Transferee Liability: When Are Shareholders Transferees?

Under Section 6901 of the Internal Revenue Code, a transferee can be held liable for the taxes of someone else. To determine whether someone is liable for taxes as a transferee, courts apply a two part test that the Supreme Court developed in *Commissioner v. Stern,* 357 U.S. 39, 42, 44-45 (1958). Under this two part test, courts first ask whether the person sought to be held liable is a "transferee." This is a question that is governed by federal law, specifically, Section 6901(h) of the Code. *Salus Mundi Found. v. Comm'r,* 776 F.3d 1010, 1017 (2014). The second prong asks the question whether the "transferee" is liable under relevant state law. *Id.*; *see also Stern,* 357 U.S. at 44-45.

While much of the recent case law on transferee liability has focused on the second prong, liability under state law, on Monday, the Ninth Circuit issued an opinion focused on the first prong. Specifically, the Court addressed how a court should determine whether shareholders are "transferees." *Slone v. Comm'r,* 2015 U.S. App. LEXIS 9546 (9th Cir. June 8, 2015).

For purposes of transferee liability, the Code defines a "transferee" to include a "donee, heir, legatee, devisee, and distributee." I.R.C. § 6901(h). Shareholders "of a dissolved corporation" are also deemed to be transferees. Treas. Reg. § 301.6901-1(b).

Slone involved two separate sales:

- *First*, Slone Broadcasting Co. sold all of its assets to Citadel Broadcasting Co. for $45 million in July 2001, recognizing a capital gain of $38.6 million and incurring capital gain liability of $15.3 million. *Slone,* 2015 U.S. App. LEXIS 9546, slip op. at *4.
- *Second*, Slone Broadcasting's stockholders sold all of their shares to Berlinetta, an affiliate of Fortrend International, LLC on December 10, 2011 for $35.8 million. *Id.*, slip op. at *5-*6. After the sale closed, Slone Broadcasting merged with Berlinetta, which had agreed to assume all of its tax liability. *Id.*, slip op. at *6.

The shareholders had conducted some investigation of Fortrend, which had indicated that it intended to restructure Slone Broadcasting to operate in the asset recovery business. *Id.*, slip op. at *5. They learned that Fortrend was considered reputable, that its business projections were reasonable, and that it was represented by reputable accountants and attorneys. *Id.* When they asked how Fortrend would reduce the relevant tax liability, they were told that its methods were proprietary but were assured that the transaction would not be a listed transaction. *Id.*

After the merger, Berlinetta changed its name to Arizona Media Holdings, Inc.; three days after the purchase of the Slone Broadcasting shares, a shareholder of Arizona Media contributed Treasury bills with a basis of $38.1 million, which Arizona Media then sold for $108,731. *Id.*, slip op. at *6. Arizona Media filed a tax return reporting both the gain from the Slone Broadcasting asset sale and an offsetting loss on the sale of the Treasury bills, and it sought a refund of a prior tax payment made by Slone Broadcasting. *Id.*

The IRS saw things differently. It assessed Arizona Media with a $13.5 million dollar deficiency for the taxes due on the Slone Broadcasting asset sale, along with interest and penalties. *Id.*, slip op. at *6-*7. After Arizona Media failed to pay, the IRS issued transferee assessments to the former shareholders, who challenged the assessments in tax court and prevailed. *Id.*, slip op. at *7-*8. The tax court concluded that the shareholders were not "transferees" because the form of the stock sale to Berlinetta had to be respected. *Id.*, slip op. at *8-*9.

In the Ninth Circuit's view, the tax court erred in concluding that the form of the stock sale should be respected because it applied the wrong legal test to the transaction. While noting that it had never specifically addressed how a transaction should be analyzed for purposes of determining transferee status, the court readily concluded that doctrine of substance over form was applicable. *Id.*, slip op. at *13. This led the Ninth Circuit to turn to *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978).

The court then noted that it had long interpreted *Frank Lyon* to require courts to consider both subjective and objective factors to determine whether "the transaction had any practical economic effects other than the creation of income tax losses." *Id.*, slip op. at *14 (quoting *Reddam v. Comm'r*, 755 F.3d 1051, 1060 (9th Cir. 2014)). Against this background, the court held that "when the Commissioner claims a taxpayer was 'the shareholder of a dissolved corporation' . . . but the taxpayer did not receive a liquidating distribution if the form of the transaction is respected," then a court must consider the relevant objective and subjective factors to determine whether the transaction had economic substance. *Id.*, slip op. at *16 (quoting Treas. Reg. § 301.6901-1(b)).

Since the tax court had not applied this test, the Ninth Circuit remanded for further proceedings. *Id.*, slip op. at *19-*20. Judge Noonan would have gone a step further and ruled that the shareholders were transferees and remand only for a liability determination under state law. *Id.*, slip op. at *20-*21 (Noonan, J. concurring and dissenting). I will drill into the majority's reasoning and Judge Noonan's dissent in more detail in a future post.

Jim Malone is a tax attorney in Philadelphia; he focuses his practice on federal, state and local tax controversies. This post is intended to provide background on a relevant issue; it is not intended as legal advice.