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9th Circ. Slone Ruling Considers Basis Of Transferee Liability

By **James Malone** (August 1, 2018, 6:04 PM EDT)

James Malone

The Ninth Circuit issued a second opinion on July 24, 2018, in a long-running dispute over transferee liability, ruling that former shareholders of Slone Broadcasting Co. were liable as transferees for its unpaid taxes.[1] The case, Norma L. Slone et al. v. Commissioner of Internal Revenue, merits discussion for two reasons: It illustrates the important role that transferee liability plays in civil tax enforcement and it also illustrates the willingness of courts to focus on substance, not form, in transferee cases.

Overview of Transferee Liability

Transferee liability gives the Internal Revenue Service the ability to collect one person's taxes from someone else. In most cases,[2] the starting point is Section 6901(a) of the Internal Revenue Code, which provides as follows:

> (a) Method of collection
>
> The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred:
>
> (1) Income, estate, and gift taxes
>
> (A) Transferees
>
> The liability, at law or in equity, of a transferee of property-
>
> (i) of a taxpayer in the case of a tax imposed by subtitle A (relating to income taxes),
>
> (ii) of a decedent in the case of a tax imposed by chapter 11 (relating to estate taxes), or
>
> (iii) of a donor in the case of a tax imposed by chapter 12 (relating to gift taxes),

in respect of the tax imposed by subtitle A or B.

Code Section 6901(a) “transferees” are defined broadly and they include “the shareholder of a dissolved corporation, ... [and] the successor of a corporation.”[3]

Section 6901 is merely a procedural device — it “neither creates nor defines a substantive liability but provides merely a new procedure by which the Government may collect taxes.”[4] As a consequence, in transferee cases, courts apply a two prong test:

- First, the court must determine whether the party is a “transferee” under section 6901 and federal tax law.

- Next, it must determine whether that party is liable for the transferor’s taxes under applicable state law.[5]

Typically, a variant of either the Uniform Fraudulent Conveyance Act or the Uniform Fraudulent Transfer Act controls liability under state law.

Background to Slone

Slone arose out of two transactions. Initially, Slone Broadcasting entered into an asset sale with Citadel Broadcasting Co., selling essentially all its assets for $45 million in a transaction that closed in July of 2001.[6] The shareholders of Slone Broadcasting then sold their stock to Berlinetta Inc. for $33 million; that transaction closed in December 2001.[7] After the stock sale closed, Sloan Broadcasting and Berlinetta merged and the survivor adopted a new name, Arizona Media Holdings Inc.[8]

The asset sale triggered significant capital gains, creating an estimated liability for federal and state taxes of $15.3 million. In October of 2001, Slone Broadcasting made an estimated payment of $3.1 million toward its federal tax liability for the fiscal year ending June 30, 2002.[9] After the stock sale closed, Arizona Media, as successor to Slone Broadcasting, filed a tax return reporting the $37.9 million gain that Slone Broadcasting had realized from the asset sale, along with an offsetting loss of $38.1 million from the sale of Treasury bills. The company claimed it had no tax liability and requested a refund of the estimated payment that Slone Broadcasting had made.[10]

In 2008, the IRS assessed Arizona Media with a tax deficiency of $13.5 million, along with a penalty of $2.7 million and interest of $7.3 million.[11] When the IRS concluded that it could not collect from Arizona Media, it sent notices to the former shareholders assessing them with liability as transferees. The former shareholders then petitioned the U.S. Tax Court for a redetermination of their liability.[12]

While the asset sale created the tax liability, the stock sale was the focus of the dispute. The IRS viewed the stock sale as the equivalent of a liquidating distribution to the shareholders and argued that the transaction should be judged on its substance, not its form.[13] Meanwhile, the shareholders argued that it was a legitimate stock sale that should be respected.[14] The Tax Court agreed with the

shareholders, but in 2015, the Ninth Circuit reversed.

Focusing on whether the former shareholders were "transferees" within the meaning of Code Section 6901, the Ninth Circuit ruled that federal tax law doctrines that look past the form of a transaction to its substance were relevant to the determination whether the former shareholders were "transferees."[15] Specifically, the Ninth Circuit considered the economic substance doctrine, which calls for courts to evaluate both subjective and objective factors to determine whether a transaction has some purpose beyond tax avoidance.[16]

Since the Tax Court had not applied the correct standard to determine whether the former shareholders were transferees, the Ninth Circuit remanded the case for further proceedings.[17] Judge John Noonan wrote a partial dissent, asserting that the record was sufficient and arguing that the stock sale lacked economic substance.[18] In his view, the former shareholders were transferees under Code Section 6901.

The case then returned to the Tax Court. There, the court focused on the question whether the former shareholders could be held liable under applicable state law, Arizona's version of the Uniform Fraudulent Transactions Act.[19] The Tax Court posited that the form of the stock sale could only be disregarded under state law if the former shareholders "had actual or constructive knowledge of the entire scheme."[20] The court ruled for the former shareholders, finding that the government "did not sustain [its] burden of proof as to either actual or constructive knowledge."[21] Because it concluded that liability under state law was not established, the Tax Court did not address the question whether the former shareholders were transferees under federal law.[22]

The government appealed, returning the case to the Ninth Circuit.

The Ninth Circuit Opinion

The Ninth Circuit's opinion opened with a brief summary of the stock sale:

Berlinetta assumed Slone Broadcasting's income tax liability. Berlinetta, using borrowed funds, paid the petitioners an amount representing the net value of the company after the asset sale plus a premium representing almost two-thirds of the amount of Slone Broadcasting's tax liability. The petitioners thus received two-thirds of the amount Slone Broadcasting should have paid in taxes after the asset sale.[23]

The court then turned to the application of the two prong test for transferee liability in light of the record.

First, the appeals court applied the economic substance doctrine to the stock sale to determine whether its form should be respected or whether it was in substance a liquidating distribution, which would make the former shareholders transferees under section 6901. The Ninth Circuit readily concluded that the stock sale lacked economic substance: "[T]he purpose of Petitioners' transaction with Berlinetta was tax avoidance."[24]

The court initially focused on the results of the arrangement, noting that Arizona Media, the successor to Slone Broadcasting, "was not engaged in any business activities."[25] Arizona Media was simply a shell holding the cash proceeds of the asset sale and the associated tax liability. In the court's view this arrangement lacked economic substance: "When Petitioners sold the stock to Berlinetta, along with that tax liability, Petitioners received, in substance, an ostensibly tax-free liquidating distribution from Slone Broadcasting. There was no legitimate economic purpose other than to avoid paying the taxes that would normally accompany a liquidating asset sale and distribution to shareholders."[26]

Next, the court of appeals focused on the financing for the transaction, commenting that the loan's structure further demonstrated that the stock sale "was only about tax avoidance."[27] While a legitimate business enterprise would have structured the financing to leave it with sufficient capital to operate and to meet its tax obligations, the court observed that the loan Berlinetta obtained required that it be repaid in full immediately.[28]

Against that background, the court of appeals ruled that "[t]he Petitioners' sale to Berlinetta was a cash-for-cash exchange lacking independent economic substance beyond tax avoidance."[29] The court specifically referenced testimony from one of the lawyers for the former shareholders, who "testified that in his nearly twenty years of private practice 'he had never seen a transaction like this.'"[30]

The court of appeals then turned to the question whether the former shareholders were liable under Arizona's Uniform Fraudulent Transfer Act. Although the Tax Court had concluded that the government had failed to show that the former shareholders lacked sufficient knowledge to be held liable, the Ninth Circuit reviewed the record and concluded that there was ample evidence of constructive knowledge. Fortrend International LLC, an affiliate of Berlinetta, had advised Jack Roberts, the accountant for Slone Broadcasting, that it could pay a premium to the former shareholders because of its ability to eliminate the tax liabilities.[31] The proposal raised suspicions among the shareholders: "Mr. Slone, the company's president, testified that upon learning that an entity wanted to purchase Sloan Broadcasting, after it had already been effectively sold to Citadel, he asked Jack Roberts, 'can that be done?' Unsure, Roberts replied, 'well, I'm going to find out.'"[32]

The court also noted the secretive approach that Fortrend and Berlinetta took, as inquiries on how the tax liability would be resolved were rebuffed: "Petitioners' retained counsel testified that when he and Jack Roberts asked for details, Berlinetta told them 'it was proprietary, it was a secret, and it was theirs, and we weren't going to be a party to it, and I said fine.'"[33]

The Ninth Circuit concluded that the Tax Court had misconstrued the record:

> The Tax Court misinterpreted Petitioners' suspicions and Berlinetta's reassurances to mean Petitioners lacked actual or constructive knowledge of the tax avoidance purpose of the scheme. This record establishes that the Petitioners were, at the very least, on constructive notice of such a purpose. In reaching a contrary conclusion, the Tax Court confused actual and constructive

> notice, in effect allowing Petitioners to shield themselves through “the willful blindness the constructive knowledge test was designed to root out.”[34]

Satisfied that the former shareholders at least had constructive knowledge that tax avoidance was the point of the stock sale, the Ninth Circuit concluded that the stock sale was a liquidating distribution the form of which was changed to avoid tax liability and that the distribution they received was a constructively fraudulent transfer under Arizona law.[35] Accordingly, the court remanded for the entry of judgment in favor of the Commissioner.

Analysis

Slone illustrates the significant role that transferee liability can play in tax administration: The government will be obtaining a judgment to recover millions of dollars in taxes that otherwise would not have been paid. And the Ninth Circuit’s fact-specific description of the warning signs associated with the stock sale may influence attorneys and other advisors in the context of future transactions.

Slone also adds to the existing case law establishing that equitable principles of federal tax law are relevant to the question whether an individual is a transferee under Code Section 6901, a point which is now fairly well-established.[36]

The main significance of Slone is on the question of liability under state law. In several cases, the IRS attempted to apply state fraudulent transfer law to a transaction after it had been recast using federal tax law principles. That position was rejected in a series of appellate cases that began with Starnes v. Commissioner[37]. Accordingly, the courts have forced the IRS to demonstrate that equitable principles of applicable state law support the recharacterization of a transaction as a prelude to establishing a fraudulent transfer.[38]

Given the equitable roots of fraudulent transfer laws, it is hardly surprising that equitable doctrines under state law would allow a court to look at the substance of a transaction rather than woodenly focus upon its form. The government has prevailed in a number of cases that have applied these standards.[39] Slone provides another example, adding to the growing body of law in this area.

James R. Malone, Jr. is a partner at Post & Schell PC.

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[1] Slone v. Comm’r, Nos. 16-73349, 16-73351, 16-73354, 16-73356, 2018 U.S. App. LEXIS 20602 (9th Cir. July 24, 2018).

[2] In certain collection cases, the IRS utilizes theories with state law roots to support third party collection measures such as alter ego or nominee liens and levies. Section 6901 is not a factor in that context.

[3] Treas. Reg. § 301.6901-1(b).

[4] Comm'r v. Stern, 357 U.S. 39, 42 (1958) (citations omitted) (discussing predecessor statute); see also Salus Mundi Found. v. Comm'r, 778 F.3d 1010, 1018 (9th Cir. 2014).

[5] See Diebold Found. Inc. v. Comm'r, 732 F.3d 172, 184 (2d Cir. 2013); see also Salus Mundi Found., 776 F.3d at 1018.

[6] Slone v. Comm'r, 788 F.2d 1049, 1050-51 (9th Cir. 2015).

[7] Id. at 1051.

[8] Id.

[9] Id.

[10] Id. at 1051-52.

[11] Id. at 1052.

[12] Id.

[13] Id. at 1051.

[14] Id.

[15] Id. at 1054.

[16] Id. at 1054-55.

[17] Id. at 1056.

[18] Id. at 1057 (Noonan, J., concurring and dissenting).

[19] Slone v. Comm'r, T.C. Memo 2016-115, 2016 Tax Ct. Memo LEXIS 116, **11-**12 (June 13, 2016), rev'd, Nos. 16-73349, 16-73351, 16-73354, 16-73356, 2018 U.S. App. LEXIS 20602 (9th Cir. July 24, 2018).

[20] 2016 Tax Ct. Memo LEXIS 116, **12.

[21] Id.

[22] Id. at **24-**25.

[23] 2018 U.S. App. LEXIS 20602 at *4 (citations omitted).

[24] Id. at *7.

[25] Id.

[26] Id. (citing Diebold Found., 736 F.3d at 175).

[27] Id.

[28] Id. at *7-*8.

[29] Id. at *8 (citation omitted).

[30] Id.

[31] Id. at *12.

[32] Id.

[33] Id. at *12-*13.

[34] Id. at *13-*14 (quoting Diebold Found., 736 F.3d at 189-90) (additional citation omitted).

[35] Id. at *14.

[36] See Shockley v. Comm'r, 872 F.3d 1235, 1247 (11th Cir. 2017); Salus Mundi Found., 776 F.3d at 1018.

[37] Starnes v. Commissioner, 680 F.3d 417, 428 (4th Cir. 2012).

[38] See Diebold Found., 736 F.3d at 186-87 (applying substance over form analysis to recharacterize a transaction under New York law).

[39] See Shockley, 872 F.3d at 1253 (application of substance over form appropriate under Wisconsin law); Feldman v. Comm'r, 779 F.3d 448, 459-61 (7th Cir. 2015) (same); Diebold Found ., 736 F.3d at 186-89 (applying New York law).