A Very Close Call: The Fourth Circuit Looks At Transferee Liability, Part Three.

This segment of my discussion of *Starnes v. Commissioner*, 2012 U.S. App. LEXIS 10948 (4th Cir. May 31, 2012), will examine the dissenting opinion, which argues that the Tax Court should have been overturned and the taxpayers tagged for transferee liability.

The dissent starts by looking at the substance of the transaction: after the sale of the warehouse, Tarcon had $3,091,955 in the bank and total tax liabilities of $881,628, and the four former shareholders were then free to distribute the net cash, which would result in a distribution to each of them of $552,582. *Starnes*, 2012 U.S. App. LEXIS 10948 at *64-*65 (Wynn, J. dissenting).

Instead, MidCoast became involved; it offered to pay the shareholders $2,621,136 for Tarcon and its $3.1 million in cash. Why did the shareholders accept that proposal? Because Tarcon was only worth $2.2 million due to its tax liabilities. *Id.* at *65-*66 (Wynn, J. dissenting). Viewing the transaction against this background, the dissenting judge saw "a transparent scam designed by the parties to fraudulently evade paying taxes." *Id.* at *66.

Turning to the question of how to define the transfer and the transferees, the dissent was highly critical of the majority's approach. At the outset, Judge Wynn posited that *Commissioner v. Stern*, 357 U.S. 39 (1958) was not controlling, since the substantive state standard for liability that was involved in that case did not require a transfer. In Judge Wynn's view, the taxpayers would be liable for Tarcon's taxes only if there was a transaction that was fraudulent under North Carolina law and the taxpayers were transferees under federal law. *See Starnes*, 2012 U.S. App. LEXIS 10948 at *67-*69 (Wynn, J. dissenting).

Noting that liability would turn on how the transaction was defined and who were the transferees, Judge Wynn concluded that "the Tax Court and this Court must make a threshold determination of which transaction is properly under review, which in turn informs the dispositive issue here of whether the former shareholders are properly characterized as transferees under § 6901." *See Starnes*, 2012 U.S. App. LEXIS 10948 at *69-*70 (Wynn, J. dissenting) (citations omitted).

Having framed the analysis, the dissent then turned to a consideration of the economic reality of the transaction in a straight-forward application of the federal doctrine of substance over form. Judge Wynn concluded that the transaction with MidCoast was a simple cash swap, not a bona fide sale of stock; this conclusion rested primarily on several factors:

- Tarcon was no longer an operating business;
- The relevant agreement expressly provided that its assets would only consist of the cash generated from the sale of its warehouse and its liabilities would only be tax liabilities;
- Tax savings to the Tarcon shareholders were a fundamental premise of the negotiations for the transaction;
- The agreement provided for the transfer of Tarcon's cash to MidCoast.

See Starnes, 2012 U.S. App. LEXIS 10948 at *72-*76, (Wynn, J. dissenting). And since cash is fungible, the dissent then concluded that "this exchange is no different in substance than if the former shareholders had received outright distributions of Tarcon's cash." *Id.* at 75, (Wynn, J. dissenting). In the dissent's view, this meant that the former Tarcon shareholders were distributees within the meaning of Section 6901: "because cash is fungible, the former

shareholders effectively received distributions of Tarcon's assets during liquidation, with MidCoast as a mere conduit. As such, the former shareholders meet the definition of 'transferees.'" *Id.* at 77, (Wynn, J. dissenting).

The dissent then applied North Carolina's fraudulent transfer statute to determine the extent of the liability of the former shareholders. Here it concluded that the transaction did not involve the receipt of reasonably equivalent value by Tarcon since the relevant agreement provided for its cash to be delivered to the escrow account of MidCoast's attorney and there was no requirement in the agreement that the cash be returned to it, which rendered Tarcon temporarily insolvent. *Id.* at *77-*78, (Wynn, J. dissenting). The dissent also concluded that the record was consistent with a transaction designed to hinder, delay or defraud the IRS within the meaning of the North Carolina fraudulent transfer statute. *Id.* at *79-*80, (Wynn, J. dissenting).

As for the former shareholders, in the dissenting judge's view, they had willfully blinded themselves to the reality of the transaction because it had offered them a windfall of over $400,000. *Id.* at *80, (Wynn, J. dissenting).

The dissent is a potent one: it is logical and easy to follow, while the majority opinion is opaque and appears circular in its reasoning. Still, if the point of Section 6901 is to allow the IRS to make a tax assessment in situations in which it could prevail in a fraudulent conveyance case under state law, then there is some force to the majority's point that the state law definition of the transfer should be employed for purposes of establishing ultimate liability.

Unfortunately, the majority does a poor job of explaining this. The correct answer probably is two-fold: First, the taxpayer who is the subject of an assessment has to be a transferee *under federal law to permit the IRS to use Section 6901* to issue an assessment. Second, if the state law basis for transferee liability requires the taxpayer to be the recipient of a transfer, then *for purposes of assessing his substantive liability under state law*, state law principles should control what is the relevant transfer and who is a transferee.

How would this work? First, in a case in which the federal definition of a transferee was broader than the state law definition, the IRS would be able to invoke the Section 6901 method to make an assessment against the transferee, rather than filing a suit under state law against the transferee, but would not prevail on the assessment. Second, in a case in which the federal definition of a transferee is narrower than the state law definition, the IRS would be unable to use Section 6901 to make an assessment, but would be free to file a claim under state law in competent court, just as any other creditor could.

Is this cumbersome and confusing? Yes, but that is simply a function of the way in which Congress set up Section 6901.

One other aspect of *Starnes* is worth mentioning: for a taxpayer facing potential transferee liability, the case provides limited comfort, as the majority held the evidence would support liability but simply deferred to the Tax Court's findings. *See Starnes,* 2012 U.S. App. LEXIS 10948 at *50-*51.

Jim Malone is a tax lawyer based in Philadelphia.