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*JANUARY 2002* *BULLETIN NO. 496*

# COLLECTION, BANKRUPTCY AND SUMMONSES BULLETIN

**Department of the Treasury** **Office of Chief Counsel** **Internal Revenue Service**

## *HELLO, WE MUST BE GOING ...*
### This is the LAST ISSUE of the CBS Bulletin

Time marches on, and so does the Bulletin. Continually published since 1960, the Bulletin provided Counsel attorneys with recent developments concerning General Litigation issues in the form of case digests and summaries of significant advisory opinions. With advances in computer technology and same-day news reporting, the once-monthly Bulletin gradually became less needed. With this issue, we conclude the Bulletin's long-standing run.

Although the Bulletin is gone, the type of information it contained will still be available to Counsel attorneys. Significant cases and important issues will be highlighted on the Procedure and Administration website, which can be found at: http://casecn01.irscounsel.treas.gov/intranet_new/pa/index.asp. The website is updated at least twice monthly, and late-breaking news of wide interest is often posted the same day. The website also contains case digests under the "Developing Issues" tab. Just click on "Litigation/Administrative Issues" under "Developing Issues" to see the recent cases.

### Tax Court Has Jurisdiction Over Failure To Pay Penalty

In a collection due process case, the Tax Court considered sua sponte whether it had jurisdiction to review a determination that the taxpayer was liable for the failure to pay penalty under section 6651(a)(2) where there was no underlying deficiency. **Downing v. Commissioner, 118 T.C. 2 (January 7, 2002)**. The court noted that, under section 6214(a), it has jurisdiction over the penalty in a deficiency case but that, under section 6665(b), it does not have jurisdiction over the penalty if no deficiency was determined. However, the court also noted that, for purposes of section 6330(d), it generally has jurisdiction over an underlying liability for income, estate, or gift tax, whether or not the court has or had deficiency jurisdiction, i.e., whether or not a notice of deficiency was issued or in which there is a deficiency. As the taxes involved were income taxes, the court found it had jurisdiction because the section 6651(a)(2) penalty related to the income tax liability.

**COLLECTION DUE PROCESS**

# CASES

1. **BANKRUPTCY CODE CASES: Assessment: Determination by Bankruptcy Court or Tax Court**
**<u>Lassiter v. Commissioner</u>, T.C. Memo 2002-25 (Jan. 25, 2002)** - Debtor died in May, 1994, after filing for Chapter 11 bankruptcy. The case continued after the death and in December, 1994, the court confirmed the joint plan of reorganization for Debtor and related entities. The confirmation order terminated the Debtor's bankruptcy estate. The Tax Court held that under I.R.C. § 1398(i) the Debtor succeeded to the NOLs of the bankruptcy estate and thus the NOLs were properly claimed on the Debtor's final income tax return.

2. **BANKRUPTCY CODE CASES: Collection of Tax: Assets in Court**
**<u>In re Bame</u>, No. BKY99-40683, 2002 TNT 7-14 (Bankr. D. Minn. Dec. 20, 2001)** - The bankruptcy court invoked the doctrine of equitable marshaling to require the Service to satisfy its secured claim by foreclosing on non-debtor spouse's real estate, to which tax liens had previously attached. The court concluded that the Service would not be unduly prejudiced if required to satisfy its tax claim by judicial foreclosure against the property. Also, marshaling would increase the amount recoverable by the unsecured creditors.

3. **BANKRUPTCY CODE CASES: Proofs of Claim: Amendment/Supplement**
**<u>In re Moser</u>, 2002 U.S. App. LEXIS 463 (4th Cir. Jan. 9, 2002) *(unpublished)*** - Over debtor's objection that the Service should not benefit from a presumption of correctness, appeals court affirmed that Service's third amended proof of claim was still prima facie valid under Bankr. Rule 3001(f).

4. **BANKRUPTCY CODE CASES: Proofs of Claim: Time for Filing**
**<u>In re Brogden</u>, No. 3-00-04709, 2002 TNT 14-23 (Bankr. M.D. Tenn., Dec. 19, 2001)** – Chapter 13 debtor did not list Service as creditor. After debtor's plan was confirmed, and the time past for filing proofs of claim, the Service discovered the debtor's bankruptcy and argued that the lack of notice provided grounds to equitably toll the 180-day period for filing its claim. The court disagreed, holding that B.C. § 509(b)(9) disallows late-filed claims in Chapter 13 cases where the creditor lacks timely notice. The court noted that its decision did not determine whether the tax debt was discharged.

5. **BANKRUPTCY CODE CASES: Proofs of Claim: Time for Filing**
**<u>In re Gold</u>, No. 892-81381-288, 2002 TNT 4-9 (Bankr. E.D.N.Y. Nov. 15, 2001)** - Trustee's notice of assets in this Chapter 7 case was mailed to the wrong Service address (Manhattan instead of Brooklyn), in violation of the bankruptcy court's local rule. The trustee objected to the Service's late-filed proof of claim, but the court found the priority proof of claim valid under B.C. § 726(a)(1) despite being filed after

interim disbursements had been made. The court held that interim disbursements do not constitute the "distribution" of the estate referred to in § 726(a)(1).

**6. COLLECTION DUE PROCESS**

**Barker v. Commissioner, T.C. Memo 2002-13 (Jan. 10, 2002)** - Form 4340 is presumptive evidence on which an Appeals Officer may rely to verify that an assessment was made. The Service is not required to provide the taxpayer with a Form 23-C, absent a showing of irregularity in the assessment.

**7. COLLECTION DUE PROCESS**

**Guerrier, Jr. v. Commissioner, T.C. Memo 2002-3 (Jan. 7, 2002)** - Under Lunsford v. Commissioner, 117 T.C. 16 (2001), the Tax Court is not required to look behind the notice of determination to determine the validity of that notice. The Court thus refused to consider petitioner's contention that he was denied an Appeals Office hearing. The Court further found that the 30-day time period of I.R.C. § 6330(d) for timely filing a Tax Court petition is 30 calendar days, not 30 business days.

**8. COLLECTION DUE PROCESS**

**Ogden v. Commissioner, T.C. Memo 2002-15 (Jan. 15, 2002)** - Petitioner challenged a notice of determination by filing a petition in district court on May 17, 2000. This action was dismissed by the district court for lack of jurisdiction on December 20, 2000. The petitioner then filed a second district court action, which was dismissed on February 8, 2002. On March 9, 2002, the petitioner brought an action in the Tax Court. The Tax Court held that the Tax Court petition was untimely because under I.R.C. § 6330(d)(1), the petition had to be filed within 30 days from the date that the District Court issued its first order dismissing petitioner's action for lack of jurisdiction.

**9. COMPROMISE & SETTLEMENT: Default**

**Roberts v. United States, 2001 U.S. Dist. LEXIS 22338 (E.D. Mo. Dec. 19, 2001)** - Taxpayer entered into offer-in-compromise, which contained the standard clause that taxpayer was required to timely file and pay taxes for the next five years. The following year (1995), taxpayer delayed filing his tax return beyond the extension date so that he could file his 1996 return and claim a large carryback loss. The Service terminated the OIC for default, and the taxpayer brought suit. The court held that the Service had authority under the OIC to default taxpayer when the taxpayer failed to pay his 1995 taxes on time. In dicta, the court noted that the OIC was breached under I.R.C. § 6151(a) when the taxpayer failed to file and pay his taxes by April 15, 1996, despite the Service having granted taxpayer an extension of time to file beyond that date.

**10. COMPROMISE & SETTLEMENT: Limitations**

**United States v. Donovan, No. 5:01-CV-1457, 2002 TNT 15-17 (N.D. Ohio Jan. 2, 2002)** - In this case involving the ten-year collection limitations period, the court held that the taxpayer's withdrawal of his offer-in-compromise was effective as of the date the taxpayer's letter was faxed to the IRS. As a result, the statute of limitations expired prior to the Service initiating collection action.

**11. SUITS: Against the U.S.: Mandamus**

**Trowbridge v. I.R.S., 2001 U.S. Dist. LEXIS 22198 (S.D. Tex. Dec. 21, 2001)** - Court denied mandamus relief under 28 U.S.C. § 1361 holding that taxpayer had no right to demand an administrative appeals hearing with respect to taxpayer's protest of proposed income tax liabilities on constitutional and other grounds. The court found the Service's procedural rules did not create mandatory legal duties which bound the Service, but were only internal administrative guidelines.

The following material was released previously under I.R.C. § 6110. Portions may be redacted from the original advice.

## CHIEF COUNSEL ADVICE

**TRANSFEREES & FRAUDULENT CONVEYANCES: Fraud**

CC:PA:CBS:Br3
TL-N-7311-00
UIL: 6901.05-00
June 1, 2001

MEMORANDUM FOR JODY TANCER, ASSOCIATE AREA COUNSEL (LMSB) – LONG ISLAND CC:LM:FSH:LI

FROM: Charles E. Samuel
Acting Chief, Branch 3 (Collection, Bankruptcy Summonses)

SUBJECT: Renamed Corporation X, formerly Corporation X
Potential Transferee Liability Issues

This Chief Counsel Advice responds to your memorandum dated February 2, 2001. In accordance with I.R.C. § 6110(k)(3), this Chief Counsel Advice should not be cited as precedent. This writing may also contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

LEGEND
Corporation X
Renamed Corporation X
Corporation Y
Company Z
Individual Q
Day 1
Year 1
Year 2
Year 3
Year 4
Date 1
Date 2
Date 3

Date 4
Date 5
Date 6
Date 7
Date 8
Date 9
Date 10
Date 11
Date 12
A Dollars
B Dollars
C Dollars
D Dollars
E Dollars
F Dollars
G Dollars
H Dollars
I Dollars

In considering your request for advice regarding potential transferee liability issues in this case, we have separated your ultimate questions into some of the smaller component issues that we needed to consider to address your concerns. Our office also requested and received assistance from Associate Chief Counsel (Corporate) and Assistant Chief Counsel (Administrative Procedures & Judicial Practice).

Your memorandum referred to Chief Counsel Notice 2001-16 (Intermediary Transactions Tax Shelter) dated January 19, 2001, which Associate Chief Counsel (Corporate) has now supplemented with Chief Counsel Notice 2001-23 (Intermediary Transaction Tax Shelter) on April 26, 2001. Consistent with these Notices and the analysis suggested in your memorandum, we understand that Corporate concurs with your proposed primary and alternative recasts (in substance) of the form of the taxpayer transactions at issue in this case. Most of Corporate's technical analysis is repeated in the Extended Discussion portion of this memorandum, following our answers to the transferee liability issues that concerned you. However, you may want to contact Branch 6 of Corporate directly if you wish to discuss these recast matters in further detail.

As a potential alternative or supplement to pursuing transferee liability against some of the parties identified in your memorandum which helped Renamed Corporation X, formerly Corporation X (and its stockholders), and Corporation Y structure the transactions, we also requested advice from APJP about the feasibility of pursuing imposition of penalties under I.R.C. § 6700. Parts of APJP's advice regarding section 6700 penalties are included in our discussion of the possibility of pursuing transferee liability with respect to the fees paid by the Transferor to those persons (and entities) involved in structuring the abusive tax transactions at issue in this case. However, you may want to contact Branch 2 of APJP directly if you wish to discuss the potential application of section 6700 penalties to the structuring of these transactions in further detail.

BACKGROUND

Corporation X was incorporated on Date 1, in Virginia. You have not given us any information regarding the number or identity of the former shareholders of Corporation X. The fiscal year of Corporation X for federal income tax purposes for the periods at issue ended on Day 1. Prior to the tax years of the transfer transactions at issue, Corporation X apparently paid federal income tax amounts for its fiscal years ended Date 2, and Date 3. Some portion of the federal income taxes previously paid by Corporation X for its Year 1 and Year 2 tax years is at issue in the Tax Court case of the Transferor, which your office is now handling, because the Transferor claimed a net operating loss (NOL) for its tax year ended Date 9, in which the first transfers at issue took place, and carried back this claimed NOL to these prior years for (tentative?) refunds.

Sometime during Year 1, Corporation Y learned that Corporation X was for sale. Negotiations between Corporations Y and X apparently reached an impasse over price and whether the acquisition was to be a stock or asset acquisition. The Corporation X stockholders wanted to sell their stock and Corporation Y only wanted to acquire the Corporation X assets. We understand that these parties were then aware that Corporation Y's proposed purchase price for Corporation X's assets was substantially greater than Corporation X's adjusted tax basis in the assets to be sold, which would result in significant capital gains income to be reported by Corporation X. If these capital gains were not legitimately offset by other loss transactions of Corporation X in the tax year, then the result would be a significant federal income tax liability for Corporation X at the corporate level, which the corporation would be required to pay before distributing any surplus (dividends) above its debts to its shareholders.

Sometime during Year 2, Company Z, controlled by Individual Q, apparently agreed to step in as an intermediary to facilitate the transactions that the Corporation X shareholders and Corporation Y both wanted for tax purposes, in exchange for some forms and amounts of compensation (fees) for Company Z and/or other companies controlled by Individual Q. In form, Company Z agreed to acquire the Corporation X stock from the Corporation X stockholders through a special purpose entity that was wholly owned by Company Z. The special purpose entity would obtain a short term bridge loan from a bank to finance the acquisition of the stock, in form, from the Corporation X shareholders. The special purpose entity then immediately planned to merge into Corporation X and change its name (but be treated the same as, a successor to, Corporation X for tax purposes). Company Z also agreed that, shortly after (but almost at the same time) these events occurred, new Corporation X would sell substantially all of its assets to Corporation Y for a prearranged price. New Corporation X would then pay off its bridge loan to the bank with the sale proceeds from Corporation Y (and from a limited amount of retained Corporation X assets).

Company Z, Individual Q, and/or related Individual Q companies (the Company Z Group) would then still be left with enough Corporation X assets (or tax attributes) to pay themselves immediate short term fees and potential longer term compensation (contingent fees or dividends?) for facilitating the whole transaction between the Corporation X shareholders and Corporation Y. The Company Z Group's willingness to facilitate these transactions and its ability to obtain the potential longer term compensation out of retained Corporation X assets (or tax attributes) depended upon the Company Z Group being able to rearrange the business of new Corporation X, on paper, so that new loss transactions would occur in the tax year of the Corporation Y asset sale to offset (and exceed) the significant capital gains income to be realized by Corporation X from the sale (and to recover federal income taxes paid by Corporation X in prior tax years through NOL carryback procedures).

We understand that your pending Tax Court case with the Transferor concerns the validity of the paper loss transactions that the Company Z Group devised for new Corporation X in its fiscal year ending Date 9, in order to offset and exceed the significant capital gains income realized by Corporation X from the asset sale to Corporation Y in this tax period. If the Service is successful in establishing the Transferor's tax liability in this pending Tax Court case, then all potential transferees will be barred from later attempting to relitigate the existence or amounts of the Transferor's tax liabilities for the tax periods at issue.[1] Conversely, if the Service is not successful in establishing the Transferor's tax liabilities in this pending Tax Court case, then we understand there are no other outstanding federal tax liabilities of the Transferor to serve as the basis for asserting potential transferee liability against the persons (including entities) at issue who may be deemed to have received transfers from the Transferor at the relevant times.

On or about Date 4,Company Z apparently entered into letters of intent with both (1) the Corporation X shareholders, to acquire their Corporation X stock (in form), conditioned upon Company Z's nearly contemporaneous sale of the Corporation X assets to Corporation Y, and (2) Corporation Y, for the sale of the Corporation X assets, conditioned upon Company Z's acquisition, in form, of the Corporation X stock. The sale of all the shares of Corporation X stock to Company Z's special purpose entity closed on Date 5, for a price of approximately A Dollars.[2] Company Z's special purpose entity had borrowed B Dollars that day from a bank (the bridge loan) to finance the transaction. The special

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[1] See Baptiste v. Commissioner, 29 F.3d 433, 435-7 (8th Cir. 1994), cert. denied, 513 U.S. 1190 (1995); Baptiste v. Commissioner, 29 F.3d 1533, 1539-41 (11th Cir. 1994); Pert v. Commissioner, 105 T.C. 370, 376-80 (1995).

[2] The Corporation X shareholders (before Date 5) all apparently reported and paid federal income taxes on their returns for this period on their respective portions of the approximately A Dollars received, in form, for their Corporation X stock.

purpose entity then immediately merged into Corporation X.[3] This same day, Company Z apparently set in motion new Corporation X's involvement in the loss transactions the Service also contends lack economic substance and which are at issue in the Transferor's pending Tax Court case.

The following day, on Date 6, the sale of substantially all of new Corporation X's assets to Corporation Y closed, with a purchase price of about C Dollars cash, plus the assumption of certain liabilities by Corporation Y. New Corporation X used the asset sale proceeds along with certain retained account receivables (apparently valued at about D Dollars) to pay off the bridge loan to the bank, which had been used to pay the net amounts due the Corporation X shareholders. On or about this date, we understand that the Company Z Group apparently had substantially completed new Corporation X's involvement in the loss transactions that are at issue in the Transferor's pending Tax Court case. On or about this date, we also understand that the Company Z Group paid itself fees totaling at least E Dollars out of the retained new Corporation X assets then under its control, for *inter alia* facilitating the transactions between the Corporation X shareholders and Corporation Y and for structuring the purported loss transactions of new Corporation X.

After Date 6, new Corporation X apparently engaged in no further active business functions, though it took another four years, until Date 12, for Renamed Corporation X to be formally terminated as a corporation recognized under Virginia law. Renamed Corporation X's tax year including the asset sale to Corporation Y and the purported loss transactions at issue in the Transferor's pending Tax Court case closed at the end of the corporation's ordinary fiscal year on Date 9, approximately four months after the series of transactions described above. For this tax year, renamed Corporation X reported combined ordinary and capital gain from the sale of assets to Corporation Y of about F Dollars, but also claimed deductions and losses arising from the purported loss transactions of more than double that amount, resulting in a claimed NOL for renamed Corporation X's tax year ended Date 9, of approximately G Dollars, which the company carried back to its prior tax years.

The timing of renamed Corporation X's filing of its Form 1120 return for its tax year ending Date 9, and of its filing requests for (tentative?) NOL carryback refunds for Corporation X's prior tax years (ending Dates 2 and 3) is uncertain to us. However, about one year after the close of Corporation X's tax year ended Date 9, in
Date 10, renamed Corporation X apparently received from the Service (tentative?) refunds arising from the NOL carrybacks described above which totaled about
H Dollars (not including any interest). The Service believes these NOL carryback refund proceeds were then either distributed to or used for the benefit of the renamed Corporation

[3] Within a month of this transaction, on Date 8, new Corporation X changed its name to Renamed Corporation X, but retained its status as a Virginia corporation and as the successor to Corporation X for federal income tax purposes.

X shareholders at that time, which we understand consisted largely, if not entirely, of members of the Company Z Group.

The income tax deficiency determined by the Service against Corporation X/ Renamed Corporation X for the corporation's tax year ended Date 9, is about
I Dollars. The income tax deficiencies determined by the Service against Corporation X/Renamed Corporation X for the corporation's tax years ended
Dates 2 and 3, are for the full amount of the NOL carryback refunds described above, which is a total of less than half of the tax deficiency determined for the alleged loss year.

Assuming the Service's determinations in the pending Tax Court case involving the Transferor's tax liabilities for its tax years ending Dates 2, 3, and 9 are sustained, there is no question that the Transferor was insolvent by at least Date 9, and for all time periods of its existence thereafter. There is also no question at this point that it would be futile for the Service to seek collection of the Transferor's tax liabilities from the Transferor, because the Transferor is now dissolved under state law and retains no known or valuable assets. Your chief questions for us are whether, for transferee liability purposes, the Transferor's tax debts existed when the transfers to the Corporation X shareholders were made (which is closely related to the question of whether the transfers to the Corporation X shareholders left Corporation X insolvent) and whether these related questions matter for all potential transferee liability theories available to the Service in this case. You also ask us to evaluate the Service's potential transferee liability theories in relation to the transfers apparently made to the Company Z Group. To address these ultimate matters, we first considered a number of predicate issues that were fairly raised by your request for advice.

ISSUES & CONCLUSIONS

Issue 1: In the facts of this case, is it appropriate for the Service to apply the economic substance doctrine to recast the transaction so that the Company Z Group members are treated as an intermediary that is disregarded and to treat Corporation X as having sold its assets directly to Corporation Y and distributed the sale proceeds to the original Corporation X shareholders in liquidation?

> Conclusion: Yes. Associate Chief Counsel (Corporate) concurs with the primary recast theory proposed by your office in this case with respect to the original Corporation X shareholders.

Issue 2: Alternatively, may the Service recast the transaction to treat Corporation X as redeeming its stock from its original shareholders?

> Conclusion: Yes. Associate Chief Counsel (Corporate) also concurs with the assertion of the alternative recast theory proposed by your office in this case with respect to the original Corporation X shareholders.

Issue 3: Since I.R.C. § 6901 only sets forth a non-exclusive method for the Service to collect a liability of a transferee of property and the secondary sources of this transferee liability (at law or in equity) must be found outside of section 6901, what are the secondary sources of law that are alternatively available for the Service in this case to establish the transferee liability of the various potential transferees?

> Conclusion: Sections 55-80 and 55-81 of the Virginia Code Annotated (1950) and the several transferee liability provisions of section 3304 of the Federal Debt Collection Procedure Act (FDCPA), 28 U.S.C. § 3001 et. seq., should all be considered by the Service in this case.

Issue 4: Under the several potential theories of Virginia and FDCPA fraudulent transfer law the Service may consider in this case for the Corporation X shareholders and new Corporation X's unpaid tax liability for its tax year ended Date 9, is it a genuine problem that the transfers at issue to the Corporation X shareholders occurred <u>during</u> the tax year when the Transferor's unpaid tax debts arose but about four months <u>before</u> the end of Corporation X's tax year ended
Date 9?

> Conclusion: No. Though it is often generally stated that a necessary element of transferee liability in equity is that the transfer was made <u>after</u> the debt of the transferor accrued, and tax practitioners understand that federal income tax liabilities do not accrue until the end of a tax period (pursuant to the Internal Revenue Code's annual accounting concept), there is also a widely accepted gloss on this principle in the case of tax debts which accrue <u>during</u> the period in which the transfer occurred. Several of the sources of potential transferee liability law

available to the Service in this case may also apply to debts that arise before, at, or after the transfer.

Issue 5: Under the several potential theories of Virginia and FDCPA fraudulent transfer law the Service may use in this case for the Corporation X shareholders and new Corporation X's unpaid tax debts arising from excessive NOL carryback refunds, is it a genuine problem that the direct transfers to the Corporation X shareholders occurred about sixteen months before new Corporation X received the excessive NOL carryback refunds for its tax years ending Dates 2 and 3?

Conclusion: No. Some of the Service's potential fraudulent transfer theories in this regard may require further factual development and Alexander v. Commissioner, 61 T.C. 278, 294-5 (1973), acq. 1974-2 C.B. 1 (1974), is an adverse case you should distinguish, but we believe the Alexander case may properly be distinguished from your case on factual and/or legal grounds.

Issue 6: Under the several potential theories of Virginia and FDCPA fraudulent transfer law the Service may use in this case for the approximately E Dollars of fees the Company Z Group apparently paid itself out of new Corporation X's assets on or about Date 6, is there an appropriate means of treating the Company Z Group as a transferee with respect to these fees under I.R.C. § 6901?

Conclusion: Yes. If the Service can establish that the fees the Company Z Group paid itself at this time were "excessive" (i.e., not for reasonably equivalent value), then the Service may properly assert transferee liability against the Company Z Group with respect to the excessive portion of these fees on any of the grounds described under Issue 4 above. Alternatively, even if the Company Z Group fees are treated as paid by new Corporation X for reasonably equivalent value, the Service may treat the Company Z Group as an "insider" of new Corporation X which received a transfer for a debt when it had reasonable cause to believe new Corporation X was insolvent, pursuant to FDCPA section 3304(a)(2).

Issue 7: Under the several potential theories of Virginia and FDCPA fraudulent transfer law the Service may use in this case for the approximately H Dollars of NOL carryback refund proceeds the Company Z Group apparently paid itself out of new Corporation X's assets in or after Date 10, is there an appropriate means of treating the Company Z Group as a transferee with respect to these distributions under I.R.C. § 6901?

Conclusion: Yes. The analysis is the same as for Issue 6, except that the Service does not need to rely on the retroactive treatment of tax debts incurred during the tax year of the transfer for transferee liability purposes (discussed under Issue 4), because new Corporation X was insolvent as a result of its tax debts in Date 10 by any measure of insolvency.

## DISCUSSION

Section 6901(a) of the Internal Revenue Code provides a procedure by which the Service may assess and collect unpaid taxes, penalties, and interest from a transferee (or from a fiduciary). Section 6901 is strictly a procedural statue; it does not create the substantive liability of a transferee for the transferor's tax debts. The existence of, or extent of, a transferee's liability is determined by applicable state or federal law, with modifications discussed below for the limitation periods applicable to debts owed the Service. A transferee's liability may be established "at law," e.g., by contract, or under a state or federal liability statute. Liability, may also be established "in equity," which is a term we are using herein as shorthand for liability under state or federal fraudulent conveyance laws. See IRM 5.17.14.3.1 (from the Service's Legal Reference Guide).[4]

A necessary element of transferee liability at law or in equity is a tax liability of the Transferor. A transferee can be held liable under I.R.C. § 6901(a) for the Transferor's income taxes (as in this case) and for other types of federal taxes. As previously discussed, the Transferor's income tax liabilities in this case should be conclusively established in the Tax Court case with the Transferor that your office is now handling. The existence and extent of the Transferor's tax liabilities may not thereafter be questioned by the transferees in their potential transferee liability cases, except that payments toward the Transferor's tax liability could reduce the amounts the Service may seek from some potential transferees.

Another common element of transferee liability in equity is for the Service to show that it has made all reasonable efforts to collect the tax liability from the Transferor and/or that further collection efforts against the Transferor would now be futile. In this case, the Transferor dissolved several years ago and has retained no assets, so the futility of the Service attempting to collect the Transferor's taxes from dissolved new Corporation X is established.

The existence and value of transfers from the Transferor to the potential transferees is a third common element of transferee liability in equity. In this case, there are three potential direct transfers to be considered:

(12) The first and largest potential transfer at issue is the payments totaling about A Dollars received by the old Corporation X shareholders on or about Date 5. The primary and alternative recast theories for the "substance" of these

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[4] The Service's Legal Reference Guide (LRG) generally follows the analytical distinction between transferee liability "in equity" and "at law" that is discussed in 14 Mertens Law of Federal Income Taxation (2000) § 53.09, even though it might be argued that transferee liability that is based upon fraudulent transfer principles that are equitable in origin but now generally prescribed by statute should be described as transferee liability "at law." IRM 5.17.14.3.6.

transactions, proposed by your office and accepted by Corporate, are intended (in large part) to show that this
A Dollars total was transferred from Corporation X to the old Corporation X shareholders, rather than from the Company Z Group's special purpose entity to the old Corporation X shareholders (per the "form" chosen for the transaction).

(13) The second and smallest potential transfer at issue is the payments apparently totaling about E Dollars that were made by new Corporation X (then under the control of the Company Z Group) to the Company Z Group on or about Date 6. Recast theories are not necessary to show these payments represented a "transfer" from Corporation X, though the recast theories may provide a useful background for considering the other elements of a transferee liability case. These payments may be tested as direct transfers to the Company Z Group and/or possibly as indirect transfers to the old Corporation X shareholders.

(14) The third potential transfer at issue is the apparent payment of about H Dollars of NOL carryback tax refund proceeds from new Corporation X to the Company Z Group on or after Date 10. Recast theories are also not necessary to show these apparent payment represented a "transfer" from Corporation X, and the facts may show these payments were also intended as indirect transfers to the old Corporation X shareholders as well as direct transfers to the Company Z Group.

These three transfers must each then be tested by applicable state and federal "constructive fraud" and "actual fraud" statutes against the two sets of federal tax debts of the Transferor that are at issue in this case: (1) the income tax liability arising during the year of the direct transfer to the Corporation X shareholders (the pending tax deficiency of about I Dollars, plus applicable penalties and interest) for the tax year ended Date 9; and (2) the income tax liabilities arising from excessive NOL carryback refunds (of about H Dollars, plus applicable penalties and interest) received by new Corporation X in Date 10, as a result of carrying back an excessive NOL from the original transfer year to pre-transfer years.

The necessary elements of a "constructive fraud" case, in addition to the three already described above (i.e., Transferor's debt, transfer from Transferor to transferee, and inability to collect from the Transferor) may vary somewhat from state to state and from state law to federal law, but the fundamental way that these laws differ from "actual fraud" laws is that the Transferor's intent in making the transfer is immaterial in a constructive fraud case. Constructive fraud laws also usually require that the transfer of property be made for inadequate consideration and that the Transferor is insolvent or is made insolvent by the transfer (or series of transfers). See IRM 5.17.14.2.2:(3).

The necessary elements of an "actual fraud" case, in addition to the three previously described above (i.e, Transferor's debt, transfer from Transferor to transferee, and inability to collect from the Transferor) may also vary somewhat from state to state and from state law to federal law, but the common element is generally that the transfer occurred with an actual intent by the Transferor to hinder, delay, or defraud a creditor in the collection of a debt owed. Under applicable state and federal fraudulent transfer laws, the creditor may show the Transferor's actual intent to hinder, delay, or defraud by circumstantial evidence known generally as "badges of fraud." Lack of adequate consideration and transfers to an insider are common badges of fraud, but many actual fraud laws do not distinguish between creditors whose debts existed before the transfer and those whose debts came into existence after the transfers intended to hinder, delay, or defraud. See IRM 5.17.14.2.2:(4).

In addition to showing that the actual transfers to the old Corporation X shareholders were from the Transferor (Corporation X), the primary and alternative recast theories proposed by your office and accepted by Corporate are also intended to show that the A Dollars paid to the old Corporation X shareholders was not made for any actual consideration, because Corporation X received no value from its shareholders when it either provided them with dividends in a liquidation or redeemed its own stock from its shareholders. Conversely, if the appropriateness of either the primary or alternative recast theories is not shown and the "form" of the transaction is respected, then the Corporation X shareholders will argue that the Company Z Group's receipt of the Corporation X stock (in form) represented value to the Company Z Group.

The principal transferee liability questions raised by your incoming memorandum concerned: (1) the appropriate state and federal fraudulent transfer laws for testing the potential transfers in this case,[5] and the proper construction of these laws; and (2) timing questions regarding the incurrence of the federal income tax debts and the transfers, for constructive fraud laws that depend upon insolvency at transfer.

Issue 1: Primary Recast – Asset Sale followed by Liquidation Distributions

Among the factors which support disregarding the Company Z Group's participation in the transaction are: (i) the Company Z Group never intended to own the Corporation X stock or assets; (ii) the Company Z Group never used any of it own funds to finance the acquisition of the Corporation X stock and never assumed any real risk with respect to repaying the loan; and (iii) the Company Z Group was paid a fee for participating in the transaction. The seminal Supreme Court decision addressing intermediary arrangements and holding that the incidents of taxation depend upon the substance of the transactions is Commissioner v. Court Holding Co., 324 U.S. 331 (1945). An expanded discussion of Corporate's primary and alternative recast analyses may be found further below.

[5] Your incoming memorandum does not discuss any potential FDCPA theories.

In addition, courts considering transferee liability cases brought by the Service have long found the "economic substance" of the transactions to be controlling in determining whether to respect the "form" of the transactions. See 14 Mertens Law of Federal Income Taxation (2000) § 53.15; Sellers v. Commissioner, 592 F.2d 227, 229 (4th Cir. 1979) (a transferee liability case involving Virginia law and citing Mertens); Sheckles v. Commisioner, 91 F.2d 192 (5th Cir. 1937); Caire v. Commissioner, 101 F.2d 992 (5th Cir. 1939); Owens v. Commissioner, 64 T.C. 1 (1975); Delpit v. Commissioner, T.C. Memo 1991-147. But see Vendig v. Commissioner, 229 F.2d 93 (2nd Cir. 1956).

Issue 3: Potential Sources of Transferee Liability Law in this Case

We have not been told that Corporation Y, in the course of purchasing the Corporation X assets, contractually made itself secondarily liable at law for paying any of the renamed Corporation X tax liabilities at issue in this case. Accordingly, we have only considered the available secondary sources of law for transferee liability "in equity" (e.g, fraudulent transfer theories), as now codified in applicable state and federal statutes. Since Corporation X and new Corporation X (Renamed Corporation X) were at all relevant times incorporated under the laws of Virginia and we have not been advised of any significant contacts the Transferor had with any other state, we agree that the transfers at issue in this case should be treated as made by the Transferor in Virginia.

In accordance with Commissioner v. Stern, 357 U.S. 39 (1958), we concur with your proposed testing of the transactions at issue against two Virginia laws that allow creditors to set aside fraudulent transfers. Virginia has not adopted the multi-state Uniform Fraudulent Conveyance Act (UFCA) or the Uniform Fraudulent Transfer Act (UFTA). However, sections 55-80 and 55-81, Va. Code Ann. (1950), respectively, describe what are commonly described as "actual fraud" and "constructive fraud" grounds for imposing transferee liability or setting aside a fraudulent transfer.

Section 55-80, Virginia's "actual fraud" law provides, in pertinent part for this case, that every "transfer ... given with intent to delay, hinder or defraud creditors ... shall, as to such creditors, ... be void" and that this provision "shall not affect the title of a purchaser for valuable consideration, unless it appear that he had notice of the fraudulent intent of his immediate grantor or of the fraud rendering void the title of such grantor."

Section 55-81, Virginia's "constructive fraud" law provides, in pertinent part for this case, that every "transfer ... which is not upon consideration deemed valuable in law, ... by an insolvent transferor, or by a transferor who is thereby rendered insolvent, shall be void as to creditors whose debts shall have been contracted at the time it was made, but shall not, on that account merely, be void as to creditors whose debts shall have been contracted or as to purchasers who shall have purchased after it was made."

Whether the Service proceeds under I.R.C. § 6901 (to make a personal assessment against a transferee) or the United States files a federal district court action on the Service's behalf to set aside a fraudulent transfer of property to the transferee (to subject property in the transferee's hands to the transferor's federal tax debts), the federal government is not barred by any state statute of limitation periods (or otherwise labeled claim extinguishment provisions) from enforcing its rights under the Internal Revenue Code to assess or collect taxes, even though the federal government may be relying on state law created grounds for attacking the transfer as an actual or constructive fraud upon the transferor's creditors.[6] This is due to federal supremacy principles. Since the Transferor in this case is still contesting its liability in the Tax Court for the unassessed federal income taxes that may later be pursued against these transferees, the one year limitation period described in I.R.C. § 6901(c)(1) (for a transferee assessment against the initial transferees in this case, after the assessment period against the Transferor expires) and the ten year period described in I.R.C. § 6502(a)(1) (for filing a federal district court case to set aside a fraudulent conveyance by the Transferor) have not even begun to run yet, so the Service may still utilize any Virginia law basis for imposing transferee liability in this case.

When the Supreme Court considered the potential sources of substantive law available to the Service to set aside a fraudulent transfer against creditors under the predecessor provision to I.R.C. § 6901 in 1958, the Stern Court could choose only between federal decisional (pre-Erie common) law and applicable state law, because Congress had not yet enacted a uniform federal law which addressed the existence and extent of a transferee's liability for such transfers.[7] However, effective on May 29, 1991, Congress enacted the Federal Debt Collection Procedure Act (FDCPA) of 1990, 28 U.S.C. § 3001 et. seq., which describes five potential grounds (in section 3304) for setting aside transfers that are fraudulent as to debts owed the United States, including tax debts.[8]

Three of these FDCPA provisions for setting aside transfers fraudulent as to the United States involve variants of "constructive fraud," subsections 3304(a)(1), 3304(b)(1)(B)(i), and 3304(b)(1)(B)(ii). A fourth FDCPA provision addresses "actual fraud," subsection 3304(b)(1)(A). A fifth FDCPA provision, subsection 3304(a)(2), involves transfers to insiders of the Transferor for even bona fide antecedent debts if the insider had reasonable cause to believe the Transferor was insolvent.[9] In addition to the two Virginia law fraudulent transfer provisions described above, the Service may also consider alternative

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[6] See United States v. Summerlin, 310 U.S. 414 (1940); Bresson v. Commissioner, 213 F.3d 1173 (9th Cir. 2000), aff'g, 111 T.C. 172 (1998) (and cases cited therein); IRM 5.17.14.2.8 and 5.17.14.3.1:(13).

[7] See Commissioner v. Stern, 357 U.S. 39, 44-5 (1958).

[8] See 28 U.S.C. § 3002(3)(B) (defining "debt" as including an amount owing to the United States on account of a "tax").

[9] Because there are no "antecedent debts" to the Corporation X shareholders under the Service's recast theories, we only consider this potential transferee liability theory further below with respect to the Transferor's apparent transfers to the Company Z Group.

reliance on any of these five FDCPA provisions as potential grounds in this case for imposing personal transferee liability (under I.R.C. § 6901) or for filing a federal district court action to set aside a fraudulent transfer with respect to the transfers to the Corporation X shareholders and to the Company Z Group members.[10] Subsection 3304(b)(2) describes eleven, non-exclusive factors (badges of fraud) to be considered in determining the Transferor's "actual intent" to hinder, delay, or defraud a creditor for purposes of the FDCPA, including: (1) the transfer was to an insider; (2) the transfer was of substantially all the debtor's assets; (3) whether the value of the consideration received by the debtor was reasonably equivalent; (4) whether the debtor was insolvent or became insolvent shortly after the transfer was made; and/or (5) the transfer occurred shortly before or shortly after a substantial debt was incurred.

The five potential FDCPA grounds, described in 28 U.S.C. § 3304, that are available to the Service for setting aside a transfer that is fraudulent as to a tax debt owed the United States are as follows:

> **§ 3304. Transfer fraudulent as to a debt to the United States**
>
> **(a) Debt arising before transfer.** – Except as provided in section 3307, a transfer made or obligation incurred by a debtor is fraudulent as to a debt to the United States which arises before the transfer is made or the obligation is incurred if –
>
> > **(1)(A)** the debtor makes the transfer or incurs the obligation without receiving a reasonably equivalent value in exchange for the transfer or obligation; and
> >
> > **(B)** the debtor is insolvent at that time or the debtor becomes insolvent as a result of the transfer or obligation; or
> >
> > **(2)(A)** the transfer was made to an insider for an antecedent debt, the debtor was insolvent at the time; and
> >
> > **(B)** the insider had reasonable cause to believe that the debtor was insolvent.
>
> **(b) Transfers without regard to date of judgment. – (1)** Except as provided in section 3307, a transfer made or obligation incurred by a debtor is fraudulent as to a debt to the United States, whether such debt arises before or after the transfer is made or the obligation is incurred, if the debtor makes the transfer or incurs the obligation –
>
> > **(A)** with actual intent to hinder, delay, or defraud a creditor; or
> >
> > **(B)** without receiving a reasonably equivalent value in exchange for the transfer or obligation if the debtor –
> >
> > > **(i)** was engaged or about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

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[10] See IRM 5.17.14.2.1:(2) and 5.17.14.2.3; BNA "Transferee Liability," Portfolio 628 (2000), at pages A-1 and A-2; Bresson v. Commissioner, 111 T.C. 172, 185 n.8 (1998), aff'd, 213 F.3d 1173 (9th Cir. 2000).

**(ii)** intended to incur, or believed or reasonably should have believed that he would incur, debts beyond his ability to pay as they became due.

Although the various limitation periods described in 28 U.S.C. § 3306(b) for these five fraudulent transfer provisions of the FDCPA may already have expired for many other types of federal debts, these limiting provisions do not curtail or limit the rights of the United States under the Internal Revenue Code to collect federal tax debts or to collect amounts collectible in the same manner as taxes (e.g., under I.R.C. § 6901).[11] As was the case with the Virginia law fraudulent transfer provisions described above, the one year limitation period described in I.R.C. § 6901(c)(1) and the ten year period described in I.R.C. § 6502(a)(1) have not begun to run yet, so the Service may still utilize any FDCPA law basis for imposing transferee liability in this case.

Issue 4: Transfers to Corp. X Shareholders and the FYE Date 9 Tax Debt

The Mertens treatise and the Service's Legal Reference Guide both describe the general transferee elements of state or federal fraudulent transfer law (for constructive fraud) as requiring a showing that the transfer was made during or after the period for which the tax liability of the Transferor accrued. See 14 Mertens Law of Federal Income Taxation (2000) § 53.27; IRM 5.17.14.3.6:(2)c. The generally accepted and applied theory of transferee liability in equity is that a transferee is "retroactively" liable for the Transferor's taxes in the year of the transfer and also prior years,[12] unless the particular law relied upon goes further (e.g., in actual fraud circumstances and in some constructive law circumstances under the FDCPA) and imposes potential liability for tax debts accrued even after the year of the transfer.

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[11] See 28 U.S.C. § 3003(b)(1); IRM 5.17.14.2.8:(2).

[12] See 14 Mertens Law of Federal Income Taxation (2000) § 53.38; Caire v. Commissioner, 101 F.2d 992 (5th Cir. 1939) (stockholder receiving March 1931 check held liable as transferee for corporate tax debt for year ending November 1931); Kreps v. Commissioner, 351 F.2d 1, 8 (2nd Cir. 1965) (corporate officer receiving proceeds of redeemed airline tickets during fiscal year ending February 28, 1951, held liable as transferee for corporate tax debt for that fiscal year); Holmes v. Commissioner, 47 T.C. 622 (1967) (stockholder receiving $28,545.00 payment from corporation on January 2, 1956, held liable as transferee for corporation's income tax liability for year ended March 31, 1956); Leach v. Commissioner, 21 T.C. 70, 75-6 (1953) ("The transferee is retroactively liable for transferor's taxes in the year of transfer and prior years"); Delpit v. Commissioner, T.C. Memo 1991-147; D'Agostino v. Commissioner, T.C. Memo 1973-202. But see Reid Ice Cream Corp. v. Commissioner, 59 F.2d 189 (2nd Cir. 1932) (interpreting scope of a purchaser's liability assumed at law, under a contract); Pert v. Commissioner, T.C. Memo 1997-150 (*dicta*, that the Service becomes a taxpayer's creditor for transferee liability purposes at the close of a taxable period in which tax arises).

Virginia's "constructive fraud" law for transferees, Va. Code Ann. § 55-81 (1950), treats voluntary transfers by an insolvent transferor (or transferor rendered insolvent by the transfer) as void "as to creditors whose debts shall have been contracted at the time it [the transfer] was made." In a transferee case under I.R.C. § 6901 and interpreting Virginia law, the Tax Court and Fourth Circuit both discussed section 55-81 and determined that a corporate officer was liable as a transferee under this Virginia law for real estate sale proceeds that he received and which also gave rise to the Transferor corporation's federal income tax liability at issue during the year of the transfers. Sellers v. Commissioner, 592 F.2d 227 (4th Cir. 1979), aff'g, T.C. Memo 1977-70.[13]

Virginia's "actual fraud" law for transferees, Va. Code Ann. § 55-80 (1950), protects purchaser's for valuable consideration who had no notice of their Transferor's fraudulent intent, but it does not condition or limit the liability of other transferees in cases where a transfer has been made "with intent to delay, hinder, or defraud creditors" to only those creditors or debts which existed when the transfer occurred. In the Sellers case, the Fourth Circuit and Tax Court also found the transferee liable under section 55-80 of the Virginia law; the Tax Court stated in its Sellers opinion that a transfer is voidable under Virginia's section 55-80 if made with the intent to delay, hinder, or defraud either existing or subsequent creditors.

The first of the FDCPA's constructive fraud provisions for initial transferees and debts owed to the United States, 28 U.S.C. § 3304(a)(1), is similar to Virginia's constructive fraud law. It treats transfers that are not made for reasonably equivalent value by an insolvent Transferor (or Transferor rendered insolvent by the transfer) as avoidable, as to debts to the United States "which arise before the transfer is made or the obligation is incurred." There does not appear to be any reported case law which interprets this provision of the FDCPA in relation to any federal tax debts that were incurred during the tax year that the Transferor (made insolvent by the federal tax debt) made a transfer that was not for reasonably equivalent value. However, the final supplementary section of the FDCPA, 28 U.S.C. § 3308, explains that except as otherwise provided within the FDCPA, "principles of law and equity ... shall apply to actions and proceedings under [the FDCPA]." In

[13] The Fourth Circuit and Tax Court in Sellers also cited a prior I.R.C. § 6901 transferee liability case which had involved a West Virginia constructive fraud statute that the Sellers court described as being in all material respects the same as the Virginia law. In that case, Weinberg Trust v. Commissioner, T.C. Memo 1970-297, aff'd sub. nom., C.D. Construction Corp. v. Commissioner, 451 F.2d 470 (4th Cir. 1971), cert. denied, 405 U.S. 988 (1972), the Tax Court relied upon Mertens statement of the general rule that a transferee is "retroactively liable" for the Transferor's taxes in the year of the transfer and prior years. See also In re Porter, 37 B.R. 56, 66-67 (Bankr. E.D. Va. 1984) (giving a "liberal construction" to the meaning of debts contracted in section 55-81 of Virginia's fraudulent transfer law to include "contingent debts" that arise from a contract entered into before the transfer, though the contingency does not occur until after the transfer).

accordance with the interpretative guidance provided by section 3308 and the general equitable origins of fraudulent transfer law, we believe that section 3304(a)(1) of the FDCPA should be interpreted as including the widely accepted state law gloss described above from the Mertens treatise and the transferee cases interpreting Virginia law – that a Transferor's tax debt incurred during the tax period the transfer at issue occurred is retroactively treated as having been made before the transfer for purposes of this constructive fraud law.

The second and third of the FDCPA's constructive fraud provisions for initial transferees and debts owed to the United States, sections 3304(b)(1)(B)(i) and (ii), apply in the described circumstances "whether such debt arises before or after the transfer is made or the obligation is incurred." Under these two FDCPA provisions, the transfer must not have been made for reasonably equivalent value, and the Transferor (in this case) either (i) was engaged or about to engage in a transaction (the Corporation Y asset sale and, payments to Corporation X stockholders) that would leave the Transferor with assets that would be unreasonably small in relation to the Transferor's debts (including federal tax debts) arising from the transaction, or (ii) reasonably should have believed that the Transferor would incur total debts (including federal tax debts) that would be beyond its ability to pay as they became due. Assuming that the Service prevails in its pending Tax Court case with the Transferor and that one of the Service's alternative recasts of the transactions in this case is sustained, the Corporation X shareholders should plainly be liable as transferees under either of these two FDCPA constructive fraud provisions for the federal income tax liability of Corporation X/Renamed Corporation X for its year ended Date 9.

The FDCPA's actual fraud provision for initial transferees and debts owed to the United States, section 3304(b)(1)(A), also applies whether the (federal tax) debt arises before or after the transfer is made or the obligation is incurred. Section 3304(b)(2) then provides a non-exclusive list of commonly cited badges of fraud which may be considered in determining the Transferor's "actual intent to hinder, delay, or defraud a creditor." Several of these listed badges of fraud apply to the recast transactions at issue in this case with the Corporation X shareholders.

Issue 5: Transfers to Corp. X Shareholders and the Carryback Tax Debts

The Illinois fraudulent transfer statute discussed in the Alexander case was an "actual fraud" law that Illinois courts had construed previously as applying only to transfers made with the intent to defraud creditors with debts existing at the time of the transfer. The Alexander court found the Service was an "existing creditor" with respect to the corporation's income tax incurred during the tax year in which the transfers occurred to a shareholder, because the court said this tax "had been derived from operations conducted prior to the liquidation distribution," but the court also found the shareholder was not an "existing creditor" with respect to a tentative carryback refund claimed by the corporation after it dissolved because these refund proceeds were received by the purchaser of the corporation's assets and not enjoyed by the shareholder. We believe that Alexander may be distinguished from the present case.

First, as previously discussed under Issue 4 above, Virginia's "actual fraud" law for transferees, Va. Code Ann. § 55-80 (1950), has previously been construed as applying to existing or subsequent creditors. The FDCPA's "actual fraud" law for transferees, 28 U.S.C. § 3304(b)(1)(A) also applies whether the tax debt arises before or after a transfer is made. The same legal rule applies for two of the FDCPA's three "constructive fraud" provisions for transferees, sections 3304(b)(1)(B)(i) and (ii); they apply in the previously described circumstances (found in your case), whether the tax debt arises before or after the transfer.

Second, further facts developed in your case may show directly or circumstantially that the Corporation X shareholders should be treated as indirect beneficiaries of the carryback refunds at issue in Year 4. These carryback refunds may have been intended or understood to be part of the long term compensation due to the Company Z Group for earlier facilitating the series of transactions at issue on behalf of the Corporation X shareholders and others. When a corporation with tax debts makes payments to third parties who are actually owed money, in whole in part, by the shareholders instead of by the payor corporation, the payments may properly be characterized as indirect transfers (when made) to the shareholders. See Kean v. Commissioner, 91 T.C. 575, 603-6 (1988). When the carryback refund proceeds were apparently paid over to the Company Z Group on or after Date 10, the Transferor had incurred all of the federal tax debts at issue and was clearly insolvent. Accordingly, if the Corporation X shareholders are found to be indirect beneficiaries of these payments to the Company Z Group, then the "constructive fraud" provisions for transferees under Virginia law and the FDCPA which refer to the Transferor's insolvency, would cleanly apply to the transactions, without disturbing the logic of the distinctions made by the Tax Court in the Alexander case.[14]

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[14] Although the Service indicated in 1974 that it acquiesced in the Alexander decision, we note now that the logical distinctions made by the Tax Court in that case are debatable. During the transfer year, in the Alexander case and in Corporation X's case, the corporation's tax debt for the transfer (and claimed loss) year "existed" on the same logical level as the corporation's tax debt for the prior carryback years because: (1) the taxes recovered through the tentative NOL carrybacks from the transfer/loss year had already been paid; (2) the transactions giving rise to the corporation's tax position (later contested by the Service) had occurred during the transfer year; (3) the corporation had decided to cease doing business and was in the process of dissolving during the transfer year, so there was no reason the corporation might elect to carry forward its claimed transfer year NOL, rather than carry back the NOL for the tentative carryback refunds at issue; and (4) the corporation's ability to use tentative carryback refund procedures for the transfer year NOL ensured that the Service would immediately pay the corporation the full requested tentative carryback refunds after the request was filed, because the Service has no opportunity to review the merits of a taxpayer's loss year position under these procedures. During the transfer year, the Transferor's tax position for the NOL carryback years (and its tax debts arising therefrom) had thus become a foregone conclusion. The Transferor's discretion to

Issue 6: The Co. Z Group and the Immediate Payments Received in Year 2

While the Service may recast the transactions facilitated by the Company Z Group in Date 7 (as described under Issues 1 and 2 above), to treat the Company Z Group as a disregarded intermediary insofar as the transferee liability of the Corporation X shareholders is concerned, the Service may at the same time take an inconsistent position in any potential litigation with the Company Z Group members over their potential transferee liability, and hold them to the "form" of the transactions they facilitated. As the Tax Court observed in the transferee liability case of <u>Pittsburgh Realty Investment Trust v. Commissioner</u>, 67 T.C. 260, 277 (1976):

> We recognize that the substance-form rubric has been successfully used by the Commissioner in attacking the form of transactions under circumstances similar to those here, but where the purpose of casting the form was to avoid taxes. But this does not mean that a party to an agreement may recast his agreement with a third party in order to avoid tax liability asserted against him by the Commissioner in reliance on the terms of the agreement entered into by the parties.

In the present case, for the reasons explained below, the old Corporation X shareholders (on the one hand) and the Company Z Group members (on the other hand) appear to have a strong incentive to assert inconsistent tax positions as defenses to the Service's potential separate transferee liability actions against each of them. The Corporation X shareholders can be expected to argue that the form of the transactions the parties selected should be respected. The Company Z Group members, on the other hand, have some incentive to argue that their stock ownership in "form" should be ignored in favor of the recasts,

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defer, for a period of time after the transfer/loss year ends, the actual filing of an application to request payment of the tentative NOL carryback refunds from the Service should not be the decisive factor in whether a shareholder receiving property from the liquidating corporation is liable as a transferee for federal tax debts of this type, which were established for all practical purposes by transactions occurring during the transfer year. Since the Service's acquiescence in <u>Alexander</u>, the Service has still asserted transferee liability against the former shareholders of some dissolved corporations for tax debts that arose from excessive post-liquidation NOL carryback refunds. <u>See Dillman v. Commissioner</u>, 64 T.C. 797 (1975); <u>Fugate v. Commissioner</u>, T.C. Memo 1977-18. Accordingly, even if the Corporation X shareholders are <u>not</u> discovered to be indirect beneficiaries of the NOL carryback refunds at issue, there are logically appealing grounds for treating the tax debts arising from these excessive carryback refunds the same as the transfer/loss year tax debts for constructive fraud transferee liability purposes – as contracted for or existing debts at the time of transfer, by a Transferor made insolvent by the transfer, for purposes of the relevant fraudulent transfer laws of Virginia (Va. Code Ann. § 55-81) and the FDCPA (28 U.S.C. § 3304(a)(1)) which refer to the Transferor's insolvency at the time of transfer. Accordingly, we intend to rethink the Service's acquiescence in the <u>Alexander</u> case.

because it could then be more difficult to label the Company Z Group members as "insiders" when the transfers to them occurred. In potential "whipsaw" situations, the Service frequently does and it permitted to take inconsistent positions. See Preston v. Commissioner, 209 F.3d 1281, 1286 (11th Cir. 2000); Wiles v. Commissioner, 499 F.2d 255, 259 (10th Cir. 1974).[15]

Under the form of the above transactions facilitated by the Company Z Group, we understand that from at least Date 5 through Renamed Corporation X's formal dissolution under Virginia law, new Corporation X's shareholders consisted largely, if not entirely, of members of the Company Z Group. Thus, at the time the Company Z Group members were apparently paid the fees at issue from retained new Corporation X assets, the Company Z Group members would be considered "insiders" of new Corporation X under FDCPA section 3301(5), 28 U.S.C. § 3301(5), and under applicable case law decided under state law fraudulent transfer theories.

When payments have been made for purported debts owed to an insider of a taxpayer, the Service has sometimes been successful in establishing transferee liability against the insider by showing the purported debt was fictitious or excessive and that the payment was actually a disguised distribution of the taxpayer's assets or profits to the insider.[16] These cases tend to be highly factual in nature and your incoming memorandum did not provide very many details that would help us assist you in evaluating the strength of the Service's potential case against the Company Z Group under this theory. Even if the fees the Company Z Group apparently paid itself from the remaining new Corporation X assets on or about Date 6, represent the

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[15] While the issue need not be decided at this point or even before the Service potentially tries and briefs the two sets of transferee cases to the Tax Court (or other court, in a potential refund action), the Service arguably may also be entitled to prevail in both sets of transferee liability actions at issue under inconsistent views of the recast transactions. Unlike the typical "whipsaw" situation, we are not confronted in a transferee liability case with an either/or contest between the two sets of potential transferees. Just as there may be more than one responsible person under I.R.C. § 6672, there may be more than one person liable as a transferee for the same tax owed by the Transferor. The limitation is that the Service may ultimately collect the Transferor's tax only once.

[16] See West v. Commissioner, 68 F.2d 246 (3rd Cir. 1933) ("bonus" to shareholders for guaranteeing corporate mortgages treated as profit sharing); Meyers v. Commissioner, 21 T.C. 331 (1953) (executive "salary" to owner's nominee treated as dividends to owner); Leach v. Commissioner, 21 T.C. 70 (1953) (salary to officer/shareholder treated as excessive compensation that is actually a distribution of assets); United States v. Markowitz, 34 F.Supp. 827 (N.D. Cal. 1940). But see Denton v. Commissioner, 21 T.C. 295 (1953); United States v. Friedman, 41-1 U.S.T.C. ¶ 9431 (N.D. N.Y. 1941).

going industry rate for structuring/facilitating what the Service considers a series of abusive corporate tax shelters for a client(s), it may be possible for the Service to challenge the fees as "against public policy" and not bona fide debts of new Corporation X for transferee liability purposes for this reason. If the payments described above to the Company Z Group were not made for a "reasonably equivalent value," then we would again follow our analysis under Issue 4 above that the payments were made after the tax debt arose (during the tax year) and that the Transferor was insolvent (on account of the tax debt arising during the tax year) when the payment was made, thus allowing the Service to pursue any of the potential Virginia law and FDCPA transferee liability theories discussed under Issue 4. We are uncertain from your incoming memorandum whether these various amounts paid to members of the Company Z Group on or about Date 6, were deducted on Renamed Corporation X's return for the year ended Date 9, and whether the deductibility of these fees by Renamed
Corporation X is somehow arguably at issue in your pending Tax Court case with the Transferor. If so, you may wish to seek assistance from Branch 3 of APJP in evaluating the extent to which principles of collateral estoppel or res judicata may affect the Service's ability to pursue the potential theory that these payments were not made for reasonably equivalent value.

Alternatively, without challenging whether Corporation X received reasonably equivalent value in exchange for these amounts paid to the Company Z Group on or about Date 7, the Service may simply assert that the transfer was made to an insider (the Company Z Group) for an antecedent debt at a time when the Transferor (Corporation X) was insolvent and that the insider had reasonable cause to believe the Transferor was insolvent, within the meaning of FDCPA section 3304(a)(2), 28 U.S.C. § 3304(a)(2). As previously discussed, this theory requires that the Company Z Group be held to the "form" of the transactions it facilitated (making it an "insider" when the payments were made), and, following our analysis under Issue 4 above, that the payments were made after the tax debt arose (during the tax year) and that the Transferor was insolvent (on account of the tax debt arising during the tax year) when the payment was made. It also requires the Service to show that the Company Z Group should reasonably have known that the offsetting loss-producing transactions that it involved new Corporation X in during the transfer tax year were not valid to eliminate the new Corporation X tax liability resulting from the Corporation Y sale.

Your incoming memorandum did not mention potential I.R.C. § 6700 penalties against the Company Z Group, but the Service has given notice that it considers the type of transactions the Company Z Group facilitated in this case to be abusive tax shelters. See Chief Counsel Notices 2001-16 (January 19, 2001) and 2001-23 (April 26, 2001). Although most of the Company Z Group's activities in facilitating these intermediate transaction tax shelters had apparently occurred by Date 6, it seems likely that much of the evidence the Service would need to consider in a section 6700 investigation of the Company Z Group in connection with these transactions has already been obtained by the Service or is likely to have been retained by the representatives of Renamed Corporation X in connection with the pending Tax Court case your office is handling. There is no period of limitation for assessment of the section 6700 penalty. See Lamb v. United States, 977 F.2d 1296 (8th Cir. 1992); Sage v. United States, 908 F.2d 18 (5th Cir. 1990). While the section 6700 penalty is generally only equal to $1,000.00 for a person liable for each activity described in section 6700(a)(1), it may be possible to treat the purported sale of Corporation X stock by each Corporation X shareholder as a separate transaction (i.e, multiple sales if there were many shareholders) subject to the penalty, in addition to the other steps you have already noted in this abusive series of transactions. If you wish to pursue section 6700 penalties against the Company Z Group and its responsible personnel, in addition to the transferee liability discussed herein, please seek advice directly from Branch 2 of APJP.

Issue 7: The Co. Z Group and Transfers of NOL Carryback Refund Proceeds

The Company Z Group's potential transferee liability with respect to the NOL carryback refund proceeds of new Corporation X that it apparently distributed to its members in or after Date 10 follows along the same lines of analysis discussed under Issue 6, except that there would appear to be fewer potential legal hurdles which may need to be crossed.

First, the Company Z Group's right (as the controlling shareholders of dissolving new Corporation X) to appropriate these NOL carryback refund proceeds to itself in Year 4 may not have even been disguised by new Corporation X as payments upon any purported debts, and, in any event, the payments are not likely to be supported by any genuine arms length negotiations over contractual terms between new Corporation X's shareholders and the payees controlled by these shareholders.

Second, the Tax Court case involving new Corporation X that is being handled by your office does not involve the tax year of new Corporation X (the year ending Date 11) in which these distributions were made to the Company Z Group and possibly deducted by new Corporation X, so there should be no possible collateral estoppel/res judicata hurdle that needs to be considered or crossed with respect to these distributions in Year 4.

Third, by any potential measure of tax debt accrual, the tax debts at issue had been incurred and therefore made new Corporation X "insolvent" by the time these NOL carryback refund proceeds were distributed to the Company Z Group.

## EXPANDED DISCUSSION OF CORPORATE'S RECAST ANALYSIS

Issue 1: The Primary Recast for Corporation X's Shareholders

From the facts described, the Company Z Group's participation in the transaction was that of a mere intermediary and lacked economic substance. Consequently, the Company Z Group's participation in the transaction should be disregarded. Once the Company Z Group's participation in the transaction is disregarded, the transaction may be recast as a direct sale of assets by Corporation X to Corporation Y followed by a liquidating distribution of the sale proceeds by Corporation X to the original Corporation X shareholders.[17]

Several factors in the instant case support disregarding the Company Z Group's participation in the transaction.

First, Company Z (and its special purpose entity) never intended to own the Corporation X stock or assets. The original negotiations relating to Corporation X were between Corporation X (and the Corporation X shareholders) and
Corporation Y. The Company Z Group was interjected into the transaction only after the discussions between the Corporation X shareholders and Corporation Y reached an impasse. After a discussion with Corporation Y, Company Z via the Company Z Group agreed to facilitate the transaction between the Corporation X shareholders and Corporation Y. The letters of intent between Company Z and the Corporation X shareholders and Company Z and Corporation Y illuminate that Company Z's sole role was that of an intermediary that never intended to have any real ownership relating to Corporation X. In fact, the letters of intent make clear the Company Z Group's role as an intermediary by specifically providing that
Company Z's purchase of the Corporation X stock was conditioned on
Corporation Y's purchase of the Corporation X assets and Corporation Y's purchase of the Corporation X assets was conditioned on Company Z's purchase of the Corporation X stock. Further, the actual stock sale by the Corporation X shareholders to Company Z's special purpose entity and the actual asset sale by Corporation X to Corporation Y occurred within one day of each other. The only activity that occurred during that two day period with respect to the Company Z Group and Corporation X was a series of transfers by the Company Z Group of leases and the Loss Stock that Corporation X used to shelter its gain from the sale of its assets to Corporation Y and generate a refund. Consequently, Company Z (and its special purpose entity) never had any real control over Corporation X and never enjoyed the normal benefits and burdens associated with ownership. Murry v. Commissioner, T.C. Memo 1984-670.

Second, Company Z (and its special purpose entity) never used any of its own funds to finance the acquisition of the Corporation X stock and never assumed any real risk with respect to repaying the loan. In order to finance the purchase of the Corporation X stock, Company Z's special purpose entity obtained a bridge loan from a bank in the amount of A Dollars. Immediately after Company Z's special purpose entity acquired the Corporation X stock, the special purpose entity merged with and into Corporation X with Corporation X assuming the loan obligation as a result of the merger. This obligation was immediately repaid by Corporation X after the sale of its assets – one day after the stock sale. Given the prearranged steps of this transaction, it is clear that Corporation X (not Company Z's special purpose entity) was the party responsible for repaying the loan.

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[17] The liquidating distribution would include certain account receivables that were not sold to Corporation Y.

Third, the Company Z Group was paid a fee for participating in the transaction. This payment of a fee further reflects the Company Z Group's role as an intermediary. The fee consisted of amounts directly paid by Corporation X to the Company Z Group and officers and directors of the Company Z Group, as well as amounts resulting from the refund. The only purpose for the Company Z Group's participation in the transaction was to shelter Corporation X's inherent gain in its assets and collect a fee. Therefore, the Company Z Group's participation in the transaction should be disregarded.

The seminal Supreme Court decision addressing intermediary arrangements is Commissioner v. Court Holding Co., 324 U.S. 331 (1945). In Court Holding, the Court recognized that entities may be disregarded in determining a transaction's true substance by providing that:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impede the effective administration of the tax policies of Congress. Id. at 334.

Several authorities have focused on the substance of the transaction in determining how a transaction should be treated for federal income tax purposes. See Estate of Kluener v. Commissioner, 154 F.3d 630 (6$^{th}$ Cir. 1998) (taxpayer's contribution of property to his controlled corporation followed by corporation's sale of property at a gain (that was offset by losses) and subsequent distribution of the sale proceeds to the taxpayer treated as a direct sale by taxpayer of the property; corporation treated as a mere conduit); Davis v. Commissioner, 88 T.C. 122 (1987) (bank's foreclosure on partnership's property and bank's subsequent sale of property to another partnership related to the first partnership pursuant to an understanding between the bank the first partnership treated as an indirect sale by the first partnership to the related partnership); Rev. Rul. 91-47, 1991-2 C.B. 16 (pursuant to an understanding between unrelated corporations P and D, P forms a new corporation ("Newco") that acquires D's outstanding debt at a discount and P subsequently sells the Newco stock to D in an attempt to help D avoid discharge of indebtedness income; stock sale disregarded and transaction recast so that D is treated as acquiring its indebtedness directly from P). See also Del Commercial Properties, Inc. v. Commissioner, T.C. Memo 1999-411; Malkan v. Commissioner, 54 T.C. 1305 (1970); West Coast Marketing Corp. v. Commissioner, 46 T.C. 32 (1966); Rev. Rul. 70-140, 1970-1 C.B. 73.

Once the Company Z Group's participation in the transaction is disregarded, there are facts to support treating the transaction as a direct sale of assets by Corporation X to Corporation Y, followed by a liquidating distribution of the sale proceeds by Corporation X to its original shareholders. As discussed above, there were prior negotiations for an asset sale between Corporation X and Corporation Y and an asset sale did occur in fact. Additionally, as part of a prearranged plan, the Corporation X asset sale was the source of the payments to the original Corporation X shareholders for their stock, with the bank serving as a mere facilitator for that payment. This is consistent with treating the cash received by the original Corporation X shareholders as a liquidating distribution. Finally, the fact that Corporation X remained in existence until Date 12 should not alter the overall recast. After Corporation X's asset sale to Corporation Y and the distribution of the sale proceeds to the original Corporation X shareholders, Corporation X had no assets, no business activity, and no ability to satisfy its liabilities. Consequently, Corporation X should be treated as having liquidated following the sale of its assets. See Treas. Reg. § 1.332-2(c); Rev. Rul 61-191, 1961-2 C.B. 251.

Issue 2: The Alternative Recast for Corporation X Shareholders

Assuming arguendo that Corporation X is not treated as having liquidated following the sale of its assets to Corporation Y and the Company Z Group's receipt of the Corporation X stock is respected, the transaction should be treated as a redemption by Corporation X of its stock from the original Corporation X shareholders (rendering Corporation X unable to satisfy its federal tax liability resulting from its asset sale to Corporation Y) with the Company Z Group receiving Corporation X stock for services. The Company Z Group member's transfer of the leases and Loss Stock should be disregarded with the losses generated by Corporation X's subsequent transfer of the leases and Loss Stock being disallowed.

With respect to recasting the purchase by Company Z's special purpose entity of the Corporation X stock from the original Corporation X shareholders as Corporation X's redemption of its stock from its original shareholders, the facts make clear that Corporation X (and not Company Z's special purpose entity) was the source of the funds used to acquire the stock from the original Corporation X shareholders. As discussed above, Company Z's special purpose entity was a newly formed, transitory corporation that used the funds from a bank loan to acquire the Corporation X stock. Immediately after its acquisition of Corporation X and as part of a prearranged plan, Company Z's special purpose entity merged with and into Corporation X with Corporation X assuming the liability for the loan used to acquire its stock. Corporation X then immediately repaid the loan obligation with the proceeds from the sale of its assets and certain account receivables not sold to Corporation Y. Because Corporation X (and not the Company Z Group) was the true source of the funds used to acquire the stock from the original Corporation X shareholders, Corporation X should be treated as redeeming its stock from its original shareholders for A Dollars. See Rev. Rul. 78-250, 1978-1 C.B. 83; Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970). Ultimately, as part of a prearranged plan, Corporation X financed the redemption of its stock from its original shareholders with the proceeds of the sale of its assets to Corporation Y with the bank serving as a mere facilitator of the redemption.[18] As a result of the distribution of the cash to the original shareholders in redemption of their stock, Corporation X was unable to satisfy its federal tax liability resulting from its asset sale to Corporation Y.

To the extent the members of the Company Z Group are treated as owning stock in Corporation X, the members of the Company Z Group should be treated as receiving such stock in return for their participation in the transaction (services) rather than for the Company Z Group members' transfer of leases and Loss Stock. As discussed in your incoming memorandum, ample authority exists for concluding that the lease and Loss Stock transfers lacked a business purpose and economic substance. The Company Z Group used Corporation X as a mere conduit for transferring the leases and Loss Stock to generate the Corporation X losses that offset the gain on Corporation X's asset sale to Corporation Y while also generating a refund of approximately H Dollars. Consequently, because the transfer of the leases and Loss Stock lacked business purpose and economic substance and Corporation X served as a mere intermediary with respect to such items,[19] Corporation X should not be permitted to recognize any loss with respect to the transfer of the leases and Loss stock. Accordingly, such Corporation X stock should be treated as being received by the members of the Company Z Group for services.

[18] The tax treatment of the Corporation X shareholders resulting from the redemption should be tested under I.R.C. § 302.

[19] The authorities discussed above relating to disregarding intermediaries would apply to treat Corporation X as a mere intermediary with respect to the Company Z Group's transfer of leases and Loss Stock to Corporation X and Corporation X's immediate retransfer of such leases and Loss Stock.