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Former shareholders liable for tax on constructively fraudulent transfer

The Ninth Circuit overrules the Tax Court a second time in a transferee liability case.

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The Ninth Circuit, reversing the Tax Court and remanding with instructions to enter judgment in favor of the IRS, found that former shareholders of a liquidated broadcasting company were liable as transferees under Sec. 6901 for unpaid taxes arising from a sale of all the company's assets followed by a sale of all the company's stock.

Facts: In 2001, Slone Broadcasting Co., a radio broadcasting company based in Arizona, sold all its assets to Citadel Broadcasting Co. for $45 million in a transaction that generated federal and state income tax liabilities of $15.3 million. In October 2001, Slone Broadcasting made an estimated tax payment of $3.1 million to the IRS for the tax year ending June 30, 2002. In December 2001, the two shareholders of Slone Broadcasting (Slone Revocable Trust and Slone Family GST Trust) sold their shares to an unrelated party, Berlinetta Inc., for $35.8 million. As part of the sale, Berlinetta agreed to assume Slone Broadcasting's income tax liabilities.

After the sale closed, Slone Broadcasting merged with Berlinetta, and the new company changed its name to Arizona Media Holdings Inc. Three days later, a shareholder of Arizona Media contributed Treasury bills with a basis of $38.1 million to the company. Arizona Media then sold the bills for $108,731. On its tax return for the year ending June 30, 2002, Arizona Media reported a capital gain of $37.9 million from the asset sale to Citadel and an offsetting loss of $38 million from the Treasury bill sale. In August 2002, the IRS refunded to Arizona Media the $3.1 million estimated tax payment previously made by Slone Broadcasting.

In 2008, the IRS issued a notice of deficiency to Arizona Media for $13.5 million in taxes due on Slone Broadcasting's asset sale, together with a penalty of $2.7 million and interest of $7.3 million. Arizona Media did not pay the assessed tax, penalty, or interest, and in 2009 the state of Arizona administratively dissolved the corporation for failure to file an annual report.

The IRS sent notices of liability to the former Slone Broadcasting shareholders, claiming that they were liable for the taxes owed on the asset sale because they were "transferees" of Slone Broadcasting under Sec. 6901. The shareholders filed a petition for review of the determination in the Tax Court, arguing that the form of the stock sale should be respected because they were not party to Berlinetta's fraudulent tax-avoidance scheme.

The Tax Court ruled in favor of the shareholders, holding that the IRS failed to prove that the stock sale should be recast as a liquidating distribution under the substance-over-form doctrine (*Slone*, T.C. Memo. 2012-57; see "Tax Matters: Tax Court Respects Stock Sale, Denies Transferee Liability (https://www.journalofaccountancy.com/issues/2012/may/substance-over-form-doctrine.html)," *JofA*, May 2012). The IRS appealed.

In its initial review, the Ninth Circuit found that the Tax Court had not applied the correct legal standard for characterizing the stock sale to Berlinetta for purposes of federal transferee liability. Thus, it remanded the case to the Tax Court (*Slone*, 788 F.3d 1049 (9th Cir. 2015); see "Tax Matters: Tax Court to Reconsider Its Previous Denial of Stockholders' Transferee Liability (https://www.journalofaccountancy.com/issues/2015/sep/stockholder-transferee-liability.html)," *JofA*, Sept. 2015). The Ninth Circuit subsequently amended its opinion to clarify how the Tax Court should address the question of transferee liability (*Slone*, 810 F.3d 599 (9th Cir. 2015)).

On remand, the Tax Court, applying the Uniform Fraudulent Transfer Act (UFTA), which has been adopted by Arizona, concluded that it could disregard the form of the stock sale to Berlinetta only if the shareholders of Slone Broadcasting knew that the sale was intended solely to avoid taxes. The Tax Court found that the shareholders had no such knowledge and, thus, ruled again in their favor (*Slone*, T.C. Memo. 2016-115).

Issues: In the second appeal, the IRS argued that the shareholders were liable as transferees under the constructive fraud provisions of Arizona's UFTA. Under the statute, a transaction is constructively fraudulent as to a creditor (in this case, the IRS) if the debtor does not receive a reasonably equivalent value in exchange for the transfer, and the debtor either (1) was engaged in a business or transaction for which the remaining assets of the debtor are unreasonably small, or (2) intended to, or reasonably should have believed that it would, incur debts beyond its ability to pay.

Holding: The Ninth Circuit held in favor of the IRS, finding that the shareholders' sale of stock to Berlinetta, and Berlinetta's assumption of Slone Broadcasting's tax obligation, was, in substance, a liquidating distribution that left neither Slone Broadcasting nor Berlinetta able to satisfy Slone Broadcasting's tax liabilities. Such a transfer, according to the Ninth Circuit, was squarely within the constructive fraud provisions of Arizona's UFTA. According to the court, reasonable actors would have been on notice that Berlinetta did not intend to pay Slone Broadcasting's tax liabilities. In Berlinetta's earliest solicitations to Slone Broadcasting, Berlinetta marketed its ability to pay the shareholders a premium by using "proprietary" methods to "resolve liabilities at the corporate level." That Berlinetta provided little information regarding how it would resolve these liabilities, coupled with payment to the shareholders in an amount greater than the company's after-tax value, served as signals of the fraudulent nature of the transaction.

According to the Ninth Circuit, the Tax Court misinterpreted the shareholders' suspicions and Berlinetta's reassurances. Rather than indicating lack of actual or constructive knowledge of the tax-avoidance purpose of the transaction, as the Tax Court had concluded, these signals, at the very least, put the shareholders on constructive notice of such a purpose. Thus, the court found the shareholders to be liable to the IRS for Slone Broadcasting's federal tax liability as transferees under Sec. 6901.

- *Slone*, No. 16-73349 (9th Cir. 7/24/2018)

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