penalties and interest that had accumulated in a five- to six-and-a-half-year period between the partnership tax due date and the Briguglios' bankruptcy petition.

Respondents objected to the IRS's proof of claims. Respondents acknowledged that, as general part-

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ners, they are liable for all lawful debts of the partnership under state law and that the assessments of the employment taxes against the partnership were timely and valid. They contended, however, that federal law prohibits the collection of the tax liabilities of the partnership from its partners unless a separate assessment of the taxes has been made against the partners individually. They further contended that the United States is now barred by 26 U.S.C. § 6501(a) from making such assessments against the partners because the three-year statute of limitations has expired.

In response, the United States maintains that the assessments against the partnership were timely and valid and that the liability of the general partners for the resulting debt of the partnership arises under state law, not the Internal Revenue Code. Accordingly, when a valid assessment has been made of the tax liability of the partnership, no additional, individual assessment against the general partners is required by federal law to proceed against the partners for their liability.

The bankruptcy courts disallowed the United States's claims, and the district courts affirmed. *In re Galletti*, 2001 WL 752652 (C.D. Cal. 2001); *In re Briguglio*, 2001 WL 429820 (C.D. Cal. 2001). Both courts relied on the proposition that "a valid assessment is a prerequisite to tax collection," quoting *El Paso Refining, Inc. v. IRS*, 205 B.R. 497, 499 (Bankr. W.D. Tex. 1996). Both courts held that the employment taxes owed by the partnership must be assessed against the general partners individually before they could be collected directly from them. Since no assessment had been made against the general partners individually within the three-year limitation period, both courts concluded

that the United States's claims were barred.

The Ninth Circuit affirmed. *In re Galletti*, 314 F.3d 336 (9th Cir. 2002). The Ninth Circuit noted that, under the Internal Revenue Code, the IRS is to collect tax deficiencies by making an assessment against the taxpayer within three years of the filing of the taxpayer's return. The court reasoned that respondents, as general partners, are taxpayers who are subject to assessment for the employment taxes owed by the partnership. The court noted that the term "taxpayer" is defined in the Code as any person subject to any internal revenue tax. In addition, the Code defines the word "person" to include an individual as well as a partnership. Relying on these definitions, the court concluded that the partnership is a taxpayer and each individual general partner is a separate taxpayer. Thus, the court held that the timely assessments against the partnership extended the statute of limitations only with respect to the partnership and left unaltered the limitations period applicable to respondents. Because the government did not assess the partnership's tax liabilities against the general partners individually within three years after the partnership returns were filed, the court held that the government is barred from collecting those taxes from respondents. The United States appealed, and certiorari was granted by the Supreme Court on June 23, 2003. *U.S. v. Galletti*, 123 S.Ct. 2606 (2003).

### CASE ANALYSIS

The IRS maintains that it may enforce the derivative liability of general partners for tax debts owed by their partnership without making a separate assessment against the individual partners. Their position is based on state law, not federal law.

In this case, the IRS made a timely assessment of federal employment tax obligations owed by the partnership. When the partnership failed to pay, the United States sought to enforce the tax liability against the general partners, who are liable under state law for all valid debts of the partnership. The IRS contends that the Ninth Circuit erred by misapprehending the essential nature of the IRS's claim. The derivative claim against the general partners for the recovery of taxes owed by the partnership is based on state partnership law, which specifies that all general partners are jointly and severally liable for all obligations of the partnership. While federal law creates the debt of the partnership for their employment taxes, it is state law that makes the general partners derivatively liable for that debt.

Under state partnership principles, it is well established that general partners are personally liable for the debts and liabilities of the partnership, including its tax liability. Accordingly, when a valid obligation of the partnership exists under federal law, that lawful debt of the partnership may be enforced directly against the general partners under state law. In this case, the uncontroverted record establishes that: (1) timely assessments of the partnership's tax liabilities were made within the three-year period allowed by 26 U.S.C. § 6501(a); (2) those timely assessments extended the time for collection of those tax liabilities for an additional 10-year period; and (3) the 10-year period has not yet expired. Therefore, the existence of the partnership debt and the liability of the general partners for that debt under state law are both irrefutable.

The IRS further notes that no individual assessment of general partners is required by the Internal

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Revenue Code to permit the collection of partnership taxes from its general partners. Without directly challenging the established rule that general partners are liable for the valid debts of their partnerships under state law, the Ninth Circuit concluded that these taxes could not be collected from the partners because they had been assessed by the IRS *only* against the partnership and not directly against the partners. This conclusion is based on a fundamental misunderstanding of the function and nature of an assessment under the Internal Revenue Code. The Code does not require that separate assessments be made for each partner in order to enforce their derivative liability for partnership taxes under state law. An assessment is merely a formal record of the amount of tax that is due. Once the amount of a tax is determined and recorded in an assessment, the commissioner may enforce that liability against *any party* that is directly or derivatively liable for it.

Section 6201(a) of the Internal Revenue Code authorizes the Secretary of the Treasury to make assessments of all taxes imposed by the Code. The assessment contemplated by and referred to in the Code is the assessment of the tax. The commissioner's assessment list, which the commissioner actually signs when he makes an assessment of the tax, does not contain the names of any taxpayer but contains only the amounts and the total tax. The assessment of a tax is thus essentially a bookkeeping notation that serves as a formal record of the amount of the tax liability. The commissioner's practice in this regard has remained consistent for the past 65 years. In this case, it is undisputed that a timely assessment of the taxes owed by the partnership was made. No other or further assessment of these taxes is con-

templated or required by the Code. Thus, the only assessment required by the Code was the assessment against the partnership.

The IRS maintains that its practices follow a straightforward application of the law. When the IRS makes a timely assessment of a tax, two important consequences ensue. First, after a tax is assessed, the IRS may employ administrative enforcement methods such as tax liens and levies to collect the outstanding tax. Second, when a timely assessment is made, the time within which the IRS may collect the tax either administratively or by a proceeding in court is extended to 10 years after the date of assessment.

In the present case, the IRS properly made a timely assessment of the taxes owed by the partnership. The federal taxes at issue are imposed directly on the employer. The Code provides that every employer who is required to deduct employment taxes shall be liable for the payment of such tax. Thus, when the partnership paid wages to its employees, it created employment tax liabilities for itself, as the employer under federal law. The government made a timely assessment of those taxes within the three-year period allowed by the Code. That timely assessment extended for 10 years the period in which a judicial action could be commenced to collect that liability. The extension of the collection period applies without regard to the identity of the party against whom the action is commenced. And it applies equally to a proceeding against a taxpayer who is directly liable for a tax and to a proceeding against a person who is derivatively liable for it. The current proceeding in court to collect the assessed taxes was begun within 10 years after the assessment of the tax. Therefore, it is timely as a matter of federal law.

The IRS argues that the Ninth Circuit incorrectly rejected this straightforward application of the Code. The court failed to understand that, when a valid assessment is made of the tax owed by the person directly or primarily liable, no further or separate assessment is required before a collection action may proceed against individuals who are derivatively liable for the tax.

The IRS believes that the Code itself reveals the error of the Ninth Circuit's interpretation. The Code provides that the amount of any tax imposed shall be assessed within three years after the partnership return is filed, making clear that it is the amount of the tax, not the taxpayer or person derivatively liable, that must be assessed. Similarly, the Code provides that, where the assessment of any tax has been timely made, suit may be brought to collect the tax within 10 years after assessment. This statutory language confirms that Congress contemplated a *single* assessment of any tax and that such assessment would trigger the 10-year period without regard to the identity of the person or persons ultimately found liable to pay the tax. Nothing in the text of the Code provides any support for the Ninth Circuit's contrary view that "individual assessments" against each potentially liable person are required.

The government further asserts that its reading of the statutory text is confirmed by a long-established body of case law holding in a variety of contexts that tax collection actions may proceed against derivatively liable persons in the absence of a separate individual assessment. In each of the following situations, the courts have held that no separate assessment was required to collect a tax from one who was derivatively liable: a transferee's derivative liability for taxes owed by a trans-

feror corporation; an executor's derivative liability for taxes owed by the decedent; and a donee's derivative liability for unpaid gift taxes owed by the donor. In each case, the court reasoned that it is the "tax" and not the "taxpayer" that is assessed.

Finally, the IRS argues that the Ninth Circuit's decision would create severe and impracticable burdens for routine enforcement of the tax laws. The IRS states that there are currently outstanding partnership employment tax liabilities in excess of \$10 billion that have been assessed in a timely manner but for which separate assessments have not been made against the general partners individually. The decision of the Ninth Circuit would bar collection of those liabilities from individual general partners in cases in which the ordinary three-year period for assessment of taxes has expired.

It is undisputed that general partners are jointly and severally liable for all outstanding debts of the partnership under state law. Until now, the IRS has typically pursued collection of partnership tax obligations from the partnerships before commencing litigation with the general partners to satisfy outstanding tax obligations. Under the abbreviated limitations period that would result from this decision, the government would be forced to bring collection suits against the general partners within the three-year period, even though parallel efforts against the partnership may remain ongoing. A requirement that such duplicative proceedings be pursued would be burdensome for general partners as well as for the government. It would subject general partners to the necessity of litigation over matters that the partnership itself should routinely resolve.

Respondents argue that the individual general partners of a general partnership are primarily, not derivatively, liable under state law. Thus, they are taxpayers who must either be sued or assessed within the three-year period. Virtually every state in the United States has statutory and case law that states that general partners of a partnership are liable for all the debts of the general partnership. The nexus between a general partnership and its general partners is substantively different than the relationship between other taxpayers and the parties which the IRS might seek to hold secondarily liable.

A general partner is jointly and severally liable for the entire amount of a partnership's tax debt simply by virtue of being a general partner at the time the tax debt arose. *Black's Law Dictionary* defines *joint and several liability* as the liability of copromisors of the same performance when each of them, individually, has the duty of fully performing the obligation, and the obligee can sue all or any of them upon breach of performance. Such liability permits the IRS to collect a tax from one or all of several taxpayers. For example, a husband and wife who file a joint income tax return are collectively and individually liable for the full amount of the tax liability. Thus, the partners as co-obligors on the tax liability were required to be assessed within the three-year period. The courts have properly sustained the respondents' objections to the IRS's proof of claims because the claims were not assessed against the general partners individually within the three-year limitation period.

While respondents believe that the general partners are primarily liable for the partnership tax liability, even if the general partners are sec-

ondarily liable, the general partners are still entitled to be individually assessed. The United States uses the concept of secondary or derivative liability but fails to provide a definition. There are a number of different kinds of secondary liability for a tax owed by a taxpayer. Secondary liability can arise under state law or federal law. For example, pursuant to the Code, secondary liability for a tax is imposed under the responsible person section, the lender liability section, and the transferee liability section. Interestingly, none of the provisions involving secondary liability permit the IRS to take administrative collection action against those asserted to be secondarily liable unless the IRS has made a separate assessment against that person. Thus, whether the general partners are primarily or secondarily liable, they are entitled to be individually assessed.

Respondents maintain that the Code anticipates a broad interpretation of those persons entitled to notice of a tax deficiency. I.R.C. § 6201 authorizes the Secretary of the Treasury to make assessments imposed by the Internal Revenue Code with respect to taxes shown on "balance due" returns filed by taxpayers, which is the case here. Section 6203, entitled "Method of Assessment," states that the assessment shall be made by recording the liability of the taxpayer in the office of the Secretary in accordance with rules or regulations prescribed by the Secretary. The regulations provide for recording of both the amount of the tax liability and the names of the persons liable for the tax liability. I.R.C. § 6303 provides that the Secretary shall, as soon as practicable, and within 60 days after the making of an assessment, give notice to each person liable for the unpaid tax, stating the amount and demanding payment. This notice "shall be left at the

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dwelling or usual place of business of such person, or shall be sent by mail to such person's last known address." Failure to provide the taxpayer with proper notice and demand within 60 days of the assessment bars the IRS from taking administrative collection action against the taxpayer and stops the running of interest on the tax debt. There is no doubt that a general partner of a general partnership, by virtue of their joint and several liability, is a person liable for the unpaid tax of the partnership. Thus, the partners are entitled to their own separate assessment, notice and demand.

Similarly, the notice provisions for establishing a tax lien suggest a broad interpretation of those persons entitled to notice of a tax deficiency. I.R.C. § 6321 provides that if any person liable to pay any tax neglects or refuses to pay the same after demand, the amount shall be a lien in favor of the United States upon all property and rights to property belonging to such persons. The Section 6321 lien attaches to only the property of the person who is liable for the tax. I.R.C. § 6323 provides for the filing of a notice of federal tax lien to perfect the IRS's lien against third parties. Thus, if a taxpayer is assessed a tax, is given timely notice and demand, and thereafter fails to pay the tax, the next step is for the IRS to file a notice of federal tax lien against the taxpayer to perfect its lien. The Code provides the taxpayer with administrative and judicial appeal rights when the IRS has filed a notice of federal tax lien. Where the IRS has filed a notice of federal tax lien against a person liable for the tax, that person may appeal the IRS's decision to file a notice of federal tax lien. I.R.C. § 6330 provides that the IRS may not levy on any property or right to property of any person unless the Secretary has

notified such person in writing of their right to a hearing. Clearly, due process of law would mandate a broad interpretation of those persons entitled to notice of the IRS's pending lien rights. The Code and associated regulations provide a comprehensive scheme that provides fair notice to those primarily liable for the tax. Certainly that must include the general partners of a partnership who are primarily liable for the partnership debt.

Alternatively, respondents assert that if the partners are not the taxpayers, their liability arises only under state law and enforcement is governed by the state's limitation periods. In the absence of California law providing that general partners are liable for the debts of their partnership, the United States would have no right to pursue respondents in their capacity as general partners for the partnership tax debt. Thus, the United States is not asserting rights against respondents according to federal law. The fact that federal law prescribes additional procedures to assist the IRS in collecting the tax does not mean that the basis for primary liability is federal law. Rather, the primary basis is state partnership law. The limitations periods for asserting liability against respondents under California law is decidedly not a federal period of limitations. The California period of limitations is three years. The government's claim against the general partners, then, is barred because it was initiated after the California three-year period of limitations.

Finally, respondents maintain that the IRS's current collection practices do not comport with due process of law. The IRS files notices of federal tax liens against general partners to secure payment of partnership taxes without assessing the partners individually and without giving the individual partners notice

and demand. The IRS also levies on the property of general partners to collect partnership taxes without assessing the partners individually and without giving them individual notices and demand for payment. The IRS has argued that notice and demand to the partnership operates as notice and demand to the general partners.

Respondents argue that the IRS's practice in this regard is clearly suspect. The protections and procedural safeguards afforded under the Due Process Clause of the Fifth Amendment guarantee the procedures necessary for the protection of ultimate decency in a civilized society. Although many controversies have raged about the cryptic and abstract words of the Due Process Clause, there can be no doubt that at a minimum what the Constitution does require is an opportunity for notice granted at a meaningful time and in a meaningful manner. The IRS's procedures hardly seem to comport with the fundamental fairness of an opportunity granted at a meaningful time and in a meaningful manner. Respondents acknowledge the important governmental interest in collecting taxes. However, the burden on the IRS to assess, and to give notice and demand for payment to the individual general partners, is negligible compared to the harm—the continuing accumulation of interest and penalties without the individual partner's receipt of notice and the ability to pay the tax and/or dispute the debt. Surely, 13 years of accumulated interest and penalties, without recourse, is not fundamentally fair.

## SIGNIFICANCE

A partnership is one of a number of business associations in which individuals can choose to conduct their business. In fiscal year 2002, approximately 2.2 million partner-

ships filed information returns with the IRS. Obviously, there are a significant number of people in the United States who are conducting some part of their business in partnership form.

The IRS's current practice for the recovery of delinquent taxes owed by a partnership (such as Social Security or withholding taxes) is to assess the partnership and not the general partners. Coincidentally, the IRS files federal tax liens against the general partners and levies execution on the partners' property. The IRS maintains that assessment and notice to the partnership is sufficient notice to the general partners.

The general partners disagree with the IRS's practice. The partners assert that since they are primarily liable for the delinquent partnership taxes, they are entitled to be assessed and notified individually. In this case, the IRS did not attempt to assess the individual partners until the statute of limitations on assessments/collection had expired. It is estimated that nearly \$10 billion will be lost by the government if the Supreme Court concludes that general partners as well as the partnership are required to be assessed for delinquent partnership taxes.

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