TRANSFEREE LIABILITY: ANOTHER VOTE FOR SUBSTANCE OVER FORM UNDER STATE LAW

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The IRS uses transferee liability to make Peter pay Paul's taxes.

To accomplish this, the government relies upon both federal and state law:

- Section 6901 of the Internal Revenue Code authorizes the IRS to collect taxes from transferees who are liable "at law or in equity" and to do so "in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred." I.R.C. § 6901(a). This permits the IRS to issue a tax assessment against a transferee who received a taxpayer's property.
- Section 6901 of the Code is simply a procedural device; it does not create liability. Thus in transferee cases, the IRS relies upon state law to establish Peter's substantive liability for Paul's taxes, typically a fraudulent conveyance or fraudulent transfer statute.

Consequently, the IRS must first establish that a potential target is a transferee under federal law so that it can rely upon section 6901 as a procedural device. Then it must establish liability under applicable state law. *See Comm' r v. Stern*, 357 U.S. 39, 42, 44-45 (1958).

Among the elements that the government must establish under state law is that Peter received a transfer from Paul, either directly or indirectly. In a series of cases, the IRS attempted to rely on a determination that a transfer occurred under federal law to establish the required transfer for purposes of state fraudulent transfer law. It took this approach for a simple reason: There is a well-established body of federal law that permits courts to recharacterize transactions to reflect their economic reality; these overlapping doctrines, which include substance over form, step transaction, economic substance, and sham transaction, are the subject of a significant number of federal judicial opinions. A series of appellate cases rejected the approach of relying upon federal law to establish a transfer for purposes of liability and required the IRS to show that a potential target in a transferee case is a transferee under both federal *and* state law. *See Salus Mundi Found. v. Comm'r*, 776 F.3d 1010, 1012 (9th Cir. 2014); *see also Diebold Found., Inc. v. Comm'r*, 736 F.3d 172, 185 (2d Cir. 2013).

Since it was required to establish the existence of a transfer under both state *and* federal law, the IRS turned to the same avoidance doctrines that exist under federal law and tied them back to state law equity principles. Conceptually, state fraudulent transfer law is derived from historical equity principles, so there was a logic behind the approach. In 2015, the Seventh Circuit endorsed this approach in *Feldman v. Commissioner*, 779 F.3d 448 (7th Cir. 2015), ruling that a substance over form analysis was viable to establish a transfer under Wisconsin's fraudulent transfer law. *Id.* at 459-460.

Feldman was a "Midco" case; it involved a transaction in which shareholders of a business with highly-appreciated assets sold its stock to another corporation (the intermediary company or Midco) which in turn sold the assets following a merger. In this scenario, the Midco claims it has losses to offset the gain from the sale of the highly-appreciated assets. In *Feldman*, the IRS disallowed the purported losses, and assessed the corporation with additional taxes. *Id.* at 453. The Seventh Circuit upheld the Tax Court's decision that the former shareholders were liable for the corporation's taxes. *Id.* at 459-460.

On October 3rd, the Eleventh Circuit reached a similar result under Wisconsin law in another Midco case. *Shockley v. Comm'r*, No. 16-13473, 2017 U.S. App. LEXIS 19111 (11th Cir. Oct. 3, 2017). Relying upon *Feldman*, the Eleventh Circuit sustained the Tax Court's determination that the Midco transaction should be disregarded under Wisconsin law and affirmed its ruling that the former shareholders were liable for the corporation's taxes:

In summary, we find that the Tax Court appropriately disregarded the Midco transaction and therefore deemed SCC to have transferred the proceeds of its highly appreciated assets to its shareholders, including Petitioners. Recasting the transaction in this manner renders Petitioners liable as transferees pursuant to federal tax principles, and it also renders them substantively liable under Wisconsin state fraudulent transfer law for the taxes generated by the built-in gain on the appreciated assets that SCC sold.

2017 U.S. App. LEXIS 19111 at *46-*47.

While the idiosyncrasies of a particular state's law might generate a different outcome in an individual case, there appears to be a trend in favor of applying a substance over form analysis under state law in transferee cases. *See Stuart v. Comm'r*, 841 F.3d 777, 780 (8th Cir. 2016) (applying Nebraska law); *Weintraut v. Comm'r*, T.C. Memo 2016-142, 2016 Tax Ct. Memo LEXIS 141, **267-**269 (July 27, 2016) (applying Indiana law); *Trirarchi v. Comm'r*, T.C. Memo 2015-21, 2015 Tax Ct. Memo LEXIS 210, **41-**49 (Oct. 14, 2015) (applying Ohio law).

By: Jim Malone

Jim Malone is a tax attorney in Philadelphia. A Principal at Post & Schell, he focuses his practice on federal, state and local tax controversies. Learn more about Post & Schell's Tax Controversy Practice >>