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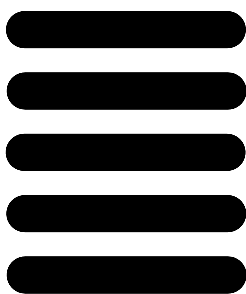

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Presto Chango, or Successor Liability

By Robert W. Wood • Wood & Porter • San Francisco

Sooner or later, most of us want to start fresh with some aspect of our lives. In the business world, wiping out (or walking away from) what may seem crushing liabilities and starting fresh is an attractive proposition indeed. Exactly how you do this (or more pejoratively, what you can get away with), is a subject of great debate. It seems likely that this debate will become more vocal as our recession continues.

The IRS recently issued CCA 200847001 (July 29, 2008), considering an increasingly common fact pattern involving successorship. Corporation B took over the operation of Corporation A. The question was whether Corporation A could be given the fresh start it sought, or was a successor in interest (and therefore on the hook with respect to) the considerable tax problems of Corporation A.

Just the Facts

Corporation A was a Puerto Rican company with substantial employment tax liabilities, federal tax liens and IRS levies. It wasn't a pretty picture. The company president (Mr. Y) discontinued operations, although the company remained listed with the Puerto Rico Department of State.

Thereafter, Mr. Y formed Company B. Mr. Y's wife, Ms. Z, was listed as incorporator (she had also been vice president of Corporation A). Mr. Y apparently admitted to a Revenue Officer that Company B was formed to keep Company A's employees working. Although the precise mechanism for the asset transfers wasn't clear, Company B ended up using Company A assets.

Also not coincidentally, former customers of Company A started making payments to Company B. Mr. Y, however, was not listed as an officer of the "new" enterprise. The facts of this ruling indicate that the corporate officers of Company B were unknown, and the shareholders of both Company A and Company B were unknown.

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With these sketchy facts, what do you think the IRS concluded with respect to alter-ego and successor liability issues?

Multiple Theories

It hardly takes a rocket scientist to read between the lines here. The IRS does a thorough job of reviewing the lien provisions of the Code (Code Sec. 6321), and the voluminous case law. If a third party holds property as the taxpayer's alter-ego, then the lien attaches. [*See CGM Leasing Corp.*, SCt, 77-1 USTC ¶9140, 429 US 338 (1977).]

The case law is fairly favorable to the IRS on the topic of sham transactions and alter-egos. Piercing the veil of one corporate entity can lead to another. [*See Oxford Capital Corp.*, CA-5, 2000-1 USTC ¶50,447, 211F3d 280 (2000).] If you're a taxpayer, of course, you may not like some of the case law, particularly some that imposes alter-ego liability even absent a formal stock ownership relationship. [For example, *see Shades Ridge Holding Co.*, CA-11 (amending opinion), 888 F2d 725 (1989).]

You heard right. Not all courts have said that linked ownership of stock is the key that unlocks the alter-ego puzzle. Indeed, in some cases, the courts may be *assuming* ownership or control without actually finding it. Moreover, sometimes it is not clear which legal theory the courts are using to uphold the IRS' interests.

For example, sometimes a court will find one corporation to be another corporation's alter-ego, despite the lack of ownership. The courts can apply a successor liability theory, and then treat the successor corporation as an alter-ego. Even so, the court may not expressly disregard the corporate structure, which you would think would be required in an alter-ego situation. In some of these cases, the basic idea is that tax liability was imposed on the successor because the corporation was a *continuation* of its predecessor. [*See Today's Child Learning Center, Inc.*, DC-PA, 98-1 USTC ¶50,252, 40 FSupp2d 268 (1998); and *Ross Controls, Inc.*, DC-PA, 94-1 USTC ¶50,256, 164 BR 721 (1994).]

Whether your flavor of the month is alter-ego or successor liability, the two seem to go hand-in-hand. Still, the alter-ego doctrine, generally requiring one to actually disregard a corporate entity, usually involves some evaluation and interaction of the following factors:

- Shareholder's control of corporate affairs
- The treatment of corporate assets as personal assets
- The unrestricted withdrawal of corporate capital
- The commingling of corporate and personal assets
- Inadequate corporate capital
- The lack of corporate records
- The nonobservance of corporate formalities
- Inaction of the other officers and directors
- Failure to declare dividends
- Shareholder held out as being personally liable for the obligations of the corporation
- Management of the corporation without regard to its independent existence

Successor Liability

Successor liability is considerably easier to understand and to apply than alter-ego theory. In general, a corporation that acquires the assets of another corporation is not liable for the debts

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of the transferor. That's the black-letter rule. The big exception, though, is successor liability.

Most jurisdictions are inclined to impose it in the following cases:

- The successor expressly assumes the liabilities of the transferor.
- The transaction amounts to a *de facto* merger.
- The successor is a mere continuation of the transferor corporation.
- The transaction is entered into fraudulently to escape liability.

[*See Dayton v. Peck, Stow and Wilcox Co.*, CA-1, 739F2d 690 (1989).]

As you might surmise, the key elements of successor liability are generally the third and fourth criteria. These factors focus on the extent to which the "new" business is a mere continuation of the old, and the extent to which the deal is a fraudulent transaction. Turning to the facts in the Puerto Rican case, the IRS had no difficulty saying that this transaction was clearly entered into for the fraudulent purpose of escaping liability. In fact, the IRS referred to Puerto Rican law standing for the sensible presumption that there is fraud on creditors when a debtor transfers property without consideration.

How did the scenario described in CCA 200847001 stand up to analysis? The relationship between the two companies, the relationship between Mr. Y and Ms. Z and their respective roles, the use of assets, identity of customers, identity of operations, *etc.*, seemed to call for strong inferences.

De Facto Mergers

There are other ways of finding successor liability, including the mere continuation and *de facto* merger criteria. Generally, these factors look at continuity of business operations, continuity of management, similar or identical assets, personnel and physical location. Yet courts can look to the presence or absence of consideration here as well.

The *de facto* merger discussions are often interchangeable, with a focus on what changes and what stays the same after the supposed transaction. The idea, of course, is to treat a transaction as having the economic effect of a statutory merger, even though it might be cast as an asset sale.

Whether one taxpayer is a mere continuation of another generally turns on five criteria:

- An asset transfer
- Less than adequate consideration
- A continuation of the prior corporation's business
- The sharing of at least one common officer
- The prior corporation being incapable of paying its creditors

Steps in the Shoes

The IRS also responds to the question whether it needs to collect its liability against the successor. Here, the question was whether another lien or levy was necessary. The answer is no. Successor liability holds the successor liable for the debts of the transferor. The successor steps on the shoes of the transferor, so a new assessment is not needed.

Of course, the IRS can decide to make a transferee assessment (under Code Sec. 6901). With a double barrel approach, the Tax Court has held that an entity can be liable both as a successor and as a transferee. [*See Southern Pacific Transportation Company*, 84 TC 387, Dec. 41,936 (1985).] However, it appears that this double barrel liability may apply only to tax liabilities incurred on the liquidation of a partnership or corporation, or on a re-organization. Oddly, employment taxes (the primary tax problem in CCA 200847001) seem not to be included in this list.

Conclusion

Conventional wisdom seems to be that in times of economic hardship, IRS collection activity goes up. Regrettably, the efficacy of these collection efforts may go down. It seems likely that some companies and some individuals will be throwing Hail Mary passes, hoping that the pass will be effective in cutting off liability to the passer, and giving the passee a fresh start. Increasingly, we can expect to have a referee called in to take a closer look at such plays.