

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

This will continue my [discussion](#) of *Starnes v. Commissioner*, 2012 U.S. App. LEXIS 10948 (4th Cir. May 31, 2012), in which a divided Fourth Circuit panel addressed transferee liability for federal taxes. Before addressing the case in more detail, a little background is in order.

In Notice 2001-16, 2001-1 C.B. 730 (Feb. 26, 2011), the IRS announced that it would be scrutinizing transactions that involved the sale of a corporation's stock to one corporation and its assets to another in what are known as "intermediary transaction tax shelters." The central feature of these transactions were separate sales of the assets and stock of a corporation, which due to the presence of an intermediary (the purchaser of the stock) resulted in no payment of tax on the gain on the sale of the assets. This could occur either because the intermediary and the corporation that it purchased were later treated part of a group filing a consolidated return and there were offsetting losses that eliminated the gain on the sale of assets, or because the purchaser of the corporation's stock was not subject to tax in the United States and liquidated the corporation.

The IRS later clarified its position on intermediary transaction tax shelters in Notice 2008-11, 2008-51 I.R.B. 1299 (Dec. 2, 2008), indicating that it would only seek to overturn these transactions in situations where the individuals who sold their shares either knew or had reason to know that the transaction was structured so that the persons who were primarily liable for the taxes on the gain from the sale of the assets would not pay that tax liability. These two IRS Notices are significant in *Starnes* because the transaction had a family resemblance to an intermediary transaction tax shelter.

Starnes included some bad facts from the taxpayers' perspective: one of the taxpayers testified that the transaction sounded "strange," and another testified that the transaction "wasn't something I wanted to understand." 2012 U.S. App. 10948 at *9. The accountant for Tarcon and the selling shareholders also had notes concerning the transaction that included a reference to Notice 2001-16. *Id.* By the same token, there was also evidence that the outside professionals associated with the transaction, including the shareholders' broker and their attorney, as well as MidCoast's attorney, all anticipated that MidCoast would pay the tax liabilities of Tarcon, and the shareholders' broker had checked MidCoast's references. *Id.* at 52-53.

The IRS argued that in determining whether there was a transfer within the meaning of Section 6901 of the Code, it was proper to recast the underlying transactions to reflect their "economic reality," and that what had really transpired was that the shareholders had received a distribution of Tarcon's cash, making them distributees of its assets. It then proceeded to argue that the distribution of cash to the shareholders violated the relevant state fraudulent transfer statute. *Id.* at 26.

The IRS took this position because the proper configuration of the transaction was critical to the ultimate question of liability under the relevant fraudulent transfer statute:

- If the only transactions that mattered were the cash exchanges that resulted from the agreement to sell the taxpayers' shares of Tarcon stock, there was no question that there was a reasonable exchange of value and Tarcon was not rendered insolvent, since it entered the transactions with \$3.1 million in cash and wound up with the same \$3.1 million.

- If, however, the transaction to be analyzed also included the subsequent transfer of Tarcon's cash a few weeks later, then there was little question that Tarcon was rendered insolvent under the fraudulent transfer law. *See id.* at 39-40.

And using federal standards to recast the nature of the transaction meant that the IRS arguably did not have to deal with the actual or constructive knowledge of the parties. *Id.* at 32-33 & n. 7. In contrast, under North Carolina law, to reconfigure the transactions, the IRS would have to show that the taxpayers had constructive knowledge that MidCoast would cause Tarcon to evade payment of the relevant taxes. *Id.* at 42-43.

The majority began its legal analysis with *Commissioner v. Stern*, 357 U.S. 39 (1958), in which the Supreme Court had held that Section 6901 of the Code was simply a procedural statute that left the substantive standard governing when a transferee was liable to be determined under state law. The majority then noted that under *Stern*, the question whether there had been a transfer and whether someone was a transferee were distinct from the ultimate question of liability and were to be determined as a matter of federal law. 2012 U.S. App. 10948 at *24-*25.

At first glance, this would appear to suggest that the position of the IRS would prevail, but it did not. Instead, the majority concluded that the determination of what transaction should be reviewed must be made under applicable state law. It cited two basic reasons for this:

- *Commissioner v. Stern* had treated the federal question of whether there was a transfer that permitted the IRS to utilize Section 6901 as an independent inquiry from substantive liability under state law. 2012 U.S. App. 10948 at 28-30.
- Liability under state law in *Stern* had not involved any question of a transfer at all because the only issue was intent to defraud creditors. 2012 U.S. App. 10948 at 30-31. In contrast, substantive state law liability in *Starnes* included a transfer as an essential element, leading the majority to conclude that state law had to control the determination of how the transaction should properly be framed.

Ultimately, the majority concluded that “the question of which if any of the multiple transactions should be ‘collapsed’ to determine whether they were fraudulent is a question of *substantive liability*, not merely a question of *the availability of the § 6901 procedure*, and thus is governed by state law.” *Starnes*, 2012 U.S. App. 10948 at *31 (emphasis by the court). With that question out of the way, the majority then reviewed the Tax Court's determination that the appropriate transaction to analyze only included that transfers that were associated with the sale of the Tarcon shares by the taxpayers because there was sufficient evidence to support the Tax Court's determination that they did not have constructive knowledge that MidCoast would cause Tarcon to fail to pay its tax liabilities. *Id.* at 42-55.

The dissent took a different view of the facts and the law; I will cover that opinion in my next post.

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