Office of Chief Counsel
Internal Revenue Service
Memorandum

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to: Lisa P. Lafferty
General Attorney (Washington, Group 3)
(Small Business/Self-Employed)

from: Nancy M. Galib
Senior Technician Reviewer, Branch 4
(Procedure & Administration)

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subject:

This Chief Counsel Advice responds to your request for assistance dated May 15, 2008. This advice may not be used or cited as precedent.

LEGEND

Corporation A =
Corporation B =
tax years 1-3 =
amount 1 =
Month Year 1 =
Mr. Y =
Date 1 =
Ms. Z =

ISSUES

What theory of liability applies when a corporation, after an IRS levy, discontinues operations and transfers its contracts to a newly formed corporation that commences operation of the same business with the same employees, equipment and customers.

CONCLUSIONS

Corporation B is a successor in interest of Corporation A.

FACTS

Corporation A is a Puerto Rico corporation that operated a business and had contracts with several corporate customers. Corporation A currently owes employment tax liabilities for tax years 1-3. Federal tax liens were filed with respect to the liability and the IRS levied on Corporation A's accounts receivable collecting approximately $amount 1. In Month Year 1, after the IRS levy, Corporation A's corporate president, Mr. Y, discontinued operations. Corporation A remains listed as an active corporation with the Puerto Rico Department of State.

On Date 1, Mr. Y formed a new corporation, Corporation B. Although Mr. Y is not listed as an incorporator of Corporation B, Mr. Y's wife, Ms. Z, is listed as an incorporator. She was also vice president of Corporation A. Revenue Officer stated that Mr. Y admitted closing Corporation A due to the levy and opening Corporation B in order to keep Corporation A's employees working. Any assets owned by Corporation A are now used by Corporation B. Corporation A's former customers now make payments to Corporation B.

Mr. Y claims he is not an officer of Corporation B.

The corporate officers of Corporation B are unknown and the shareholders of both Corporation A and Corporation B are unknown.

LAW AND ANALYSIS

1. Alter Ego

I.R.C. § 6321 creates a lien in favor of the United States upon a delinquent taxpayer's property and rights to property. Property ostensibly held by third parties may fall within the ambit of I.R.C. § 6321 if the third party holds the property as the taxpayer's alter ego. G.M. Leasing Corp. v. United States, 429 U.S. 338, 350-51 (1977). The IRS may levy on all of the assets of an alter ego corporation to collect the liability of a taxpayer if "the separate corporate entity is merely a sham, i.e., it does not exist independent of its controlling shareholder and that it was established for no reasonable business purpose or for fraudulent purposes." Oxford Capital Corp. v. United States, 211 F.3d 280, 284 (5th Cir. 2000). The alter ego doctrine generally involves piercing the corporate veil to hold a shareholder liable for the debts of a corporation or reverse piercing to hold the corporation liable for the debts of a shareholder. When applying the doctrine, courts look "at the level of control evidenced by the actual, substantial relationship of the parties." William M. Fletcher, Fletcher Cyclopedia of the Law of Corporations § 41.10 (2007).

Some jurisdictions have imposed alter ego liability absent a formal stock ownership relationship. Shades Ridge Holding Co. v. United States, 888 F.2d 725, 729 (11th Cir. 1989) (holding a corporation liable for an individual's tax liability even though the individual was not a shareholder); Labadie Coal Co. v. Black, 672 F.2d 92, 97 (D.C. Cir. 1982) (court looked to control, not mere "paper ownership"). Other jurisdictions have declined to apply the alter ego doctrine "unless one of the 'alter egos' owns stock in the other." Bollore S.A. v. Import Warehouse, Inc., 448 F.3d 317, 325 (5th Cir. 2006) (citing Permian Petroleum Co. v. Petroleos Mexicanos, 934 F.2d 635, 643 (5th Cir. 1991)) (applying well established Texas case law). In both Shades Ridge and Labadie, the individual taxpayer "controlled" or "dominated" the alter ego entity. In two separate tax collection cases, the District Court for the Eastern District of Pennsylvania found one corporation to be another corporation's alter ego when neither corporation was a shareholder of the other. Today's Child Learning Center Inc. v. United States, 40 F. Supp.2d 268, 272-74 (E.D. Pa. 1998); Ross Controls Inc. v. U.S. Dept. of Treasury I.R.S., 164 B.R. 721, 726-27 (E.D. Pa. 1994). In both cases, the court principally applied successor liability and then stated that the successor corporation was also liable as an alter ego. In neither case, however, did the court disregard the corporate entity; the corporation was not liable as a shareholder or because it exercised undue control. Rather, liability was imposed because the corporation was a continuation of its predecessor corporation. In Today's Child Learning and Ross, the original and successor corporations had the same owners; continuity of ownership is often a key factor in the successor liability analysis. Alter ego and successor liability are easily confused, but distinct, doctrines. See Explosives Corp. of America v. Garlam Enterprises Corp., 615 F. Supp. 364, 368 (D.P.R. 1985) ("[T]he doctrine of disregarding the corporate entity is distinct from the question of a successor's liability.").

State law generally determines when a corporation is an alter ego. Puerto Rico law recognizes the alter ego doctrine and appears to recognize its application to a corporate shareholder. The Puerto Rico Supreme Court held that "a corporation is the alter ego or business conduit of its stockholders when there is such unity of interest and ownership that the personalities of the corporation and the stockholders--whether natural or *artificial persons*--are intermingled and, as a result, the corporation actually is not a separate and independent entity." Departamento de Asuntos del Consumidor v. Alturas de Florida Development Corp. and Luis Acosta Construction Corp., 1993 P.R.-Eng. 840226 (P.R. 1993) (emphasis added). The corporation will be the mere alter ego of its stockholders, "with the benefits produced by the corporate business accruing exclusively and personally to them, … if it is necessary to prevent fraud or the accomplishment of an illicit purpose, or to prevent an injustice or wrong." Id. (citing Cruz v. Ramirez, 75 P.R.R. 889, 895 (1954)). "The party seeking to pierce the corporate veil has the burden of proving that there is no adequate separation between the corporation and the stockholder, and that the facts are such that acknowledging said legal personality would be tantamount to 'sanctioning fraud, promoting injustice, evading a legal obligation, defeating public policy, justifying inequity, protecting fraud, or defending crime.'" Id. (citing Srio. D.A.C.O. v. Comunidad San José, Inc., 130 D.P.R. 782, 798 (1992)).

Courts deciding whether to disregard the corporate entity are guided by the following factors:

> (1) the stockholder's control of corporate affairs; (2) the treatment of corporate assets as personal assets; (3) the unrestricted withdrawal of corporate capital; (4) the commingling of corporate and personal assets; (5) the inadequate structure of corporate capital; (6) the lack of corporate records; (7) the nonobservance of corporate formalities; (8) inaction of the other officers and directors; (9) failure to declare dividends; (10) the stockholder's holding himself or herself out as being personally liable for the obligations of the corporation; and (11) management of the corporation without regard to its independent existence.

Id. at n.3.

A critical consideration when evaluating whether Corporation B is an alter ego of Corporation A is whether sufficient stock ownership or control exists to justify application of the alter ego doctrine. If neither corporation owns stock of the other or exercises control of the other, then an alter ego relationship between Corporation A and Corporation B does not exist and an alter ego lien would not be appropriate. If, however, one corporation controls the other to the extent that their separateness should be disregarded under the above factors, then an alter ego lien would be appropriate.

2. Successor Liability

Generally, a corporation that acquires the assets of another corporation is not liable for the debts of the transferor corporation. This general rule is subject to certain exceptions. Successor liability law embodied in most jurisdictions imposes liability in the following circumstances: (1) when the successor expressly assumes the liabilities; (2) when the transaction amounts to a de facto merger; (3) when the successor is a mere continuation of the seller corporation; and (4) when the transaction is entered into fraudulently to escape liability. Dayton v. Peck, Stow and Wilcox Co., 739 F.2d 690, 692 (1st Cir. 1989); Feliciano v. Valsyn, S.A., Civ. No. 04-1809 PG, 2006 WL 3718177 (D.P.R.). Successor liability is generally determined under state law. LiButti v. United States, 178 F.3d 114, 124 (2d Cir. 1999).

A. Fraudulent Transaction

Successor liability applies in this case because the transaction at issue was entered into for the fraudulent purpose of escaping liability. Under Puerto Rican law, a presumption of fraud on creditors arises when a debtor transfers property for no consideration.[1] "The statute essentially states that any contract in which a debtor alienates goods for free (or gratuitously) may be considered fraudulent against any creditors." Feliciano, 2006 WL 3718177 at *5. The presumption in this case arises because Corporation A transferred assets to Corporation B for no consideration after Corporation A owed a federal tax liability. Further, Corporation A's acts (via Mr. Y) evidence an intention to avoid creditors. See id.; see also Ed Peters Jewelry Co. v. C & J Jewelry Co.,124 F.3d 252, 266 (1st Cir. 1997). Mr. Y incorporated Corporation B shortly after the IRS levied on Corporation A's receivables and has admitted starting Corporation A due to the IRS levy. Mr. Y was president of Corporation A and signed contracts as president of Corporation B. His wife incorporated Corporation A and Corporation B. Corporation B operates the same business with the same employees and serves the same customers. These facts militate towards a finding that the transaction was nothing but an attempt to escape liability. Recognition of both Corporation A and Corporation B would be "tantamount to sanctioning the evasion of obligations, fraud, injustice or the defeat of public policy." Gonzalez v. San Just Corp., 1 P.R. Offic. Trans. 240 (P.R. 1973). In short, "[i]f a corporation goes through a mere change in form without a significant change in substance, it should not be allowed to escape liability." Brandon v. Anesthesia & Pain Management Associates, Ltd., 419 F.3d 594, 600 (7th Cir. 2005) (citing Vernon v. Schuster, 688 N.E. 1172, 1176 (Ill. 1997)).

B. Other Theories of Successor Liability

The de facto merger and mere continuation exceptions both generally look to whether the successor corporation shares common officers, directors and shareholders with the transferor corporation. See John S. Boyd Co., v. Boston Gas Co., 992 F.2d 401, 408-09 (1st Cir. 1993); Explosives Corp., 615 F. Supp. at 368. Among other factors that may be considered are continuity of business operations, management, assets, personnel and physical location. Courts may also look to the sufficiency of consideration rendered in exchange for the transferring corporation's assets. Id.; Crawford Harbor Associates v. Black Construction Co., 661 F. Supp. 880, 884 (E.D. Va. 1987). The de facto and mere continuation terms are often "used by courts interchangeably" to refer to similar concepts. Milliken & Co. v. Duro Textiles, LLC, 887 N.E.2d 244, 255 n.15 (Mass. 2008). For a transaction to constitute a de facto merger, however, some courts require that the successor's stock be transferred to the original corporation's shareholders in exchange for the assets of the original corporation. Tracey by Tracey v. Winchester Repeating Arms Co., 745 F. Supp. 1099, 1110 n.18

[1] P.R. Laws Ann., tit. 31, § 3498 (2005) provides, "Contracts by virtue of which the debtor alienates property, for a good consideration, are presumed to be executed in fraud of creditors." The editors note to the English version of the statute explains that "[t]he phrase 'for a good consideration' in the English of this section reads in the Spanish 'a titulo gratuito'. It appears to mean consideration founded on natural duty, moral obligation, affection, generosity, etc., as distinguished from 'valuable consideration.' For this distinction, see Black's Law Dictionary 'Consideration'; 17 Corpus Juris Secundum, Contracts, § 92, p. 438; 12 American Jurisprudence, Contracts, § 78, p. 569." Puerto Rico has not adopted the Uniform Fraudulent Transfer Act (UFTA) or the Uniform Fraudulent Conveyance Act (UFCA).

(E.D. Pa. 1990). This requirement is consonant with the purpose of a de facto merger: treating a transaction having the economic effect of statutory merger as a statutory merger even though the transaction is cast as an asset sale. Fletcher, supra § 7124.20 The facts do not indicate that Corporation B transferred stock in exchange for assets, so the de facto merger theory would not apply.

Whether a corporation is a mere continuation "turns upon factfinding inquiries into five emblematic circumstances: (1) a corporation transfers its assets; (2) the acquiring corporation pays less than adequate consideration for the assets; (3) the acquiring corporation continues the divesting corporation's business; (4) both corporations share at least one common officer who was instrumental in the transfer; and (5) the divesting 'corporation is left incapable of paying its creditors." Ed Peters Jewelry Co.,124 F.3d at 268 (citations omitted). The mere continuation theory cannot be relied upon at this point because we do not know the identity of the stockholders of either corporation or the identity of the corporate officers of Corporation B. Continuity of ownership and management are vital considerations. Gonzalez, 1 P.R. Offic. Trans. 240 (Puerto Rico Supreme Court refused to find a merger or identity between two corporations because plaintiff did not present evidence regarding commonality of corporate ownership, directors, officers, stockholders, or operations).

The Puerto Rico Supreme Court has principally addressed successor liability in the context of labor law. Puerto Rico Labor Relations Board v. Asoc. Condominos Playa Azul I,17 P.R. Offic. Trans. 25 (P.R. 1986). In order to impose liability on the successor entity, "substantial similarity in the management of the business and continuity in the identity of the business before and after the change" is required. Id. The successorship doctrine may apply "when there is a sale or transfer of assets, even without… continuity of financial interest or management control." Id. When applying successor liability in the context of labor cases, Puerto Rican courts have looked at the following factors: (1) whether there has been a substantial continuity of business operations; (2) whether the new employer uses the same plant; (3) whether he uses the same or substantially the same work force; (4) whether he uses the same or substantially the same supervisory personnel, (5) whether the same jobs exist under substantially the same working conditions; (6) whether he uses the same machinery, equipment and methods of production; and (7) whether he produces the same product. Rodriguez Oquendo vs. Petrie Retail Inc. D.I.P., No. CC-2004-900, 2006 WL 999949 (P.R.); EEOC v. MacMillan Bloedel Containers, Inc., 503 F.2d 1086 (6th Cir. 1974). These factors are borrowed directly from the federal courts and have been collectively referred to as the substantial continuity test. The test generally allows for broader liability because it does not require continuity of ownership and management.

Federal courts initially applied the substantial continuity test in labor law successor liability cases. Courts have expanded its use for successor liability determinations under a limited number of federal statutes, such as Title VII of the Civil Rights Act of 1964 (employment discrimination). Puerto Rico has also expanded the test to apply to discrimination cases. Bruno Lopez v. Motorplan, Inc., No: RE-92-37, 1993 WL 839816

(P.R.). The Puerto Rico Supreme Court has not yet expanded the test for use in other areas of the law. See Zayas Fontanez v. M.J. Consulting, Inc., Civil No. DKDP20030643, 2007 WL 915380 (P.R.) (court of appeals declined to apply the test in a negligence action because the plaintiff was not an employee of the defendant corporation). As the United States District Court for the District of Puerto Rico stated, "[T]he 'Successor Employer' doctrine is a federal labor law claim that the Puerto Rico Supreme Court has engrafted to state law labor claims." Santiago Sanchez v. Gate Engineering, Corp., 193 F. Supp. 2d 392, 395 (D.P.R. 2002). An argument may be made that the substantial continuity factors should apply in case. Relying on that argument, however, is unnecessary because Corporation B is liable under established Puerto Rican law, as explained above.

You also inquired as to whether the IRS must make an additional assessment against Corporation B in order to file a lien or levy against Corporation B in this case. Successor liability holds the successor liable for the debts of the transferor corporation; the successor corporation steps in the shoes of the transferor corporation. A pre-existing assessment exists with respect to Corporation A; a new assessment against Corporation B is not required. See United States v. Bess, 357 U.S. 51 (1958). We note that the IRS may make a transferee assessment under I.R.C. § 6901 for: (1) collection of income, estate and gift taxes or (2) collection of other taxes, including employment taxes, if the liability arises on the "liquidation of a partnership or corporation, or on a reorganization within the meaning of section 368(a)." I.R.C. § 6901(a)(2). The Tax Court has held that an entity may be liable as both a successor and a transferee. Southern Pacific Transportation Company v. Commissioner, 84 T.C. 387, 395 (1985). Because employment taxes are at issue, I.R.C. § 6901 does not apply unless the liability was incurred on a liquidation or reorganization. More facts are required to determine whether a liquidation or reorganization occurred in this case.[2] Further, even if I.R.C. § 6901 did apply, a transferee assessment is not necessary because the IRS made an assessment with respect to Corporation A.

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[2]We assume that a statutory merger was not undertaken in this case and, thus, I.R.C. § 368(a)(1)(A) does not apply. I.R.C. § 368(a)(1)(F) provides for reorganization treatment if a transaction amounts to a "mere change in identity." Prop. Reg. § 1.368-2(m) provides that a transaction involving an actual or deemed transfer is a "mere change" only if the following four requirements are met: (1) All of the stock of the resulting corporation, including stock issued before the transfer, is issued in respect of stock of the transferring corporation; (2) There is no change in the ownership of the corporation in the transaction, except a change that has no effect other than that of a redemption of less than all the shares of the corporation; (3) The transferring corporation completely liquidates in the transaction; and (4) The resulting corporation does not hold any property or have any tax attributes (including those specified in section 381(c)) immediately before the transfer. The first two requirements, which reflect the Supreme Court's holding in Helvering v. Southwest Consolidated, 315 U.S. 194 (1942), do not appear to be satisfied. In Southwest Consolidated, the Court stated that a "transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of organization' within the meaning of clause (E)." Id. at 203 (citing former 26 U.S.C.A. § 112(g)(1)(E)). The ownership structures of Corporation A and Corporation B remain unknown. We do not reach a conclusion as to whether a reorganization occurred.

You also inquired as to whether Corporation B is entitled to a Collection Due Process (CDP) hearing if lien or levy action is commenced. CDP notice is given to “the person described in section 6321” for lien filing notices and “the person described in section 6331(a)(1)” for levy notices. I.R.C. § 6320; Treas. Reg. § 301.6330-1(a)(3) A-A2. The person described in I.R.C. §§ 6321 and 6331 is the “person liable to pay any tax” who “neglects or refuses to pay the same.” Corporation A failed to pay the tax liability at issue and we assume that proper notices of lien filing and intent to levy were issued to Corporation A. Corporation B, as Corporation A’s successor, is not entitled to CDP lien and levy notices if Corporation A previously received both notices with respect to the same unpaid tax.[3] A taxpayer is only entitled to a CDP hearing with respect to the first notice of lien filing or first pre-levy or post-levy CDP notice with respect to an unpaid tax. If the taxpayer does not request a CDP hearing following the first notification, the taxpayer forgoes the right to a CDP hearing. Treas. Reg. §§ 301.6320-1(b)(2) A-B4; 301.6330-1(b)(2) A-B2.

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Please call (202) 622-3630 if you have any further questions.

[3]We do not opine as to whether Corporation B would be entitled to a CDP hearing if Corporation A did not previously receive both CDP notices (no prior lien or levy action with respect to the unpaid tax).