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Federal Court Rules Against IRS on Individual Liability of Partners

The Ninth Circuit Court of Appeals recently decided a partnership-related tax case in the taxpayers' favor, entering a rare judgment against the Internal Revenue Service on a procedural issue. The court in *In re Galletti* found that the IRS could not collect the partnership's tax debt from the individual partners who composed the partnership.

Background

The partnership at issue failed to pay the requisite federal employment taxes from 1992 to 1995; the IRS assessed \$400,000 in unpaid taxes against the partnership in 1994, 1995, and 1996. The individual partners in *Galletti* subsequently filed for Chapter 13 bankruptcy in 1999 and 2000, and the IRS filed proofs of claim against them for the assessed taxes.

By making an assessment within three years of the filing of a taxpayer's return, the IRS secures an extension of the statute of limitations for a judicial action to collect the taxes, to 10 years from the date of assessment. The IRS asserted that its timely assessments of the partnership's unpaid taxes extended the time for collection of the taxes from the individual partners, and, further, that it could bring a state law claim against the partners because California law made them jointly and severally liable for partnership debts.

The plaintiffs protested that the IRS had assessed only the partnership, not the individual partners, so the three-year statute of limitations had run and no actions could be brought against them for the partnership's tax debts.

The Court's Holding

The Ninth Circuit decision addressed each of the IRS' arguments. In considering the effect of the IRS assessments on the individual partners, the court examined the language of the Internal Revenue Code. It noted several code sections that presumed a taxpayer with a deficiency assessed against him or her would be the same taxpayer for whom the statute of limitations is extended — in each of the sections, the individual or entity subject to the assessment must be a separately identified taxpayer.

The court concluded that, while the partnership constitutes a "taxpayer" for purposes of the statute, each individual debtor also qualifies as a taxpayer. Because the IRS failed to assess tax deficiencies against the individual partners within the prescribed three-year period, it was barred from collecting the unpaid taxes from the partners directly.

The assessment, the court ruled, applied to extending the statute of limitation for the partnership only, not for the individual partners.

It should be noted, however, that the partners were indeed liable for the tax debt. As the court noted, the partners conceded that they were liable for the taxes but argued that, in the absence of individual assessments or judgments against them, the IRS was procedurally barred from collecting those unpaid taxes from them.

The IRS also argued that California law allowed it to pursue the individual partners. Because the assessment was a partnership debt that the IRS had a right to collect against the partnership, the IRS claimed it could bring an action under state law to obtain a judgment against the debtors for the taxes.

The court disagreed with this position, citing section 16307(c) of the California Corporations Code, which provides that a judgment against a partnership isn't the equivalent of a judgment against a partner; to satisfy a judgment from a partner's assets, there must also be a judgment against that partner.

The court noted that the individual partners were liable for the partnership's debts under state law, but, again, the IRS could not collect in this case because it had failed to obtain a judgment against them. As the applicable statute of limitations had run, the IRS had no recourse under state law.

Proceed with Caution

While the *Galletti* decision is notable in that the IRS lost a procedural case, it has limited value for guiding the decisions of partnerships. Although the partners in this case were ultimately able to elude the IRS, they were nonetheless liable for the partnership's debts.