

1950

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Recommended Citation

Albert A. De Stefano, *Transferee Liability on the Sale and Disposition of Corporate Assets*, 19 Fordham L. Rev. 311 (1950).
Available at: <http://ir.lawnet.fordham.edu/flr/vol19/iss3/3>

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COMMENT

TRANSFEEE LIABILITY ON THE SALE AND DISPOSITION OF CORPORATE ASSETS

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Since the immediate is always of more concern than the prospective, the problem of future transferee liability in the sale and disposition of corporate assets has always been shunted into the background by the immediate specter of double taxation. A practitioner faced with a transaction involving the sale of corporate assets, gives little if any thought to Section 311 of the Internal Revenue Code.¹ The emphasis is rather on the cases of *Commissioner v. Court Holding Co.*² and *United States v. Cumberland Public Service Co.*³ Yet, it is submitted, the two problems are inextricably interrelated and any tax appraisal of a contemplated sale of a corporate business without an evaluation of the potential transferee liability consequences is incomplete. It is with a view to considering this comparatively neglected facet of the tax consequences flowing from the sale of corporate assets that this paper has been prepared.

THE STATUTE

In substance, Section 311 provides a summary and expeditious remedy for the taxing authorities in situations where the taxpayer has transferred or disposed of his assets, leaving himself unable to pay his federal taxes.⁴ It is, therefore, procedural rather than substantive in character. It permits the government to utilize the same method of tax collection against a transferee as in the case of the transferor, that is, notice by the Commissioner to the transferee and opportunity accorded to the latter either to pay and sue for a refund or to proceed before the Tax Court, with a right of review by the courts.⁵ However, even under the statute the substantive basis of transferee liability is deter-

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1. Section 311 of the Internal Revenue Code is the successor to § 280 of the Revenue Act of 1926 which section enabled the United States for the first time to proceed against those secondarily liable in the same manner as against those primarily liable. For an exhaustive treatment of that first statute, see Latham, *Liability of Transferees under the Revenue Act of 1926*, 22 ILL. L. REV. 233, 397 (1927).

2. 324 U. S. 331 (1945).

3. 338 U. S. 451 (1950).

4. The constitutionality of the statute was upheld in the case of *Phillips v. Commissioner*, 283 U. S. 589 (1931).

5. INT. REV. CODE 311 (a). "METHOD OF COLLECTION. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds). . . ."

mined by settled principles of the common law⁶ and is the same as that which could have been enforced prior to the statute by appropriate remedy in the federal courts.⁷ Thus the statute provides that it is "The liability, at law or in equity, of a transferee of property of a taxpayer in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this Chapter"⁸ which can be so enforced.

The liability of a transferee may, therefore, be either established at law or in equity—at law, where the transferee, in connection with the transfer of assets, expressly or impliedly assumes the obligations of the transferor;⁹ in equity, under the trust fund doctrine¹⁰ as, for example, where that doctrine impresses on transferred property in the hands of a transferee who is not a bona fide purchaser for value without notice, a trust for the benefit of the creditors of a dissolved corporation.¹¹ Thus, differing from his liability at law, the extent of which is determined by contract, the liability of a transferee in equity is limited to the actual value of the transferred assets received.¹²

The statute in defining a transferee as including an "heir, legatee, devisee and distributee,"¹³ hardly sheds much light on the question as to who may be

6. "That section [Section 280 of the Revenue Act of 1926] imposes no new obligation upon the transferee of property of a tax-payer, but it permits collection from him, by a summary procedure, of taxes owed by the transferor, to the extent that the municipal law makes him liable at law or in equity for the transferor's taxes." *Hatch v. Morosco Holding Co.*, 50 F. 2d 138, 139 (2d Cir. 1931). To the same effect: *Harwood v. Eaton*, 68 F. 2d 12 (2d Cir. 1933), *cert. denied*, 292 U. S. 636 (1934); *John Robert Brewer*, 17 B. T. A. 713, 717 (1929).

7. It should be noted that the statutory proceeding is not exclusive and whenever the Commissioner deems it expedient he may institute suit against the transferee rather than send a deficiency notice under the statute. *United States v. Fisher*, 57 F. Supp. 410 (E. D. Mich. 1944).

8. INT. REV. CODE § 311 (a) (1).

9. *Shepard v. Commissioner*, 101 F. 2d 595 (7th Cir. 1939); *Continental Baking Co. v. Helvering*, 75 F. 2d 243 (D. C. Cir. 1934); *Helvering v. Wheeling Mold & Foundry Co.*, 71 F. 2d 749 (4th Cir. 1934). *But cf.* *Reid Ice Cream Corp. v. Commissioner*, 59 F. 2d 189 (2d Cir. 1932). Of course the Government may proceed against both the promisor and any other person who may have received the assets as a transferee. *Humbert v. Commissioner*, 24 B. T. A. 828, 829 (1931); *Fifty-Three West Seventy Second Street, Inc.*, 23 B. T. A. 164, 167 (1931).

10. 1939-1 (CUM. BULL. (Part 2) 353; *Updike v. United States*, 8 F. 2d 913 (8th Cir. 1925); *United States v. McHattan*, 266 Fed. 602 (D. C. Mont. 1920). For a general discussion of the trust fund doctrine, see 15A FLETCHER, CYCLOPEDIA ON THE PRIVATE LAW OF CORPORATIONS § 7369 (1938).

11. While it is true that the liability of a transferee is secondary and derivative, where a corporation has dissolved, the Commissioner is not required to proceed against it before asserting transferee liability. *United States v. Garfunkel*, 52 F. 2d 727 (S. D. N. Y. 1931); *Updike v. United States*, 8 F. 2d 913 (8th Cir. 1925).

12. *Scott v. Commissioner*, 117 F. 2d 36 (8th Cir. 1941). However, that liability is several so that the Commissioner need not join other transferees in a proceeding against him to enforce that liability. *Phillips v. Commissioner*, 283 U. S. 589 (1931).

13. INT. REV. CODE § 311 (f).

a transferee. While the Regulations¹⁴ do expand this definition, the determination in the last analysis, as to whether an individual, partnership or corporation can be held as a transferee, depends on the facts in each case.¹⁵

THE PROBLEM

Our concern in this paper is with the potential transferee liability consequences inherent in the sale and transfer of corporate assets.

Basically there are three methods by which corporate assets may be transferred.

(1) The corporation may make the sale itself, distributing to its stockholders the proceeds from such sale.

(2) The stockholders may first liquidate the corporation, obtain the assets themselves and sell them to the purchaser.

(3) The stockholders may sell their stock to the purchaser who can then obtain the assets by liquidating the corporation.

While other considerations¹⁶ certainly play an important part in determining which of these methods are used, it is doubtlessly true that federal tax consequences are among the most compelling determinants. Thus because of the double tax which would result from the use of the first method,¹⁷ few, if any, corporate sales are now conducted in that manner. Rather, the second or third method is utilized. The Internal Revenue Bureau has, of course, consistently argued that despite the method used, the transaction is a sale by the

14. U. S. Treas. Reg. 111, § 29.311-1 (1945). "The term 'transferee' as used in this section includes an heir, legatee, devisee, distributee of an estate of a deceased person, the shareholder of a dissolved corporation, the assignee or donee of an insolvent person, the successor of a corporation, a party to a reorganization as defined in Section 112, and all other classes of distributees."

15. Lessors' stockholders to which rentals were paid directly by lessees under terms of leases, were liable as lessors' "transferees" for income taxes on rentals. *Commissioner v. Western Union Tel. Co.*, 141 F. 2d 774 (2d Cir. 1944). See also: *Jacob et al. v. Commissioner*, 139 F. 2d 277 (9th Cir. 1943), *reversing*, 47 B. T. A. 381 (1942); *John Hancock Mutual Life Ins. Co. v. Helvering*, 128 F. 2d 745 (D. C. Cir. 1942), *reversing*, 42 B. T. A. 809 (1940). While the Commissioner has the burden of proving that the respondent is a transferee (INT. REV. CODE 1119 (a)); *Phillips v. Commissioner*, 283 U. S. 589 (1931)) the even more onerous burden to prove that no tax liability existed on the part of the transferor, rests on the transferee (*Wayne Body Corp.*, 22 B. T. A. 401, 413 (1931)).

16. For example, franchises or other valuable leaseholds might only be obtainable by purchasing the stock and maintaining the corporate entity; or the expense of conveying title where the corporation involved owns considerable real estate would make the sale of assets inexpedient; or the purchaser may not be willing to assume unknown or contingent liabilities of a corporation and, therefore, would refuse to purchase stock.

17. Assuming of course a gain on the sale, the first tax would be on the gain realized on the sale by the corporation; and the second tax would be the gain realized on liquidation by the stockholders (assuming that the value of the property distributed is in excess of the cost basis of the stock). INT. REV. CODE 117 (a) and (j). *Commissioner v. Court Holding Co.*, 324 U. S. 331 (1945).

corporation and should be taxed as such.¹⁸ Prior to the *Public Cumberland Service* case¹⁹ the Bureau was very successful in attacking on that ground transactions involving liquidation of the corporation followed by a sale of the assets (second method).²⁰ What the actual effect of the *Cumberland Public Service* case will be on that trend must await further decisions.²¹ In contrast to this, at least pre-Cumberland, success with reference to the second method, the Bureau has uniformly been defeated in its efforts to have the sale imputed to the corporation where the liquidation follows the sale of stock (third method).²²

At the outset, it should be noted that while we are for the most part concerned with the potential transferee liability of either the selling stockholders or the purchaser, in the event the Bureau's contention that the transaction was in fact a corporate sale is upheld, the transferee liability for corporate taxes other than those arising out of the transaction in question, must not be overlooked.²³

As is to be expected, it is in connection with the orthodox transfer (first method) that the major body of law involving transferee liability is to be found. Therefore, it is the principles enunciated in those cases which must be kept in mind whenever the sale of corporate assets by any method is under consideration.

LIABILITY AT LAW

As has already been indicated, the liability of a transferee may be either

18. The position of the Bureau was aptly stated by the Supreme Court in the *Court Holding* case: "A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities would seriously impair the effective administration of the tax policies of Congress." 324 U. S. 331, 334 (1945).

19. See note 3 *supra*.

20. *Meurer Steel Barrel Co. v. Commissioner*, 144 F. 2d 282 (3d Cir. 1944), *cert. denied*, 324 U. S. 860 (1945); *Guinness v. United States*, 73 F. Supp. 119 (Ct. Cl. 1947), *cert. denied*, 334 U. S. 819 (1948); *Rose Kaufman*, 11 T. C. 483 (1948), *aff'd*, 175 F. 2d 28 (3d Cir. 1949). *But see* *Howell Turpentine Co. v. Commissioner*, 162 F. 2d 319 (5th Cir. 1947); *A Campo Winery & Distilleries, Inc.*, 7 T. C. 629 (1946).

21. It would appear that taxability or non-taxability will depend on the trial court's finding of fact. Thus Justice Black stated: "It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. Here as in the *Court Holding Co.* case we accept the ultimate findings of fact of the Trial Tribunal." *United States v. Cumberland Public Service Co.*, 338 U. S. 451, 456 (1950). Compare the comparable treatment given to the equally perplexing problem of family partnership in *Commissioner v. Culbertson*, 337 U. S. 733 (1949).

22. *Dallas Downtown Development Co.*, 12 T. C. 114 (1949); *Steubenville Bridge Co.*, 11 T. C. 789 (1948); *J. T. S. Brown's Sons Co.*, 10 T. C. 840 (1948). *See*, however, dissenting opinion of Disney, J., in the *Dallas Downtown* case, *supra* at 126.

23. *Continental Baking Co. v. Helvering*, 75 F. 2d 243 (D. C. Cir. 1934); *Concrete Industries Co.*, 19 B. T. A. 655 (1930). Thus in *United States v. Armstrong*, 26 F. 2d 227 (8th Cir. 1928), transferees were held liable for a new tax retroactively levied.

at law or in equity. Since liability at law arises from the assumption of the liabilities of the seller, it is the purchaser who usually is accorded the dubious distinction of being held as a transferee on this ground. It is with reference to this potential source of liability that meticulous draftsmanship may well mean the difference between such transferee's liability or non-liability since it doubtlessly is not the intention of a prospective purchaser to assume liability for the tax imposed on the profit to be made by the seller.

In *Shepard v. Commissioner*,²⁴ the agreement for the purchase of the assets provided for the assumption by the purchaser of "all existing liabilities" of the seller corporation. The purchaser was held liable as a transferee for the corporate tax due on the profit made by the seller corporation on the sale of the assets. The liability of the purchaser was predicated on a dual basis, its assumption agreement and as the result of the application of equitable principles. For the present, we are concerned with the former. In this regard the court succinctly stated: ". . . petitioner, by his agreement to assume all of the Old Company's 'existing liabilities' became bound to pay the income tax which the consummation of said agreement created."²⁵ On the other hand, in *Reid Ice Cream Corp. v. Commissioner*,²⁶ the purchaser was more fortunate. The agreement provided that the purchaser "assumes and agrees with the company to discharge all liabilities of the company existing on this date" (the closing date). The Court of Appeals in reversing the Board of Tax Appeals, held there was no liability, either by statute or contract. The court said:

"On this sale, the seller made a profit of 68 per cent. It is unreasonable to assume that it was the intention of the petitioner to assume the liability for the tax imposed on this profit."²⁷

and further on in the opinion:

"A tax on the profits of a sale such as is involved here is one of extraordinary liability, and, unless assumed in plain terms, ought not to be imposed upon the transferee of the property."²⁸

How much weight can be given to the *Reid* case is conjectural. The difference in the language of the agreements in the *Reid* and *Shepard* cases would appear to be more nominal than real. In any event, it is clear that these cases set up a caveat which a purchaser's attorney disregards at his client's peril.

A further indication of the broad construction placed on assumption agreements by the courts can be gleaned from the cases of *Helvering v. Wheeling Mold & Foundry Co.*,²⁹ and *Continental Baking Co. v. Helvering*,³⁰ in which

24. 101 F. 2d 595 (7th Cir. 1939).

25. *Id.* at 598.

26. 59 F. 2d 189 (2d Cir. 1932).

27. *Id.* at 190.

28. *Id.* at 191.

29. 71 F. 2d 749 (4th Cir. 1934).

30. 75 F. 2d 243 (D. C. Cir. 1934).

the taxes involved were not on the profit on the sale. In the *Wheeling Mold & Foundry Co.* case, the vendees undertook "to pay, satisfy and discharge all the lawful debts of the vendor. . . ." The Board of Tax Appeals held the purchaser not liable as a transferee on the ground a tax was not a debt in the ordinary sense. However, the purchaser's relief was short-lived. The Court of Appeals for the Fourth Circuit unanimously reversed, and held the purchaser to be a transferee. The Court quoted with approval the following language from the case of *Tevander v. Ruysdael*:³¹

"It is apparent from the language used that the parties intended that the purchaser should assume all obligations or liabilities of the business. The parties knew that the law imposes income taxes. All parties knew that at the time of the sale the income taxes were liabilities in futuro; that they would become when imposed, a fixed liability, a thing owing to the government. The purchaser, therefore, by assuming the debts of the business, included income taxes of the business."³²

Similarly, in the *Continental Baking Co.* case, a corporation which purchased all the assets of another company and assumed "all existing liabilities" of the transferor was held as a transferee and therefore liable for taxes determined as due by the Commissioner at a time subsequent to the sale. The court said:

"We are of the opinion that such a liability may be imposed upon a transferee of the assets of a corporation against whom a tax was levied, providing that under the contract of purchase the transferee assumed the liability. . . . The mere fact that a claim of deficiency taxes is unknown at the date of the transfer does not relieve the transferee from liability."³³

LIABILITY IN EQUITY

It is with reference to the liability of the transferee in equity that we reach the kernel of our inquiry.

Where the first method of selling and disposing of the corporate assets is utilized, there would hardly appear to be any question but that to the extent of the proceeds received, the stockholders of the seller corporation can be held as transferees.³⁴ However, it is in connection with the position of the purchaser in that transaction that considerable doubt has been expressed. One eminent authority has unequivocally stated, "it is hard to see a sound basis for transferee liability on Purchaser."³⁵ While at first blush, it might appear to be flying in the face of reason to hold as a tax-liable transferee the purchaser who bought and paid value for the assets, it is submitted that on closer analysis the Bureau's position takes on added weight.

31 299 Fed. 746 (7th Cir. 1924).

32. *Helvering v. Wheeling Mould Foundry Co.*, 71 F. 2d 749, 752 (4th Cir. 1934).

33. 75 F. 2d 243, 244 (D. C. Cir. 1934).

34. *Forest Glen Creamery Co. v. Commissioner*, 123 F. 2d 522 (7th Cir. 1941); *Humbert v. Commissioner*, 24 B. T. A. 828 (1931); *Fifty Three West Seventy-Second Street, Inc.*, 23 B. T. A. 164 (1931); *Robert N. Parrett*, 15 B. T. A. 1313 (1929).

35. Magill, *Sales of Corporate Stock or Assets*, 47 COL. L. REV. 707, 718 (1947).

The Court of Appeals in the *Shepard* case succinctly stated the Bureau's position:

"Equally clear and definite must be the holding that one who dispossesses another company of all its assets, paying the consideration therefor to a third party, and leaving the propertyless corporation unable to pay its debts, including taxes which were inchoate at the time, becomes a trustee and liable in such trusteeship for taxes and other debts in an amount not exceeding the value of the property taken from the debtor taxpayer."³⁶

In a similar vein, the Board of Tax Appeals noted in a case involving transferee liability covering prior years:

"The courts have uniformly held the purchasing corporation liable to creditors of the selling corporation, to the extent of the value of the property received, the sale being in fraud of creditors and the purchaser being a party to such fraud through his knowledge that the result of the transaction must necessarily leave such creditors with no assets from which to satisfy their claims."³⁷

The position of those who would deny any liability on the part of a purchaser who has paid value finds support in the following terse language from the *Reid* case:

"A purchaser of property for value has, in his position as a transferee, no liability to pay his vendor's tax. . . ."³⁸

It is submitted that this latter statement gratuitously assumes that which in each case must be ferreted out from the facts. It certainly would appear that a strong argument can be made that a purchaser of corporate assets who knows that the consideration he pays will be distributed to the stockholders is lacking in the requisite good faith so as to entitle him to be protected against the claims of creditors of the selling corporation. At any rate, the Bureau has and will apparently continue to take that position whenever expedient and in view of that fact alone, the possibility of this unexpected liability merits consideration by the attorney for the purchaser.

While there is a paucity of cases involving transferee liability where either the second or third method has been utilized, it would seem the principles laid down in the *Shepard* and kindred cases would be applicable. Thus, in *J. T. Wurtsbaugh*,³⁹ the Lodwick Lumber Company entered into a contract for the sale of timber. Prior to completion of the contract, it liquidated and transferred its assets to its shareholders who thereafter completed the sale. The court, after imputing the sale to the corporation under the Court Holding doctrine, held one of the shareholders of the lumber company liable as a transferee for the tax on the gain in the sale. The court stated:

36. 101 F. 2d 595, 599 (7th Cir. 1939).

37. *Concrete Industries Co.*, 19 B. T. A. 655, 659 (1930).

38. 59 F. 2d 189, 191 (2d Cir. 1932).

39. 13 T. C. 1059 (1949).

"As a result of receiving assets of Lodwick on dissolution, petitioner stood in the shoes of the dissolved corporation and was liable as transferee for payment of Lodwick's incurred tax liability for 1941 to the extent of the value of such assets."⁴⁰

While the case for holding the shareholder who sold assets it received from the corporation is therefore stronger than that for holding the purchaser, still in view of the broad language employed in the *Shepard* and *Concrete Industries* cases, caution is dictated in either case. Up to this date the amount of potential transferee liability involved in the sale of corporate assets accomplished by a sale of stock followed by liquidation is limited. The court has found little merit to the Bureau's contention that the transaction is in substance a sale by the corporation. However, because of a vigorous Tax Court dissent,⁴¹ prognostication is hazardous and it is certainly within the realm of possibility that the Tax Court may reevaluate its present position.

The basic question—that is, whether the seller of the stock or the purchaser could be held as a transferee—appears to have been definitively answered in the recent case of *J. T. S. Brown & Son, Co.*⁴² While certain earlier cases⁴³ seemed to indicate that the seller of the stock could be held as a transferee, the *Brown* case definitely decides the contrary. The facts of the *Brown* case, insofar as is pertinent here are relatively simple. One Brown sold his stock to one Favret who shortly thereafter liquidated the corporation and received all of the assets. The Commissioner attempted to hold both Brown and Favret as transferees. While the court disallowed so much of the liability as was predicated on the Commissioner's contention that the sale in substance was of the assets of the corporation, there were certain other unpaid taxes due which necessitated a decision as to whether the seller of the stock or the purchaser should be held as a transferee for those unpaid taxes. The Tax Court decided that the purchaser and not the seller was liable as a transferee, noting:

"For this reason we must decide the issue of transferee liability. It is clear from the facts as found by us that petitioner Creel Brown, Jr. is not liable as a transferee. He simply sold his shares of stock to a willing buyer and received cash for them. He received none of the assets of the company in liquidation. Under these circumstances, he is not liable as a transferee. On the other hand, it is clear to us that petitioner James R. Favret is liable as a transferee for whatever deficiencies and penalties are determined against the company in a recomputation under Rule 50. The company was completely liquidated and left with no assets and Favret received all the assets, which had a value considerably in excess of all the liabilities of the company, including the liability for federal taxes."⁴⁴

40. *Id.* at 1071.

41. *Dallas Downtown Development Co.*, 12 T. C. 114 (1949); see Disney, J., dissenting at 126.

42. 10 T. C. 840 (1948).

43. *George M. Brady, et al.*, 22 B. T. A. 596 (1931); *Taylor Oil & Gas Co., et al.*, 15 B. T. A. 609 (1929). See also *Caire v. Commissioner*, 101 F. 2d 992 (5th Cir. 1939). *Contra*: *Southern Bell Telephone & Telegraph Co.*, 34 B. T. A. 540 (1936), *aff'd*, 102 F. 2d 397 (6th Cir. 1939).

44. 10 T. C. 840, 852 (1948).

Thus it would appear that the seller of stock is in a much stronger and the buyer of stock in a much more vulnerable position than their counterparts in a case where the disposition of the assets has been accomplished by a liquidation followed by a sale of the assets. In that case there hardly appears to be any question but that the seller of the assets would be liable as a transferee⁴⁵ while the transferee liability of the purchaser still remains a moot question.⁴⁶

CONCLUSION

The tax practitioner faced with a contemplated transaction involving the sale or purchase of corporate assets, would do well to consider carefully the potential transferee liability consequences inherent in the transaction. Certainly it is only by such an appraisal that all danger signals can be noted and proper safeguards set up. Further, such an appraisal prevents the possibility of a totally unexpected awakening when transferee liability is asserted against the client by the Commissioner and gives to the client at the very inception of the transaction the complete tax picture to which he is entitled.

45. See notes 34, 39 and 40 *supra*.

46. See notes 35, 36, 37 and 38 *supra*.