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When IRS Can Collect Taxes From You Owed By Someone Else

It seems bad enough that you have to pay your *own* taxes, let alone someone *else's*. But it can happen. The IRS sometimes comes after one taxpayer to collect the tax liability of someone else. How is this possible, you might wonder? The answer is "transferee liability," a concept embodied in Section 6901 of the tax code. Actually, the concept has deep roots in legal history. In fact, it is a creditor protection device going back hundreds of years. Essentially, the IRS can pursue a "transferee"—someone who received assets or money for less than full and fair value from the taxpayer. You might think of it as kind of a stolen property rule.

Example: Uncle Johnny owes the IRS a pile of money. He gives you his Mercedes. You may enjoy driving it and may have no idea Johnny owes the IRS. Even so, the IRS may be able to repossess it. The IRS claim on the Mercedes trumps yours, even if you didn't know about the taxes. The result is the same if you paid Johnny $5,000 for it but the car is really worth $20,000.

As with everything else in the tax code, applying these rules isn't simple, and procedure and timing are both important. First a bit of nomenclature. The person *owing* taxes is the "transferor," and the *person being pursued* the "transferee." There are two bases of transferee liability: at law and in equity. You are liable as a transferee *at law* when you are responsible for the transferor's tax liability by contract. The IRS must prove the tax liability was within the terms of the contract. In some cases, this arises by statute, such as in corporate mergers.

The great majority of transferee liability cases involve claims in equity. You are liable as a *transferee in equity* when you receive the transferor's assets for less than full, fair and adequate consideration and leave the transferor insolvent and unable to pay the tax liability. An example is the Mercedes your Uncle Johnny gave you. You got it for free, or for a bargain price, so you are on the hook. Your liability is limited to the value of the assets you received. To collect, the IRS must prove five elements:

1. The transferor *became insolvent* when the transfer occurred, or because of a series of asset transfers.

2. The transfer was for *less than adequate consideration*.

3. The transfer was made *after the tax liability* accrued. The tax liability need not have been assessed at the time of the transfer, as long as the tax debt had accrued.

4. The *transferor was liable* for the tax.

5. The IRS made *reasonable attempts* to collect from the transferor, *or it would be futile*. An example of the latter would be a dissolved corporation.

In *Commissioner v. Stern*, 347 U.S. 39 (1958), the U.S. Supreme Court said that the IRS must first satisfy a two-pronged test: (1) the person must be a "transferee" within the meaning of Code Section 6901(h); and (2) the transferee must be substantively liable for the transfer under applicable state law. The principal source of substantive liability to satisfy the second prong of the *Stern* test is state fraudulent conveyance law. These days, this generally means the Uniform Fraudulent Transfer Act ("UFTA"). Under the UFTA, creditors can invalidate a property transfer by their debtor if: (1) the debtor did not receive reasonably equivalent value in exchange for the transfer; and (2) the debtor was insolvent at the time of the transfer or was left in a perilous financial condition.

Many transferee liability cases are not slam-dunk cases for the IRS. In fact, the IRS has lost a number of transferee liability cases in court. However, fighting with the IRS takes time and is expensive.

For alerts to future tax articles, email me at Wood@WoodLLP.com. This discussion is not legal advice.