42 - Shareholders Liable As Transferees For Corporation's Tax Liability

Marshall, (CA 9 7/23/2919) 124 AFTR 2d ¶2019-5072

The Ninth Circuit Court of Appeals has held that the Tax Court properly determined that a corporation's shareholders and their wholly owned LLC were liable, as transferees, for a corporation's unpaid taxes under Code Sec. 6901 and the Oregon Uniform Fraudulent Transfer Act (OUFTA).

Background. Code Sec. 6901 is a procedural statute that authorizes the assessment of transferee liability in the same manner and subject to the same provisions and limitations as the tax with respect to which the transferee liability was incurred. Code Sec. 6901 does not create or define a substantive tax liability; it merely provides the IRS with a way to enforce and collect from a transferee the taxpayer/transferor's existing liability. (Stern, (S Ct 1958) 1 AFTR 2d 1899)

Once a transferor's own tax liability is established, the IRS may assess that liability against a transferee under Code Sec. 6901 only if two distinct requirements are met. First, the transferee must be subject to liability under applicable state law. Second, the person must be a transferee within the meaning of Code Sec. 6901. (Swords Trust, (2014) 142 TC 317)

For purposes of Code Sec. 6901, the term "transferee" includes a shareholder of a dissolved corporation. (Reg §301.6901-1(b))

The state law applicable to determining transferee liability is the law of the state where the transfer transaction took place. (*Stern*)

The transfer transaction in this case took place in Oregon. Oregon has adopted the Uniform Fraudulent Transfer Act (OUFTA). (Or. Rev. Stat. secs 95.200 to 95.310 (2015))

The OUFTA broadly defines transfer as "every mode" of disposing of, or parting with, an asset or an interest in an asset. (Or. Rev. Stat. sec 95.200(12)) When a debtor transfers property to a transferee and thereby avoids creditor claims, OUFTA provides creditors with certain remedies against the transferee. (Or. Rev. Stat. sec. 95.260) Under Oregon common law, the creditor must prove a fraudulent transfer under the OUFTA by a preponderance of the evidence. (Norris v. R&T Mfg., LLC, (Or. Ct. App. 2014) 338 P. 3d 150)

Under the OUFTA, a transfer is fraudulent with respect to a creditor when: (1) the creditor's claim arose before the transfer; (2) the transferor did not receive reasonably equivalent value in exchange for the transfer; and (3) the transferor was insolvent at the time of the transfer or became insolvent because of the

transfer. The OUFTA does not require intent to defraud. (Or. Rev. Stat. sec. 95.240(1))

A creditor is any person who has a claim. (Or. Rev. Stat. sec. 95.200(4)) A claim is a right to payment. (Or. Rev. Stat. sec. 95.200(3)) The right to payment does not need to be reduced to judgment, liquidated, fixed, matured, undisputed or secured. (Or. Rev. Stat. sec. 95.200(3))

If a transferee has constructive knowledge that a transferor's tax liability would not be paid, multiple transfers may be collapsed. Constructive knowledge may be found where the transferee became aware of circumstances that should have led to further inquiry into the transaction, but no inquiry was made. (Diebold Foundation, Inc., (CA 2 11/14/2013) 112 AFTR 2d 2013-6901)

In Notice 2001-16, 2001-1 CB 730, the IRS identified certain tax avoidance transactions as "listed transactions." One of the transactions listed in Notice 2001-16 deals with the use of an intermediary to sell the assets of a corporation, i.e., an intermediary transaction tax shelter. This shelter attempts to avoid the corporate income tax from a sale of assets.

Taxpayers who participate in "listed transactions" are required to notify the IRS of their participation in such a transaction. Taxpayers may use Form 8886, Reportable Transaction Disclosure Statement, for this purpose.

The IRS has the burden of proving that a person is liable as a taxpayer's transferee. (Code Sec. 6902(a)) However, the IRS does not have the burden of proving that the taxpayer/transferor was liable for the tax. (Code Sec. 6902(a)) The transferee has the burden of proving that the taxpayer/transferor is not liable for the tax. (Welch v. Helvering (S Ct 1933) 12 AFTR 1456)

Facts. Marshall Associated Contractors, Inc. (MAC) was a C corporation, and its four shareholders were brothers Richard and John Marshall and their wives Patsy and Karen (the Marshalls). The Marshalls also owned Marshall Associated, LLC, (MA LLC) an Oregon limited liability company.

Until 1999, MAC was a contractor specializing in heavy construction. After 1999, MAC wound down its contracting business and concentrated on recovering money it was owed on a contract with the Department of the Interior.

In 2002, MAC received an almost $41 million award for contract damages and interest from the Interior Department. After receiving the award, MAC made estimated tax payments of $889,990 to Oregon and $3,825,000 to the IRS.

In 2003, MAC entered into a complex multiple-step transaction (MAC transaction) that resulted in all or substantially all its assets being transferred to its shareholders, the Marshalls, and MA LLC.

Before completing the MAC transaction, the Marshalls had the MAC transaction reviewed by their long-time attorney and PricewaterhouseCoopers (PwC). After its initial research, PwC concluded that the MAC transaction was similar to a transaction listed in Notice 2001-16, 2001-1 CB 730, (intermediate transaction tax shelter) and that PwC could not consult or advise further on the MAC transaction. The Marshalls' attorney advised the Marshalls against the MAC transaction citing the risk of transferee liability and that it could be considered a listed transaction.

In 2003, MAC filed its Form 1120, U.S. Corporation Income Tax Return, for its 2003 tax year, which reflected a refund of $3,825,000. To get the refund, MAC claimed a bad debt deduction of $39 million on its return which offset its taxable income from the 2002 litigation award. The bad debt deduction MAC claimed was based upon assets that were contributed to MAC as part of the MAC transaction and had a claimed tax basis of $53 million.

After receiving its tax refund, MAC was administratively dissolved and ceased to exist under Oregon law.

In 2004, the Marshalls filed their 2003 individual tax returns, which included Form 8886, Reportable Transaction Disclosure Statement, for the MAC transaction. Richard and Patsy also attached Form 8271, Investor Reporting of Tax Shelter Registration Number, for the MAC transaction to their 2003 tax return.

In 2009, the IRS disallowed MAC's claimed $39 million bad debt deduction and mailed the corporation a deficiency notice. When the period for filing a Tax Court petition expired, the IRS assessed MAC's tax liability.

In 2011, after determining that MAC had no assets from which the IRS could collect the tax liability, the IRS sent notices of transferee liability to the Marshalls and MA LLC.

Tax Court decision. The Tax Court found the Marshalls liable for MAC's taxes as transferees under Code Sec. 6901 and the OUFTA.

First, the Tax Court determined that under OUFTA the multiple-steps of the MAC transaction could be collapsed because the Marshalls had constructive knowledge that MAC's taxes would not be paid. Before the MAC transaction was closed, the Marshalls' attorney and PwC both advised the Marshalls not to engage in the MAC transaction. The Tax Court also found that the Marshalls' protective disclosures (Forms 8886) attached to their 2003 individual returns were evidence that they knew the MAC transaction was problematic. Therefore, the Tax Court collapsed the multiple steps of the MAC transaction into a de facto liquidation to the Marshalls.

Second, under the OUFTA, the Tax Court found that the MAC transaction was a constructively fraudulent transfer because: (1) the Marshalls knew about the IRS's claim, which was generated by the litigation award, before the MAC transaction; (2) the Marshalls received excess consideration for their MAC stock and, therefore, they did not receive reasonably equivalent value for their stock; and (3) MAC became insolvent as a result of the MAC transaction.

Appeals Court decision. The Ninth Circuit Court of Appeals affirmed the Tax Court's holding that the Marshalls and MA were liable as transferees for MAC's unpaid taxes under Code Sec. 6901 and OUFTA. According to the Appeals Court, the Tax Court properly determined that, under OUFTA, the multiple steps in the transaction through which the Marshalls sold their MAC stock could be collapsed and deemed a transfer from MAC to the Marshalls if the Marshalls had constructive knowledge that MAC's taxes would not be paid.