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IRS Gets Too Much Time To Go After Transferred Assets

Law360, New York (November 19, 2013, 1:53 PM ET) -- The IRS has a wide variety of tools to collect taxes but, as with most creditors, experiences problems when the debtor/taxpayer transfers assets to a third party. Section 6901 of the Internal Revenue Code provides one solution: using the normal IRS administrative processes to assess and then collect from transferees. Alternatively, the IRS can proceed directly to court without assessing the transferee and seek to set aside the transfer and treat the property transferred as still owned by the transferor (taxpayer).

A recent split decision by the Tenth Circuit, in United States v. Holmes[1], addressed this collection alternative (a “direct suit”). Although most of the court’s discussion surrounded the question of whether this alternative was even permissible, the most interesting aspect of the opinion was a questionable conclusion regarding the statute of limitations for such lawsuits.

Holmes was the sole shareholder of Colorado Gas Compression Inc., and received a series of distributions from the company from 1995 to 2002, as the company was winding up its affairs. In 2005, the Tax Court upheld the IRS determination that Colorado Gas owed over $2 million for 1994, 1995 and 1996. The IRS assessed Colorado Gas but was unable to collect from it. In 2008, the IRS filed a direct suit against Holmes to collect Colorado Gas’s outstanding tax liabilities. The lawsuit was based on state law, including: (a) a provision that shareholders receiving assets in the liquidation of a company are liable for the company’s debts; and (b) the Colorado version of the Uniform Fraudulent Transfer Act. The district court granted summary judgment to the government.

Holmes raised two arguments on appeal: 1) the IRS could not proceed against Holmes directly, but only under the procedural provisions of Section 6901 of the Code; and 2) the IRS, by suing under the state statute, was subject to the shorter state law statute of limitations, which had expired. The Tenth Circuit ruled against Holmes on both points.

Is a Direct Suit Even Permissible?

Holmes asserted the IRS could not proceed directly against him without assessing him individually. The majority rejected this argument, and compared it to a similar argument rejected by the Supreme Court in United States v. Galletti.[2]

In Galletti, the IRS assessed employment taxes against a partnership, and later sued the general partners of the firm to collect the partnership’s unpaid taxes. The partners argued that because they were not individually assessed under Section 6501 of the Code, the IRS could not directly collect from them. The Supreme Court rejected this argument and held that the assessment procedure under the Tax Code is "little more than the calculation or recording of a tax liability."[3] Moreover, “[o]nce a tax has been properly assessed, nothing in the Code requires the IRS to duplicate its efforts by separately assessing the same tax against individuals or entities who are not the actual taxpayers but are, by reason of state law, liable for payment of the taxpayer’s debt.”[4]

The Holmes dissent disagreed, arguing that the Galletti holding should be limited to secondary liability (of partners for the partnership’s debts) and not extended to transferee liability resulting from a transfer of the taxpayer’s assets. In the latter situation, the dissent argued Section 6901 applies and therefore requires a separate assessment of the transferee rather than a direct suit. The mandatory language of Sections 6901 and 6501 effectively preempts the IRS’s right to proceed by direct suit.

While the dissent's reading of Galletti and the Code are plausible interpretations, it failed to adequately rebut a line of cases which held "the collection procedures contained in section 6901 are not exclusive and mandatory, but are cumulative and alternative to the other methods of tax collection recognized and used prior to the enactment of 6901 and its statutory predecessors."[5] While the cases allowing a direct suit are distinguishable, it is unlikely that the dissent's position will prevail in future disputes. The right to collect by direct suit seems secure.

The Relevant Statute of Limitations

The most important holding of Holmes — and in our opinion incorrect — was the conclusion that the relevant statute of limitations for a direct suit by the IRS to collect from a transferee is provided by the Code rather than state law. Section 6502(a) provides that when a tax has been properly assessed, the statute of limitations for collection of the tax is 10 years from the date of assessment.

The majority reasoned that "[e]ven though the government here proceeds against Mr. Holmes by invoking a provision of state law, we must not ignore the reality that 'the present suit, though not against the corporation but against its transferee[] to subject assets in [his] hands to the payment of the tax, is in every real sense a proceeding in court to collect a tax.'"[6] Because the IRS was attempting to collect a tax, the court held that the government was "acting in its sovereign capacity in an effort to enforce rights ultimately grounded on federal law," and as such, was not subject to state statutes of limitations.[7] Under those circumstances, the United States "cannot be deemed to have abdicated its governmental authority so as to become subject to a state statute [of limitations]."[8]

The Supreme Court's decision in United States v. Summerlin, is often cited by the IRS and courts for the principle that "the United States is not bound to state statutes of limitations."[9] But in United States v. California[10], the Supreme Court cautioned against the broad application of Summerlin. California involved a contractor, working for the federal government, that was assessed $14 million in California state taxes. The contractor paid the taxes and then challenged its assessment through the California state court and administrative proceedings, eventually receiving a $3 million refund. The United States sought a refund of the remaining $11 million by filing suit in federal court against the state, claiming a federal common law right to recover erroneously or illegally assessed taxes. The United States cited Summerlin and argued that it was not bound by the ninety-day limitation period under state law. The Supreme Court disagreed, distinguishing Summerlin because "the right at issue [in Summerlin] was obtained by the Government through, or created by, a federal statute"; in contrast, "the Government here became entitled to its claim by indemnifying a private contractor's state law debt."[11]

The Holmes majority followed Bresson v. Commissioner[12], in which the Ninth Circuit interpreted California to say that the United States is not bound by state statutes of limitations only if 1) the "right at issue was obtained by the government through, or created by a federal statute," and 2) "the government was proceeding in its sovereign capacity in an effort to enforce rights ultimately grounded on federal law."[13] The Bresson court concluded that the United States was proceeding in its sovereign capacity and that the right at issue was "to collect a tax."[14] Because this right was created by the Internal Revenue Code, the government satisfied the Summerlin/California test and the longer federal statute of limitations applied. The Holmes majority agreed.

Both Bresson and Holmes made a fundamental error in concluding that the right at issue was created by a federal statute. Section 6502 grants the government the right to collect assessed taxes from the taxpayer assessed. Federal law, by itself, does not allow the government the right to collect the assessed taxes from a transferee. Only by satisfying the requirements of state law, such as the Uniform Fraudulent Transfer Act, does the government obtain the right to collect assessed taxes from a third party to whom the taxpayer has transferred assets. The proper result, under the Summerlin/California test, would have been to allow the government the ten year period in Section 6502 to collect from Colorado Gas but a shorter period, as set forth in state law, to collect from Holmes.

This interpretation is supported by the Supreme Court's decision in Commissioner v. Stern[15], which involved an administrative proceeding under Section 6901 rather than a direct suit. The court noted that the "fallacy in the Government's argument is the premise that Congress has imposed a tax liability against the beneficiary."[16] The Internal Revenue Code did not create a liability for the transferee, but merely provided the IRS an alternative method of collection if a valid claim existed. Because the right to assess the transferee depended on the state's version of the Uniform Fraudulent Transfer Act, "the Government's substantive rights in the case were precisely those which other creditors would have under state law."[17]

A statute of limitations itself is traditionally considered procedural rather than substantive. But the right to collect from a transferee is a substantive right. The IRS cannot collect before it demonstrates to the court that the applicable provisions of state law were met. Stern reminds us that this substantive right to collect from the transferee, whether by assessment under Section 6901 or a direct suit, depends on state law. Under the Summerlin/California test, this does not qualify to shield the government from a state statute of limitations.

Conclusion

Several circuit courts have reached this erroneous conclusion that direct suits to collect from a transferee are not subject to state statutes of limitations.[18] However, those rulings depended on an overly broad interpretation of the right at issue as the right to tax and collect. Defining the right more narrowly, as the substantive right to collect from a third party, makes it clear that state statutes of limitation do apply in this context.

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[1] U.S. v. Holmes, 727 F. 3d. 1230 (10th Cir. 2013).

[2] 541 U.S. 114 (2004).

[3] Id. at 122.

[4] Id. at 123.

[5] Id. at 1234 (quoting U.S. v. Russell, 461 F.2d 605, 606 (10th Cir. 1972) and citing Leighton v. U.S., 289 U.S. 506 (1933)).

[6] Holmes, 727 F. 3d. at 1235 (citing U.S. v. Updike, 281 U.S. 489, 494 (1930)).

[7] Id. (citing Bresson v. Comm'r, 213 F.3d 1173, 1178 (9th Cir. 2000) and U.S. v. Summerlin, 310 U.S. 414, 435 (1940)).

[8] Holmes, supra note 2 at 1235.

[9] U.S. v. Summerlin, 310 U.S. 414, 416 (1940).

[10] 507 U.S. 746 (1993).

[11] Id. at 757.

[12] 213 F.3d 1173 (9th Cir. 2000).

[13] Bresson, 213 F.3d at 1177.

[14] Id. at 1174. Bresson also noted a difference between a “statute of limitations” and a “claim extinguishment clause” in state law. The latter may not be subject to the Summerlin rule. However, we conclude that even a state statute of limitations limits the time within which the government can collect from a transferee by direct suit.

[15] 357 U.S. 39 (1958).

[16] Id. at 47.

[17] Id. (emphasis added). Several courts recently applied Stern in the context of “midco” transactions” to conclude that a determination of transferee liability under Section 6901 is based on state law and cannot apply federal tax common law of substance-over-form. See, e.g., Frank Sawyer Trust v. Comm’r, 712 F.3d 597 (1st Cir. 2013); Starnes v. Comm’r, 680 F.3d 417 (4th Cir. 2012); Diebold Foundation v. Comm’r, 2012 U.S. App LEXIS 22964 (2d Cir. Nov. 14, 2013). But see Feldman v. Comm’r, T.C. Memo 2011-297.

[18] In addition to Bresson and Holmes, the Fifth Circuit reached a similar conclusion in United States v. Fernon, 640 F.2d 609 (5th Cir. 1981) as did the Eighth Circuit in United States v. Wurdemann, 663 F.2d 50 (8th Cir. 1981)