The Tax Court Rejects the Government's Position on Transferee Liability.

Section 6901 of the Internal Revenue Code provides the government with a procedural tool to assist it in collecting taxes from third parties who hold property that was transferred to them by a taxpayer. It permits the IRS to issue a transferee assessment if two conditions are met: where the target of the assessment is a transferee, which is decided under federal law; and where the transferee is liable under applicable state law, such as fraudulent conveyance law.

The government has been pressing an approach to transferee liability under Section 6901 that first asks a court to recast a transaction or series of transactions using federal tax law doctrines such as substance over form and then apply state law to the transaction as recast under federal law. Several courts of appeal have rejected this approach, including the Second Circuit. *Diebold Foundation, Inc. v. Comm'r*, 736 F.3d 172, 184-85 (2d Cir. 2013). These courts hold that while federal law controls whether someone is a transferee for purposes of Section 6901, any effort to recast a transaction or series of transactions must be permissible under applicable state law to support transferee liability.

In line with this trend, the Tax Court has now explicitly rejected the government's position on Section 6901, holding explicitly that the IRS must show that state law would permit it to recast the transaction as part of the determination that the transferee is liability. *Swords v. Comm'r,* 2014 U.S. Tax Ct. LEXIS 20, slip op. at *37-*41.

This is good news. The government has been pressing transferee cases in fairly extreme situations where there does not appear to be any evidence that the target of the transferee assessment had any knowledge that it was involved in something improper.

The *Swords* case is an example: after reviewing applicable law, the Tax Court found no basis to show that the targets, a group of trusts, had any knowledge that their counterparties in a series of transactions had an intent to avoid taxes. *Id.,* slip op. at *48-*54.

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