Julia R. Swords Trust v. Commissioner, 142 T. C. No. 19 (2014)

The U. S. Tax Court ruled that the Julia R. Swords Trust and related trusts were not liable as transferees under IRC § 6901 for Davreyn Corp. ‘s unpaid federal income taxes. The court determined that Virginia state law, rather than federal law, governs the determination of transferee liability. The trusts had sold their stock in Davreyn to Alrey Trust without knowledge of Alrey’s subsequent plan to liquidate Davreyn and illegitimately avoid taxes on the sale of Davreyn’s assets. This ruling clarifies the application of state law in assessing transferee liability and highlights the importance of the transferee’s knowledge and intent in such transactions.

Parties

The petitioners were the Julia R. Swords Trust, David P. Reynolds Trust, Margaret R. Mackell Trust, and Dorothy R. Brotherton Trust, with Margaret R. Mackell, Dorothy R. Brotherton, and Julia R. Swords serving as co-trustees. The respondent was the Commissioner of Internal Revenue.

Facts

Davreyn Corp. was a Virginia corporation primarily holding Alcoa stock. The petitioner trusts owned all of Davreyn’s common and preferred stock. In February 2001, the trusts sold their Davreyn stock to Alrey Trust for $13,102,055. Alrey Trust subsequently liquidated Davreyn and sold its Alcoa stock, attempting to offset the gains through a Son-of-Boss transaction involving BMY stock. The trusts were unaware of Alrey Trust’s plan to liquidate Davreyn and avoid taxes. The trusts reported gains from the stock sale on their 2001 tax returns and paid the associated taxes. The IRS assessed a tax deficiency against Davreyn for its taxable year ending February 15, 2001, and sought to collect this deficiency from the trusts as transferees.

Procedural History

The Commissioner issued notices of transferee liability to the trusts on February 25, 2010, asserting that the trusts were liable for Davreyn’s unpaid tax liability of $4,602,986, plus additions to tax, penalties, and interest. The trusts petitioned the U. S. Tax Court for a review of these notices. The Commissioner had previously assessed a deficiency against Davreyn, which went uncontested and resulted in an assessment on January 14, 2009. The Tax Court consolidated the cases of the four trusts for hearing and decision.

Issue(s)

Whether the petitioner trusts are liable as transferees under IRC § 6901 for Davreyn Corp. ‘s unpaid federal income tax liability for the taxable year ending February 15, 2001?

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Rule(s) of Law

IRC § 6901(a) allows the Commissioner to collect unpaid federal income tax from a transferee if an independent basis exists under applicable state law or state equity principles for holding the transferee liable for the transferor's debts. The applicable state law is that of the state where the transfer occurred, which in this case is Virginia law.

Holding

The U. S. Tax Court held that the petitioner trusts are not liable as transferees under IRC § 6901 for Davreyn's unpaid federal income tax liability. The court determined that Virginia law, rather than federal law, governs the determination of transferee liability, and no independent basis under Virginia law existed to hold the trusts liable.

Reasoning

The court rejected the Commissioner's two-step analysis, which proposed first recasting the transactions under federal law and then applying state law to the recast transactions. Instead, the court adhered to the principle established by the U. S. Supreme Court in Commissioner v. Stern that state law governs the determination of transferee liability under IRC § 6901. The court found no Virginia case law supporting the application of a substance over form doctrine to recast the transactions in question. Additionally, the court determined that the trusts did not know of, nor had reason to suspect, Alrey Trust's plan to liquidate Davreyn and avoid taxes. The court examined Virginia's fraudulent conveyance statutes (Va. Code Ann. §§ 55-80 and 55-81) and the trust fund doctrine, concluding that none of these provided a basis for holding the trusts liable as transferees. The court found that the trusts received valuable consideration for their Davreyn stock and that Davreyn remained solvent at the time of the sale, with sufficient assets to cover its existing tax liabilities.

Disposition

The U. S. Tax Court entered decisions in favor of the petitioners, holding that they were not liable as transferees under IRC § 6901 for Davreyn Corp. 's unpaid federal income tax liability.

Significance/Impact

This case reinforces the principle that state law governs the determination of transferee liability under IRC § 6901, rejecting the Commissioner's attempt to apply a federal substance over form doctrine in such cases. It underscores the importance of the transferee's knowledge and intent in assessing liability under state fraudulent conveyance laws and trust fund doctrines. The decision provides guidance for taxpayers and practitioners on the application of IRC § 6901 and highlights the need

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for clear evidence of fraudulent intent and insolvency to establish transferee liability. Subsequent courts have followed this precedent in similar cases, emphasizing the role of state law in determining transferee liability.

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