Transferee Liability: More on Shareholders as Transferees.

This post will continue my coverage of *Slone v. Commissioner*, 2015 U.S. App. LEXIS 9546 (9th Cir. June 8, 2015), which addressed the test for when a former shareholder is a transferee within the meaning of Section 6901(h) of the Internal Revenue Code. *Slone* involved two transactions: an asset sale by a C Corporation, Slone Broadcasting, that generated a sizeable capital gain, and a stock sale by its shareholders to an affiliate of Fortrend International, LLC that yielded more than they would have received in a liquidating distribution from that corporation.

After the stock sale, Slone Broadcasting merged with another Fortrend affiliate and the surviving corporation became known as Arizona Media Holdings; it filed a return that claimed an offsetting loss to eliminate the capital gain from the asset sale. That did not work, and the IRS initially assessed the surviving corporation; when it failed to pay, it looked to the former shareholders of Slone Broadcasting.

Several things are interesting about *Slone.* First, if you read the appellate opinion in a vacuum, you would think that the tax court made a huge error because it failed to analyze whether the former shareholders were transferees under Section 6901(h), leading the court of appeals to remand. *Slone,* 2015 U.S. App. LEXIS 9546 slip op. at *19-*20.

But there was a reason why the tax court approached the case the way it did: the government's theory of the case changed. Initially, it approached the case as an intermediary tax shelter, but it abandoned that approach and acknowledged that the initial asset sale was independent from the subsequent stock sale. It also conceded that transferee liability hinged on whether the form of the stock sale should be respected.

Accordingly, the tax court focused on the basic question of whether the doctrine of substance over form permitted the government to disregard the form of the stock sale and treat it as a liquidating distribution, which was the government's new theory. The tax court also noted that the government had raised in an untimely fashion the economic substance doctrine, a related common law doctrine that was codified in 2010. *See Slone v. Comm'r,* 2012 Tax Ct. Memo LEXIS 54, slip op. at *22 & n. 7 (Mar. 1, 2012), *vacated and remanded,* 2015 U.S. App. LEXIS 9546 (9th Cir. June 8, 2015). The tax court's determination that the government had waived any economic substance argument is a bit puzzling.

I generally look at the substance over form doctrine as a broad concept that has two different sub-components: the first is the economic substance doctrine, which permits a court to disregard a transaction when an examination of objective factors (such as economic impact) and subjective factors (such as business purpose) indicate that the transaction should not be respected; the second is the step transaction doctrine, which permits a court to aggregate or disaggregate steps in a series of transactions to determine the taxpayer's liability.

The Ninth Circuit was apparently of the same view; the panel opinion noted that the tax court had failed to explain the difference between the substance over form doctrine and the economic substance doctrine and concluded that "any subtle difference between these doctrines is not relevant for our analysis here." *Slone,* 2015 U.S. App. LEXIS 9546, slip op. at *9 n.2. The court of appeals then applied the economic substance doctrine. *Id.*, slip op. at *13-*14.

The next thing that is interesting about *Slone* is the Ninth Circuit's failure to affirm. Generally, an appellate court is free to affirm "on any ground supported by the record, whether or not the

decision . . . relied on the same grounds or reasoning that we adopt." *Atel Financial Corp. v. Quaker Coal Co.*, 321 F.3d 921, 926 (9th Cir. 2003). The tax court had concluded that the form of the stock sale should be respected after applying factors that the Ninth Circuit recognized were relevant "to the question whether the shareholders lacked actual or constructive knowledge of the entire tax evasion scheme that rendered their transaction with Fortrend fraudulent." 2015 U.S. App. LEXIS 9546, slip op. at *19. As the Ninth Circuit earlier held in *Salus Mundi Foundation v. Commissioner*, 776 F.3d 1010, 1020 (9th Cir. 2014), actual or constructive knowledge is required to support liability as a transferee under state law. Given the tax court's determination that actual or constructive knowledge was missing, the court of appeals could have affirmed, even if the tax court erred in how it analyzed the question whether the former shareholders were "transferees." The Ninth Circuit, however, chose not to do so.

And then there is the dissent. Judge Noonan agreed with the panel's basic determination that the standard to determine whether the former shareholders were transferees was one of economic substance, but would have decided the issue on the basis of the existing record. *Slone*, 2015 U.S. App. LEXIS 9546, slip op. at *20-*21 (Noonan, J. concurring and dissenting). Judge Noonan focused on the Sixth Circuit's opinion in *Owens v. Commissioner*, 568 F.2d 1233 (6th Cir. 1977), as it dealt with a similar situation. Looking at factors such as Slone Broadcasting's lack of any operations and any assets other than cash, as well as the manner in which the purchaser financed the transaction, Judge Noonan concluded that the facts demonstrated that the sale of the Slone Broadcasting shares was, in substance, a liquidating distribution, which meant that the former shareholders were transferees. *Slone*, 2015 U.S. App. LEXIS 9546, slip op. at *24-*25 (Noonan, J. concurring and dissenting). As with the panel, Judge Noonan would remand for a determination of liability under state law.

To me, *Slone* looks like a case where the court of appeals had some skepticism over the tax court's findings and overall approach to the case. Consequently, it sent the case back to give the tax court the chance to get it right.

Jim Malone is a tax attorney in Philadelphia; he focuses his practice on federal, state and local tax controversies. This post is intended to provide background on a relevant issue; it is not intended as legal advice.