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The disappearance of the requirement that the Internal Revenue Service exhaust all reasonable collection efforts against the primary obligor

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The Internal Revenue Service ("IRS") can, and often does, attempt to collect unpaid income taxes from the recipient of assets from a delinquent taxpayer. To do so, the IRS utilizes the procedure prescribed by Section 6901 of the Internal Revenue Code ("Section 6901") to enforce secondary liability against the transferee.[1] For decades, the United States Tax Court required the Commissioner of the IRS (the "Commissioner") to exhaust all reasonable collection efforts against the primary obligor as a condition precedent to imposing liability on a transferee. This rule safeguarded against the Commissioner overlooking a primary obligor who may still be able to satisfy all or part of the outstanding indebtedness in favor of an individual or entity with deeper pockets.

Recently, an increasing number of Memorandum Decisions in the United States Tax Court have summarily disposed of this requirement by stating that the existence and extent of transferee liability must be determined by state law, which often does not require the exhaustion of all reasonable collection efforts. Nevertheless, this rule has yet to be affirmed in a United States Tax Court Opinion, and the legislative and judicial history of the requirement to exhaust all reasonable collection efforts may not support its relegation to state law.

Origin of Transferee Liability

Prior to 1926, there was no statutory provision or procedure by which the Commissioner could collect income taxes from the transferee of assets from a delinquent taxpayer. If the Commissioner wanted to collect an outstanding tax obligation, he was required to obtain a judgment against the taxpayer, and then institute a creditor's bill in equity to set aside any transfer and to subject the transferred property to the outstanding liability.[2]

The Revenue Act of 1926 provided the first statutory mechanism for the Commissioner to initiate direct proceedings against a transferee of assets. Section 280 of the Revenue Act of 1926 allowed the Commissioner to impose liability, at law or in equity, against a transferee in the same manner and subject to the same provisions and limitations as it could against the taxpayer by permitting creditors to follow transferred property from a debtor to a third party.[3] According to the Senate Finance Committee Report, the purpose of Section 280 was to enable the Commissioner to enforce transferee liability through the procedure provided in the Revenue Act.[4] The Conference Report accompanying H.R. 1 on Section 280 acknowledged the need to pursue the primary obligor by noting that "where the taxpayer remains in existence after the transfer, an unsatisfied return of a distraint warrant, issued in pursuance of an assessment lawfully made after a deficiency letter has been mailed to the taxpayer, would suffice in lieu of an unsatisfied execution to establish the liability of the taxpayer."[5]

Section 280 was implemented to codify existing practices, not to "define or change existing liability."[6] In an opinion released soon after the enactment of Section 280, the U.S. Board of Tax Appeals stated that Section 280 demonstrated Congress' intent that the same conditions precedent (i.e., exhausting all collection efforts) be met as existed prior to the enactment of Section 280.[7] The court explained that "no new liability is created and the [Revenue Act of 1926] does not purport to provide for a proceeding against the transferee before action would otherwise lie against such transferee."[8] After the enactment of Section 280, the United States Tax Court consistently required the Commissioner to prove the exhaustion of all reasonable collection efforts against the transferor in cases of transferee liability.

Procedural Versus Substantive Elements of Transferee Liability

In *Commissioner v. Stern9*, the U.S. Supreme Court distinguished between the substantive and procedural elements of liability under Section 6901. The Supreme Court explained that because Section 311 (the successor to Section 280) of the Revenue Act is a procedural statute, courts must look to other sources for the elements of the substantive liability, such as state fraudulent transfer and conveyance statutes.[10] Consequently, the Supreme Court held that for the Commissioner to bring a claim under Section 6901, the cause of action must be recognized by the state in which the alleged transaction and transfer occurred.[11]

In the immediate aftermath of *Stern*, little changed in the Tax Court's analysis of transferee liability, and the requirement to exhaust all reasonable collection efforts remained a condition precedent to the enforcement of secondary liability.[12] The Tax Court did not apply a specific set of elements to analyze liability under Section 6901 and only discussed those conditions precedent that may be in dispute in any given case.

The Tax Court's approach to transferee liability under Section 6901 changed in *Gumm v. Commissioner13* with the formation of a six-element test to establish transferee liability under Section 6901. While each element is deeply rooted in Tax Court precedent for transferee liability, they had never been compiled into a singular test. The court stated that the procedural requirements of transferee liability which must be established by the Commissioner under section 6901(a) are: (1) that the alleged transferee received property of the transferor; (2) that the transfer was made without consideration or for less than adequate consideration; (3) that the transfer was made during or after the period for which the tax liability of the transferor accrued; (4) that the transferor was insolvent prior to or because of the transfer of property or that the transfer of property was one of a series of distributions of property that resulted in the insolvency of the transferor; (5) that all reasonable efforts to collect from the transferor were made and that further collection efforts would be futile; and (6) the value of the transferred property (which determines the limit of the transferee's liability). The Tax Court cited prior Tax Court decisions in support of each element.

The so-called *Gumm* elements were called into question only four years later when the Tax Court held that strict reliance on the elements is improper because state law dictates substantive liability of an alleged transferee under Section 6901(a).[14] The peril of relying on the *Gumm* elements, according to Judge Halpern, is the possibility of deviating from the substantive elements of transferee liability under the applicable state law. For example, certain provisions in statutes such as UFTA or UFCA (which have been collectively adopted by 45 states and are usually the underlying basis to impose liability under Section 6901(a)) allow a creditor to state a claim for constructive fraud with proof of the lack of fair consideration by a person who is or will be rendered insolvent. In this situation, the debtor's intent to defraud is not a necessary element. Alternatively, actual fraud may be proven when the debtors acted with the intent to defraud its creditor even if the debtor is not rendered insolvent by such a transferor and provided fair consideration. In these situations, all six *Gumm* elements are not necessarily to establish the substantive liability that is dictated by state law. For this reason, Judge Halpern concluded that elements outlined in *Gumm* are only required to prove transferee liability if necessary under state law. At no point did Judge Halpern discuss the viability of the requirement that the Commissioner exhaust all reasonable collection efforts against the transferor.

The Disappearance of the Requirement to Exhaust All Reasonable Collection Efforts

Recent Memorandum decisions from the United States Tax Court have held that the Commissioner is not required to exhaust all reasonable collection efforts against the transferor in order to succeed on a claim against a transferee. These cases have cited *Hagaman* as support.

In *Kardash v. Commissioner*, T.C. Memo. 2015-51, Judge Goeke summarily concluded that the Florida Uniform Fraudulent Transfer Act does not require a creditor to pursue all reasonable collection efforts against the transferor and, therefore, the Commissioner was not required to exhaust collection efforts against the transferor. *Id. at* *9. In a footnote, the court cites to Judge Halpern's decision in *Hagaman* as support. The same reasoning was adopted in *Shockley v. Commissioner*, T.C. Memo. 2015-113. But in *Tricarichi v. C.I.R.*, T.C. Memo. 2015-201, the Tax Court held that in certain circumstances the IRS may be required to show that it exhausted all reasonable efforts to collect the tax liability from the transferor before proceeding against the transferee.

None of those cases, all non-binding Tax Court Memorandums, deal with the question of whether the requirement to exhaust all reasonable collection efforts is a substantive element of transferee liability that is governed by state statutes, or whether it is a procedural requirement of transferee liability that is governed by federal law, and therefore a viable condition precedent. *Gumm* introduced the elements as a procedural requirement for liability under Section 6901(a). Unlike the other *Gumm* elements of transferee liability, however, the requirement that the Commissioner first exhaust all reasonable collection efforts against the transferor can be traced back to federal common law as a procedural requirement of transferee liability. Had it not been added into the formulaic test in *Gumm*, it may never have been questioned or doubted.

Whether the Commissioner exhausted all reasonable collection efforts against the primary obligor does not prove whether the underlying transfer was fraudulent or hindered the Commissioner's ability to collect delinquent income taxes from the taxpayer. It is part of the procedure the Commissioner is required to fulfill before imposing secondary liability, such as sending a notice of deficiency and instituting the proceedings within one year after the expiration of the period of limitations for assessment against the transferor.[15] These procedures are not required by UFTA, but are still considered conditions precedent to the enforcement of liability under Section 6901(a).

It is difficult to imagine the Tax Court backing away from the trend of eliminating the requirement to exhaust all reasonable collection efforts. Yet, it will remain an open issue and potential argument for transferees until it is definitively decided in a Tax Court Memorandum.

This issue was recently brought back to the attention of Judge Halpern in a motion for summary judgment filed by the petitioner on the grounds that the Commissioner had failed to exhaust all reasonable collection efforts against the primary obligor.[16] That motion was denied without a discussion as to the viability of the all reasonable collection effort because the court found that it could not sufficiently review whether the Memorandum Opinions called into question by the Motion (*Kardash* and *Shockley)* were properly decided without delaying the trial that was set to begin in two months. The court also held that an issue of fact existed as to whether further collection actions would have yielded positive results.

Should the Tax Court hold that the exhaustion of collection efforts is required only to the extent provided by state law, it may still be relevant to a transferee liability case under Section 6901. In *Hagaman*, after concluding that the *Gumm* elements are not strictly required, Judge Halpern stated that the inquiry whether the Commissioner exhausted all reasonable collection efforts remains a useful inquiry in transferee liability in equity. The Tax Court has not further elucidated on what is meant by "useful inquiry," and that loose standard will need to be addressed in subsequent decisions. ■

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1. *Bellin v. Commissioner*, 65 T.C. 676, 683 (1975).
2. *United States v. Updike*, 281 U.S. 489 (1930).
3. *Summary Procedures Against Transferee of Assets Under the Revenue Acts of 1926 and 1928*, 5 St. John's L. Rev. 1 (2014)
4. *See* Senate Finance Committee Report of Section 280 of the 1926 Revenue Act, p. 30.
5. Conf. Report to accompany H.R. 1, H.R. Rep. No. 356, 69th Cong., 1st Sess., February 22, 1926, p. 44.
6. Senate Finance Committee Report of Section 280 of the 1926 Revenue Act, p. 30.
7. *Wire Wheel Corp. v. Commissioner*, 16 B.T.A. 737, 742 (1929).
8. *Id.*
9. *C.I.R. v. Stern*, 357 U.S. 39, 44, (1958).
10. *Id.* at 44.
11. *Id.*
12. *Millikin v. Commissioner*, T.C. Memo. 1959-210; *Holmes v. Commissioner,* 47 T.C. 622, 630 (1967); *Zadorkin v. Commissioner*, T.C. Memo. 1985-137.
13. *Gumm v. C.I.R.*, 93 T.C. 475 (1989), *aff'd,* 933 F.2d 1014 (9th Cir. 1991)
14. *Hagaman v. C.I.R.*, 100 T.C. 180, 183 (1993).
15. *Oyer v. C.I.R.*, 85 T.C.M. (CCH) 1510 (T.C. 2003) *aff'd sub nom. Oyer v. Comm'r of Internal Revenue Serv.*, 97 Fed. Appx. 68 (8th Cir. 2004); *Bresson v. C.I.R.*, 111 T.C. 172, 183 (1998) *aff'd,* 213 F.3d 1173 (9th Cir. 2000).
16. *Leroy Loudermilk A.K.A. Lee Loudermilk v. Commission of Internal Revenue Service*, No. 12054-11.

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