Transferee Shareholders and The Long Arm of the IRS

By Lori McMillan

Lori McMillan

Lori McMillan is a professor at the Washburn University School of Law.

McMillan discusses *United States v. Holmes* and concludes that it has made liability management more challenging for the nonresident shareholder and has created problems for the unwary.

There is a fundamental principle in U.S. law that corporations are legal persons, separate and distinct from the shareholders who own them. This separate personhood, although a legal fiction, means that corporations are able to enter contracts in their name, sue and be sued in their own name, and have taxes assessed on their own account. Usually, the separate legal existence of the corporation is respected, and situations in which shareholders are held accountable for the legal debts of the corporation by ''piercing the corporate veil'' are relatively rare. It is for those reasons that nonresidents considering what form their U.S. trade or business should take often choose to incorporate a U.S. subsidiary to manage their liability exposure. However, when a person, including a shareholder, receives a payment from a corporation that is winding down and the corporation is unable to pay the taxes it owes, that person might be on the hook for the corporation's unpaid taxes, up to the amount of the distribution received.

With that in mind, the procedure to be followed in pursuit of the collection of those taxes can be a bit confusing. The Tenth Circuit Court of Appeals in *United States v. Holmes* (2013 WL 4491924), nos. 12-1164, 12-1220 (Aug. 23, 2013), recently addressed this situation, but a strong dissent makes the decision far from clear. In *Holmes*, the corporation, Colorado Gas Compression Inc., was assessed corporate incomes taxes for the years 1994 through 1996 in the amount of $2,533,930.94, as determined by the district court. The corporation did not pay the taxes, and from 1995 to 2002, it made distributions to its sole shareholder, Holmes, totaling more than $3.6 million, while in the process of winding up its active operations. The district court ruled that Holmes was liable for the corporation's taxes because of these distributions, and the tax liability was set on motion at the full amount outstanding.

While the case explored several issues, the most relevant to nonresidents is the procedure by which the IRS can pursue shareholders for unpaid taxes in this situation. The crux of Holmes's argument was that the statute of limitations to initiate an action against him had expired because the IRS had never assessed him directly for the taxes, and therefore the Service was precluded from collecting from him personally. The IRS in turn argued that it had assessed the corporation and therefore did not need to assess the transferee shareholder who would be responsible for the taxes. While section 6901 authorizes the IRS to assess tax against a transferee and to take the steps necessary to collect the tax, the circuit court, in an opinion by Judge William Holloway, reaffirmed that the procedures outlined in the statute do not supersede the other avenues of tax collection available. The court also cited *United States v. Galletti*, 541 U.S. 114 (2004), for the proposition that the IRS assesses taxes rather than taxpayers, and therefore ''the IRS was not required to separately assess the taxes against Mr. Holmes individually.'' Therefore, the court held that the IRS did not need to assess Holmes and that the statute of limitations he relied on to prevent the IRS from collecting the corporation's taxes from him was inapplicable.

The strong dissent by Judge Timothy Tymkovich in this case is noteworthy. That Holmes himself was never assessed the corporation's taxes bothered Tymkovich, based on the directive in section 6901(a) that transferees are to be treated as taxpayers are treated. The principles behind section 6901(a) are meant to apply to all stages of tax collection, including assessment and collection. The dissent interpreted this to mean that under section 6501(a), the IRS cannot collect tax from anyone who has not been assessed during the appropriate assessment period. The dissent acknowledged that taxes may be collected through the courts rather than by the assessment process, which applies to transferees as well, but noted that the IRS is barred from doing so unless a suit is brought before the assessment period has lapsed. Because Holmes was not assessed for his transferee tax liability and the suit was brought after the assessment period had expired, the opinion of the dissent was that the suit was untimely.

In Tymkovich's analysis, inconsistent application of precedent from *United States v. Continental National Bank & Trust Co.*, 305 U.S. 398, 404-405 (1939), was part of the reason for the confusion, as initial transferees and subsequent transferees have been differentiated by different courts. "Some courts have construed *Continental* as applying to subsequent transferees only," Tymkovich wrote, "leaving initial transferees to be governed by the rule that the IRS wants to apply here." Treating initial transferees differently from subsequent transferees muddies the waters, and this was part of the reason why the dissent interpreted initial transferees as being entitled to the same procedural protections enjoyed by the initial corporate taxpayer, as well as all subsequent transferees. There is no compelling policy reason to treat one transferee differently from another, and the policy reasons that might be argued to support this disparate treatment apply to all transferees — not just initial ones — and are capable of legislative fix. The dissent also took issue with the use of *Galletti* to stand for the proposition that the IRS does not assess taxpayers, but rather taxes, since that case involved partners who would be legally responsible for the debts of the partnership, including taxes, with no separate legal personhood existing to block their responsibility as in *Holmes*. While many states recognize that partnerships are entities separate from their partners for many purposes, the reality is, absent personal guarantees, partners are responsible for a partnership's debts in a way that shareholders generally are not. Tymkovich clearly grasped the inconsistencies that result when different procedures are put in place for transferees and again for secondary transferees, making it harder for shareholders to exercise their rights and meet their obligations appropriately.

From the perspective of a nonresident, this is unsettling. When managing liability through a U.S. subsidiary, it would be helpful to know the procedure that the federal government must follow when pursuing a parent corporation or individual shareholder for nonpayment of the U.S. subsidiary's taxes. It appears unclear whether the IRS must actually assess the transferee shareholder for the taxes of the corporation after the corporation itself has been assessed. Many nonresident shareholders are active in the affairs of their U.S. subsidiaries, so they would be aware of the assessment of taxes against a subsidiary and their potential liability arising from payments made to them during the relevant time period. However, many shareholders do not actively participate and may have completely divested their ownership before the assessment against the corporation is even made. Accordingly, there is an outside chance that a nonresident shareholder could incur significant tax liability without ever receiving appropriate notification through the assessment process.

While the majority in *Holmes* strongly suggests that the IRS does not need to assess a transferee shareholder, the dissent makes a compelling argument that it does. The various applicable statutes of limitation differ significantly — three years as opposed to 10 — depending on whether assessment is required, and if a transferee shareholder does not need to be assessed, it is possible that these shareholders might not be on notice of the liability they are ultimately responsible to pay. This can make liability management more challenging for the nonresident shareholder and ultimately create headaches for the unwary.