

**Administrative Practice Committee**  
**2012 Joint Fall CLE Meeting**  
*Boston, Massachusetts*

**Transferee Liability Panel**

# Transferee Liability

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- *Moderator:*
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- *Panelists:*
  - Tamara Ashford
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  - Robert Probasco
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# Overview of Transferee Liability

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- Section 6901(a)(1) authorizes assessment of transferee liability in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the transferee liability is incurred.
  - Does not independently impose tax liability upon a transferee
  - Provides a procedure through which the Commissioner may collect from a transferee unpaid taxes owed by the transferor of the assets
- Federal law determines whether a person is a transferee. See I.R.C. 6901(h) (defining “transferee”).
- State legal and equitable principles that enable creditors to collect the debt of a transferor from the transferee based upon various factors, such as whether the transferor received anything of equivalent value in return and whether the transfer left the transferor insolvent.
- Thus, Federal law determines whether a person is a transferee, State law determines the elements of liability against a transferee, and section 6901 provides the mechanism for the IRS to collect that liability.

## Basic Facts of a Midco Transaction

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- A company sells all of its assets for cash, leaving only cash and the tax liability on the gain from the asset sale.
- The shareholders sell their stock to a third party (the “Midco”) for more than the net worth of the company.
  - Example: Assume that the cash remaining was \$100 and the tax liability was \$30, making the net value of the entity \$70. The shareholders would sell the stock to the Midco for \$80.
- The Midco withdraws the cash from the company it just bought and causes the company to engage in a new transaction that eliminates the tax liability.
- Result:
  - The shareholders receive \$10 more than the net value of the entity. The Midco keeps \$20 in cash (the \$100 in cash it withdrew from the company less the \$80 it paid the shareholders).

# ***Starnes v. Comm’r*, No. 11-1636 (4th Cir. 5-31-12)**

## **(No Transferee Liability)**

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- The Government’s Position
  - A threshold question is whether the Former Shareholders were transferees of the corporation in order to trigger the application of section 6901.
    - Look to federal law (substance over form) to determine if the Former Shareholders were transferees:
      - recast the stock sale as a liquidation so that the Former Shareholders are viewed as receiving cash directly from their old corporation.
    - Once the stock sale is recast as a liquidation, state law would determine the substantive liability based on the recast transaction.

## *Starnes (Con't)*

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- The Court's Response

- No need to address the threshold question of whether the Former Shareholders were transferees under federal law because the IRS failed to show that they were liable under state law.
- Although the court said that application of the substance-over-form doctrine “may well be a correct framing” of the “transferee” question, the court went on to analyze the substantive liability of the Former Shareholder by respecting the form of the stock sale.
- The court examined various arguments under North Carolina state law and found that the IRS failed to show that the Former Shareholders knew or should have known that the entity would fail to pay the taxes once owned by the new owner – a very fact specific inquiry.

## ***Feldman v. Comm’r*, TC Memo 2011-297 (Transferee Liable)**

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- Tax Court said that it must first decide if the purported stock sale should be, for Federal income tax purposes, recognized as such or instead treated as a sham.
- Tax Court reviewed Federal tax cases involving substance-over-form and other similar doctrines and concluded that the sale was not a bona fide sale of stock.
  - Key for the court was a finding that all the parties “knew and understood” that price paid for the stock reflected a “split of the projected tax liabilities that no one intended to pay.”
- Having recast the transactions, the Tax Court applied Wisconsin’s Uniform Fraudulent Transfer Act and found the family members liable for the taxes due because they knew or should have known that, as a result of the transactions, the entity would have debts beyond its ability to pay.

## Other Cases with Appeals Pending

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- *Frank Sawyer Trust* – First Circuit
  - Under Mass. law, Tax Court found that facts insufficient to find that transferee knew or should have known that the intermediary was using the transaction as part of an illegitimate tax scheme.
- *Salus Mundi* – Second Circuit
  - Under NY law, when a creditor seeks to recharacterize a series of transactions for purposes of showing that no fair consideration was given, the creditor must prove that the multiple transactions were linked and that the transferee has actual or constructive knowledge of the entire scheme.
- *Slone* – Ninth Circuit
  - Tax Court declined to recast stock sale as liquidating distribution, and since there was no transfer, the court never addressed the substantive liability under state law.



## Question

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- Why was it important to the government in *Starnes* to argue that Federal law governed the recharacterization rather than relying on a state law doctrine to accomplish the same goal?

## Question

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- The taxpayer victories after *Feldman* distinguished *Feldman* factually, saying that in that case the court found that the transferee knew of the purpose to avoid paying taxes. Is that all that distinguishes *Feldman*?

## Question

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- Are the taxpayer victories on appeal materially different from *Starnes*?
- What has, or will, the government argue differently in these cases?

## Question

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- If the IRS were to prevail, what would be the impact with respect to claims by other creditors against former shareholders?

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- Any more questions?