

The Ninth Circuit Rules that Transferee Liability Must Be Determined Under State Law.

When the IRS is confronted with a taxpayer who cannot pay the taxes due, it can turn to Section 6901 of the Internal Revenue Code, which authorizes the IRS to issue assessments of those tax liabilities against direct and indirect transferees of the taxpayer's property.

Section 6901 does not establish transferee liability, it merely establishes a procedure that permits the IRS to issue a tax assessment against a transferee instead of filing a law suit.

Courts have construed Section 6901 to require an examination of two issues:

- Whether a party is a transferee, which is decided under federal law;
- Whether that party is liable as a transferee, which is decided under applicable state law governing fraudulent transfers.

One controversial issue has been the role of federal law in recasting a transaction: in the government's view, it can use federal law, such as the substance over form doctrine *before* applying state fraudulent transfer law. Last year, the Second Circuit joined a growing group of courts that have rejected this position. See *Diebold Foundation v. Commissioner*, 736 F.3d 172 (2d Cir. 2013). I covered this case in two pieces:

<http://www.taxlawinphilly.com/2013/11/19/transferee-liability-second-circuit-finds-constructive-knowledge-midco-case/>; <http://www.taxlawinphilly.com/2013/11/25/transferee-liability-second-circuit-finds-constructive-knowledge-midco-case-part-ii/>.

Now the Ninth Circuit has addressed the issue, indicating that it agrees with the approach taken by the Second Circuit in *Diebold*. See *Salus Mundi Found. v. Comm'r*, 2014 U.S. App. LEXIS 24240 (Ninth Cir. Dec. 22, 2014).

The Ninth Circuit's reasoning is somewhat truncated because it was dealing with a case that arose out of the very same transactions that the Second Circuit had addressed in *Diebold*. The Court noted that "absent a strong reason to do so, we will not create a direct conflict with other circuits." *Salus Mundi*, 2014 U.S. App. LEXIS, slip op. at *24 (quoting *United States v. Chavez-Vernaza*, 844 F.2d 1368, 1374 (9th Cir. 1987)). The Court also noted that precedent called for it to follow tax decisions of other circuits unless they are "demonstrably erroneous" or there are "cogent reasons for rejecting them." *Id.* (quoting *Beecher v. Comm'r*, 481 F.3d 717, 720 (9th Cir. 2007)). In the Ninth Circuit's view, while the IRS had some plausible arguments, they did not justify creating an inter-circuit conflict. *Id.*, slip op. at *22.

Since the government has now lost in the First Circuit, *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013), the Second Circuit (in *Diebold*), the Fourth Circuit, *Starnes v. Commissioner*, 680 F.3d 417, 428 (4th Cir. 2012), the Ninth Circuit (in *Salus Mundi*), and the Tax Court, *Swords v. Comm'r*, 2014 U.S. Tax Court LEXIS 20 (May 29, 2014), the issue appears to be settled. The IRS, however, may continue to contest the issue; it filed an appeal in *Swords* and initially sought review in the Sixth Circuit where the issue had not been addressed. That appeal has been transferred to the Fourth Circuit, which will presumably simply follow *Starnes*.

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. © 2014, MALONE LLC.