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Surprisingly, IRS Can Collect Someone Else's Taxes From You

It is bad enough that you have to pay your *own* taxes, let alone someone else's. Yet sometimes, the IRS can come after one taxpayer to collect the tax liability of someone else. It usually starts with you accepting money or property from someone else in what seems like a very good deal. What's more, a recent case suggests that the IRS may soon get bolder still. How is this possible? The answer is transferee liability.

The concept is embodied in Section 6901 of the tax code, but it has deep roots in legal history. In fact, it is a creditor protection device going back hundreds of years. Essentially, the IRS can pursue a transferee—someone who received assets or money for less than full and fair value from the taxpayer. Think of it as kind of a stolen property rule. Suppose that your Uncle Johnny, a deadbeat when it comes to taxes, gives you his Mercedes. You might assume a gift is a gift, and that you can safely enjoy driving it. You may have no idea that Uncle Johnny owes the IRS.

The exterior of the IRS building in Washington on March 22, 2013. (Photo credit: AP Photo/Susan Walsh, File)

The IRS claim on the Mercedes trumps yours, even if you didn't know anything about the taxes that might be due. The result is the same if you paid Johnny $5,000 for it but the car is really worth $20,000. Of course, this is a simple example, and procedure and timing are important. The person owing taxes is the "transferor," and the person being pursued the "transferee." There are two bases of transferee liability: at law and in equity. You are liable as a transferee at law when you are responsible for the transferor's tax liability by contract. The IRS must prove the tax liability was within the terms of the contract.

The vast bulk of transferee liability cases involve equity. You are liable as a transferee in equity when you receive the transferor's assets for less than full, fair and adequate consideration, and when you leave the transferor insolvent and unable to pay the tax liability. Fortunately, your liability is limited to the value of the assets you received. And the IRS must generally prove that the transferor became insolvent; the transfer was for less than adequate consideration; the transfer was made after the tax liability; the transferor was liable for the tax; and the IRS made reasonable attempts to collect from the transferor.

The IRS can assess and collect taxes from a transferee using the same procedures it can use against the taxpayer. But there are safeguards in the case law, including from the U.S. Supreme Court. In *Commissioner v. Stern*, 347 U.S. 39 (1958), the Court said that the IRS must first satisfy a two-pronged test: (1) the person must be a "transferee" within the meaning of Code Section 6901(h); and (2) the transferee must be substantively liable for the transfer under applicable state law.

The principal source of substantive liability to satisfy the second prong of the *Stern* test is state fraudulent conveyance law. These days, this generally means the Uniform Fraudulent Transfer Act ("UFTA"). Under the UFTA, creditors can invalidate a property transfer by their debtor if: (1) the debtor did not receive reasonably equivalent value in exchange for the transfer; and (2) the debtor was insolvent at the time of the transfer or was left in a perilous financial condition.

For almost a decade, the IRS has been fighting to impose transferee liability on shareholders participating in certain corporate deals. For example, so-called midco transactions involve an intermediary that comes between the buyer and seller of a business and is meant to sop up corporate tax liabilities. The midco entity usually disappears, so the IRS is left holding the bag.

The IRS has usually chased the seller who benefits. The seller usually says they had no idea the midco deal was not real. To win, the IRS generally needs to persuade the court to collapse the several steps into something simpler, usually a corporate asset sale followed by a liquidating distribution. The problem is that the First, Second, Fourth and Ninth Circuits have refused to permit this unless the IRS demonstrates that the shareholders *knew*, either actually or constructively, that the tax due on the corporate asset sale would be left unpaid. That's a major hurdle for the IRS.

The IRS must undertake an exhaustive factual inquiry into what shareholders knew or should have known. It isn't easy, not even for the IRS. Yet the IRS's persistence finally paid off in *Feldman v. Commissioner*, 779 F.3d 448 (7th Cir. 2015). In *Feldman*, the Seventh Circuit permitted the IRS to re-characterize a midco transaction as a liquidation without regard to what the selling shareholders knew or should have known. According to the court, the shareholders' "due diligence and lack of knowledge of illegality [are] simply beside the point."

The Tax Court has already followed *Feldman* in two cases, *Shockley v. Commissioner*, and *Weintraut v. Commissioner*. The elimination of the shareholder-knowledge requirement is a dream come true for the IRS. Does that mean the IRS will win more transferee liability cases? Probably. Will the IRS argue transferee liability in more cases when it isn't paid and can follow the money? What's your guess?

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.