A Very Close Call: The Fourth Circuit Looks at Transferee Liability, Part One.

State law generally provides a creditor with a remedy when someone who owes a debt engages in a fraudulent conveyance in an effort to put money or property out of reach. Since law suits can be cumbersome, Congress gave the IRS special powers to collect from transferees, enacting Section 6901(a) of the Code, which provides that transferees of property are subject to liabilities for income, estate or gift taxes. Specifically, liabilities of a transferee are to be "assessed, paid, and collected in the same manner and subject to the same provisions as in the case of the taxes with respect to which the liabilities were incurred." *Id.* In other words, if you are a "transferee" you step into the shoes of the transferor and are subject to the same administrative procedures that apply to the taxpayer as the IRS attempts to collect from you.

So how can you tell who is liable as a transferee? Section 6901(h) provides a definition, which indicates that "the term 'transferee' includes donee, heir, legatee, devisee, and distributee." Once you identify someone as a transferee under that definition, however, his substantive liability is governed by state law, typically a fraudulent conveyance statute. *See Commissioner v. Stern,* 357 U.S. 39, 45 (1958).

In tax cases, a common problem is how to define a transaction; courts periodically invoke a variety of federal common law principles to recast the form of a transaction, invoking notions such as substance over form, economic reality and the like. If the IRS is attempting to collect taxes from a third party, can it use these federal common law principles to re-characterize a transaction prior to applying state law to assess substantive transferee liability? A divided Fourth Circuit panel addressed this question in *Starnes v. Commissioner,* 2012 U.S. App. LEXIS 10948 (4th Cir. 2012), with a majority concluding that it could not.

Starnes involved the final stages in the life of a trucking company, Tarcon, that had ceased operations. It was owned by three shareholders who wanted to sell their interests in the company and retire. The shareholders looked at three options:

- They could sell Tarcon's remaining physical asset, a warehouse, and distribute the proceeds along with its cash;
- They could sell Tarcon on a going concern basis by selling their stock; or
- They could do a combined asset/stock sale in which the warehouse was sold first, and then the stock was sold to a buyer.

The shareholders hired a broker to assist them in finding an appropriate buyer. First, they received a proposal to buy the warehouse from a REIT; then they were contacted by MidCoast Acquisitions Corp., which offered to buy their stock.

MidCoast, which had no affiliation with the REIT that was to purchase the warehouse, told the shareholders that it would put Tarcon in the asset recovery business and that it would pay its tax liabilities; since Tarcon had no ongoing operations and would be entering a new business, the value of the stock would have been equal to the assets (cash) minus the liabilities (taxes due on the asset sale). Midcoast, however, indicated that it could pay more since it expected its operations to generate initial losses that would decrease the amount of the tax liabilities. Since this proposal was the most favorable from the shareholders' perspective, they elected to pursue it.

After the warehouse was sold, the transaction then concluded in the following steps:

- MidCoast transferred the cash to purchase the shares to its attorney's escrow account;
- The shareholders resigned as officers and furnished their stock certificates to their attorney;
- Tarcon's cash was transferred to their attorney's escrow account;
- The shareholders' attorney tendered the share certificates and closing documents to the buyer's attorney and transferred Tarcon's cash to the escrow account of MidCoast's attorney;
- MidCoast's attorney disbursed cash from his escrow account to pay the shareholders for their stock;
- Tarcon's cash was deposited into its "post-closing bank account" after a brief detour through MidCoast's account. 2012 U.S. App. LEXIS at *14-*16.

Just one problem: MidCoast was apparently operating a scam. Eleven days after the closing, it sold all of its shares in Tarcon to a Bermuda company, which then transferred Tarcon's cash to an off-shore account, where most of its cash was disbursed to a third party. Tarcon then submitted tax returns that purported to offset its taxes on the income from the sale of the warehouse with other losses, but the losses were disallowed. *Id.* at *16-*18.

When the IRS was unable to collect from Tarcon, it sent the shareholders notices of transferee liability, which indicated that it viewed the relevant transactions as a sale of assets followed by a distribution to shareholders. The notice also indicated that it was either an intermediary transaction shelter under Notice 2001-16, or it was a sale of assets followed by a redemption of the Tarcon stock held by the shareholders. *Id.* at *18-*19. After the shareholders filed a petition with the Tax Court, they prevailed at trial, as the court concluded that the IRS had failed to meet its burden of proof to establish their liability as transferees. *Id.* at 19.

After the IRS appealed to the Fourth Circuit, the majority held that the IRS was not permitted to recast the transactions under federal common law standards prior to assessing whether the shareholders were liable as transferees under state law. *Id.* at 31-33. In contrast, the dissent concluded that the Tax Court was required to make a "threshold determination of which transaction is properly under review," an exercise in which it was appropriate to consider federal tax doctrines such as substance over form. *Id.* at 70-73 (Wynn, J. dissenting).

I will drill into the details in a future post.

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