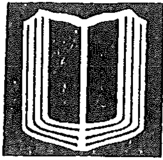

SECTION EDUCATION INSTITUTE

THE STATE BAR OF CALIFORNIA

ASSET PROTECTION: THE IRS AND YOU! - RISKS TO LAWYERS WHO ADVISE TAXPAYERS

MCLE: 2 hours Legal Ethics
Legal Specialization: 2 hours Taxation Law

PROGRAM 70
Sunday, December 3, 1995
10:15 a.m. - 12:15 p.m.

TAXATION SECTION
(Tax Procedure & Litigation Committee)

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Asset Protection: the IRS and You
Risks to Lawyers Who Advise Taxpayers

I. Introduction.

A. This outline focusses on certain situations where clients seek protection from transferee liability and attorneys are asked to provide structures and advice. The treatment of these subjects is not encyclopedic.

B. Transferee liability has two components:

1. First, a transferee could be liable for a transferor's tax liability because of either transferee liability in equity (fraudulent conveyance) or transferee liability at law (e.g., contractual assumption, liability of a corporate successor, donee's liability under § 6324).

2. Second, now focussing on procedure, the Service can pursue its rights against a transferee in two different ways:

a. in a civil action such as a state law fraudulent conveyance case;

b. or through administrative assessment procedures involving issuance of a "notice of liability" under section 6901, allowing the transferee to contest liability in the Tax Court.

C. This outline is concerned with transferee liability, in most cases, liability for taxes that were unassessed at the time of the transfer. Had the taxes been assessed, and especially if a notice of tax lien was filed before the transfer, the government would pursue its lien rights and be in a stronger position than it is when it pursues transferee liability.

II. Transferee liability is pervasive.

A. The case of <u>Mayors v. Commissioner</u> shows how broad are the circumstances where the Commissioner might assert that a transferee is liable for the tax liabilities of

a transferee. 785 F.2d 757 (9th Cir. 1986), rev'g 48 T.C.M. 680 (1984).

B. In that case, Susan Mayors went to work as secretary-receptionist in Dr. Joseph Averna's podiatry office. They became emotionally involved, lived together, had a daughter, but never married. Mayors continued to work for Averna but at below market wages. She also kept house without compensation. Mayors and Averna later separated in December, 1978, and Averna transferred to Mayors his equity in their home. IRS asserted tax deficiencies against Dr. Averna for 1977 and 1978, and IRS was unsuccessful in collecting from Averna. IRS then issued a notice of transferee liability to Mayors asserting that she was liable as transferee for Averna's liabilities.

C. The Tax Court held Mayors liable because the transfer was without fair consideration. The Court acknowledged the viability of Marvin-type rights, but ruled that Mayors failed to prove the existence or value of any uncompensated services.

D. The Ninth Circuit reversed, reasoning that the Tax Court inappropriately focussed on the actual value and viability of a Marvin-type claim. Under California law, it was important that Mayors and Averna believed in good faith that she had a valid claim, and the transfer was made in exchange for her forbearance in enforcing it. Under California law, either good faith compromise of a claim, or an agreement to forebear upon exercise of a right, is sufficient consideration, even if the claim is doubtful or disputed.

E. In short, when a lawyer advises a client about virtually any sort of asset transfer, the possibility of transferee liability should be considered.

III. Transferee Liability in Equity: Sometimes a Scary Proposition.

A. The relevant law is state law regarding fraudulent conveyances. California and 32 other states have enacted the Uniform Fraudulent Transfer Act. The elements necessary to hold a transferee liable are usually enumerated as follows:

1. A transfer.

2. The transferor is liable for tax.

3. The transfer is made after tax liability accrued.

4. There is inadequate consideration or fraudulent intent.

5. The transferor is insolvent.

6. Collection remedies against the transferor have been exhausted.

B. For California lawyers, the most important statutory provision is Civil Code section 3439.05:

> § 3439.05. Transfers fraudulent as to present creditors
>
> A transfer made or obligation incurred by a debtor is fraudulent as to a creditor whose claim arose before the transfer was made or the obligation was incurred if the debtor made the transfer or incurred the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor was insolvent at that time or the debtor became insolvent as a result of the transfer or obligation.

C. The focal point is a transfer for inadequate consideration ("without receiving reasonably equivalent value"). Fraudulent intent is not an element under section 3439.05.

D. When does a tax claim arise?

1. The harsh answer is that tax obligations are considered to arise at the close of the taxable period. Edelson v. Commissioner, 829 F.2d 828 (9th Cir. 1987).

2. Under Civil Code section 3439.01(b), a "claim" is "a right to payment, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured."

3. Hence, a tax liability "exists" even though no assessment has been made, even though the deficiency procedures have not been started, and even though the transferor and transferee believe in good faith, after exercising due diligence, that there are no outstanding tax liabilities.

E. Insolvency is a tricky concept.

1. Under California law, a debtor is insolvent if, at fair valuations, the sum of the debtor's liabilities exceed his or her assets. A debtor not paying his or her debts as they become due is presumed to be insolvent. Civil Code § 3439.02.

2. A debtor's accrued tax liabilities are reflected in the insolvency computation, even if they are unknown and unassessed at the time of the transfer. Coca-Cola Bottling Company v. Commissioner, 37 T.C. 1006 (1962), aff'd 334 F.2d 875 (9th Cir. 1964).

3. An attorney involved in "structuring" for a debtor might ask the client to sign an affidavit of solvency.

F. If the government can prove fraudulent intent, it can proceed under Civil Code section 3439.04, providing:

> A transfer . . . is fraudulent as to a creditor, whether the creditor's claim arose before or after the transfer . . . , if the debtor made the transfer . . . [w]ith actual intent to hinder, delay, or defraud . . . .

Solvency and adequacy of consideration are not relevant.

IV. Transferee liability at law, something else to worry about.

A. One basis of transferee liability at law is a transferee's contractual assumption of liabilities, an exercise in contractual interpretation. Examples include contractual assumption in connection with a purchase of assets or a merger or consolidation.

B. Transferee liability at law is sometimes based on statute, e.g., state law regarding mergers and bulk sales; and Code section 6324, secondary liability for estate taxes.

C. Matters such as the transferor's solvency and adequacy of consideration are not relevant, if the government has a basis to pursue transferee liability at law.

V. Transferee liability in the corporate context

A. Liability can be imposed on a fraudulent transfer basis in some surprising contexts:

1. Distributions to shareholders, direct and

indirect, are transfers, possibly giving rise to transferee liability. Hicks v. Commissioner, 29 TCM 1175 (1970); aff'd, 73-2 USTC ¶ 9526 (9th Cir. 1973).

2. Unreasonable compensation has been treated as a gratuitous transfer, making the payee liable as transferee for the corporation's taxes. Smith v. Commissioner, 6 T.C. 529 (1947); aff'd 184 F.2d 1011 (6th Cir. 1950), cert. den., 340 U.S. 953 (1951).

3. A corporation's cancellation of $1.5 million in loans to its sole shareholder was a transfer giving rise to transferee liability. Merriam v. Commissioner, 70 TCM 627 (1995).

B. Statutory liability.

1. California bulk sales rules -- see Comm. Code § 6101 and following. However, the government was considered not to be a creditor under the Washington bulk sales provisions. True's Oil Co. v. United States, 64-2 USTC ¶ 9761 (E.D. Wash. 1964).

2. Upon a merger, the surviving corporation is subject to all the debts and liabilities of the disappearing corporations. Corp. Code § 1107.

3. Dissolution: Directors must execute a certificate of dissolution stating that the corporation's known debts and liabilities have been paid or adequately provided for, at least as far as assets permit; and further stating that a person or corporation assumes Franchise Tax Board liabilities, including those assessed and coming due after the assumption. Corp. Code § 1905. Any improper distributions may be recovered from the shareholders. Corp. Code § 2009, 2011.

4. Dividends -- a shareholder is liable for improper distributions. § 506.

5. A purchaser or other transferee of a business liable for sales tax must withhold a portion of the purchase price until a former owner proves that there is no liability. The purchaser has personal liability for the amount required to be withheld, up to the amount of the purchase price. Rev. and Tax Code §§ 6811, 6812.

VI. Dead men's attorneys do tell tales -- about transferee liability in the estate context.

A. We want to avoid this kind of scenario: "The good news is, I received a nice chunk of change when Aunt Sally died. I quit my job, took an expensive trip around the world, spent the money on utterly frivolous stuff. When I got home, I found a notice from IRS, telling me that they wanted me to pay Aunt Sally's taxes! It looks like I'm going to lose my condo, and maybe all the nice turquoise jewelry I bought. I sure wish the lawyer had warned me about this." An equally bad scenario is where IRS tries to impose personal liability on the fiduciary. Fiduciaries really like their attorneys when this happens.

B. Fiduciary liability.

1. Under 31 USC § 3713 (formerly Revised Statutes § 3713), an estate's federal tax debts take priority over other claims, and a fiduciary who pays another debt before the IRS is liable for the unpaid tax claims to the extent of the non-priority debt payments.

2. The fiduciary is not liable unless he/she knows or has notice (under the prudent man standard) of the tax claims. Want v. Commissioner, 280 F.2d 777 (2d Cir. 1960).

a. The taxes need not be assessed. A fiduciary was liable where she had been advised by a Revenue Agent of a proposed liability, and that no distribution should be made until the liability was dealt with. Viles v. Commissioner, 233 F.2d 376 (6th Cir. 1956).

b. A fiduciary who is on notice must conduct a good faith investigation and inquiry, and may not investigate "wrongly or haphazardly", nor will a "rapid cursory investigation" negate the fiduciary's liability. Haimowitz v. Commissioner, 15 TCM 66 (1956).

c. The fiduciary must be chargeable with knowledge or notice of the tax debt at a time when the estate had sufficient assets with which to pay the debt. Bank of the West v. Commissioner, 93 T.C. 462 (1989); here, executor had knowledge of estate tax liability, delinquent filing of the Form 706, and the failure to pay the tax shown on the

return -- yet distributed the assets and was held liable.

3. The government's apparent absolute priority under R.S. § 3713 is interpreted as subordinate to costs of administering the estate, and funeral expenses and widow's allowances. Rev. Rul. 80-112, 1980-1 C.B. 306.

4. A fiduciary must give notice to the IRS on Form 56 of the fiduciary relationship. §§ 6036, 6903. Once notice is given, the fiduciary takes over the taxpayer's powers, rights, duties and privileges, although the tax liability is generally collectible from the estate, not from the fiduciary's personal assets. If a notice of deficiency is issued to a deceased taxpayer, it will be sent to the fiduciary, if Form 56 has been filed, and otherwise it will be sent to the taxpayer's last known address.

5. A fiduciary may apply for a discharge from personal liability from the decedent's income and gift taxes, and estate taxes. The application may be filed after the return or returns are filed. The IRS may notify the fiduciary of the amount of tax liability and, if so, there is a discharge upon payment of that amount. In case IRS does not provide such notification, the fiduciary is discharged nine months after the application if received. §§ 2204, 6905.

6. Liability under 31 USC § 3713 may be enforced through the transferee liability provisions under the Code, § 6901(a)(1)(B), or through court action.

7. An attorney advising a fiduciary should:

   a. Advise the fiduciary of the general concern, i.e., the fiduciary is liable for tax claims the fiduciary knows of or has notice of, if other claims lacking priority are paid.

   b. File Form 56.

   c. Determine whether appropriate tax returns have been filed. If not, file them.

   d. Determine whether tax liabilities shown on returns and any other assessments have been paid. If not, pay them.

e. Follow up diligently on any information about unassessed taxes.

f. Seek an indemnity agreement from the distributees, if there's any doubt.

C. Liability for estate taxes.

1. Beneficiaries of an estate have personal liability for the estate tax. § 6324(a)(2). The donee of a gift is personally liable for the gift tax. § 6324(b).

2. Beneficiary/donee can be held liable "in equity":

a. A surviving joint tenant who acquires property on the co-tenant's death is not a transferee. Tooley v. Commissioner, 121 F.2d 350 (9th Cir. 1941).

b. If life insurance proceeds are included in the estate, the beneficiary is potentially liable under section 6324.

D. Liability for income taxes.

1. Transferee liability in equity applies to all heirs, devisees, etc.

2. Whether a life insurance beneficiary is subject to transferee liability depends on state law. If insurance premiums are paid fraudulently, the beneficiary is liable to the extent of the premiums, plus interest, but not for the full proceeds. United States v. Truax, 223 F.2d 229 (5th Cir. 1955). However, state law may exempt a life insurance beneficiary from the insured's creditors, in which case, transferee liability does not apply. Commissioner v. Stern, 357 U.S. 39 (1958). Where the policy beneficiary is the estate, a distributee of the estate would be subject to transferee liability as a distributee, not as a life insurance beneficiary. Kieferdorf v. Commissioner, 142 F.2d 723 (9th Cir. 1944), cert. denied, 323 U.S. 733 (1944).

3. As to pension benefits, IRS has ruled that benefits exempt from creditors under state law are not subject to transferee liability. PLR 8125045 (March 25, 1981).

VII. Procedural Matters. How do they do it?

A. The government may pursue transferee liability in an appropriate civil action. Also, the Code gives IRS an alternative method -- parallel to the procedures followed against delinquent taxpayers. The government may issue a notice of transferee liability, and the transferee has 90 days to challenge the determination by filing a petition in the United States Tax Court. If a timely petition is not filed, the IRS may make an assessment against the transferee. § 6901; Tax Court Rule 13.

B. How bad is it, doctor? The extent of transferee liability.

1. The section 6901 procedures usually apply to income, estate and gift taxes. They apply to other taxes if the liability arises on the liquidation of a partnership or corporation, or upon a reorganization. § 6901(a)(1).

2. Liability under section 6901 applies both to tax shown on a return, and to a deficiency. § 6901(b).

3. In general, the transferee is liable for the transferor's tax, penalties and interest, assuming the value of the transferred assets exceeds the tax, penalty and interest. However, if the transferred assets are less than the transferor's liability, the extent of liability depends on a variety of factors. If transferee liability at law is involved, then the extent of liability, liability for interest in particular, is a matter of contractual interpretation or statutory construction. In a case involving transferee liability in equity, the extent of liability depends on a reading of relevant state law.

C. Multiple transferees have joint and several liability.

D. The statute of limitations for issuing a notice of liability is one year in addition to the limitations period on assessment against the transferee. § 6901. The government will ordinarily have four years to pursue a transferee, therefore, since the usual period of limitations on assessment is three years.

E. IRS has the burden to show that the transferee is liable as transferee. The transferee has the burden to show that the taxpayer is not liable for the tax.

F. Similar remedies are available to the Franchise Tax Board to collect state income taxes. Rev. and Tax Code

§§ 18621 and 18622.

VIII. Nominee, transferee and alter ego liens.

IX. Ethical Issues

A. Rules of Professional Conduct

B. Circular 230

X. Criminal Aspects of Transferee Liability

A. Section 7201 states that "any person who wilfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall ... be guilty of a felony ...".

1. Emphasis here is on evasion or defeat of <u>the payment</u> of a tax.

2. Examples: Making false statements; concealment of assets; placing assets in the name of nominees.

B. Fraud and false statements, § 7206.

1. Under section 7206, willful false statements under penalty of perjury are a felony. § 7206(1). Moreover, under what is usually called the "preparer statute", it is a felony to aid, assist, counsel or advise a return or other document that is false as to a material matter. § 7206(2).

2. Note that IRS collection statements are signed under penalty of perjury, and contain broad questions about interests in trusts, estates, etc.

C. Title 18, Section 371 makes criminal a conspiracy "either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose.

XI. Some additional thoughts on avoiding transferee liability

A. The best solution is to diligently determine the tax liability in the first instance and get it paid.

B. In a commercial context, representations and warranties about tax liabilities should be obtained from solvent parties. Negative assurance letters might be obtained from principals, accountants and other tax advisors.