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TAX LAW

Yes, the IRS Can Pierce the Corporate Veil

You can run, but you cannot hide (behind your other entity); IRS attorneys are instructed to use alter-ego analysis

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In a chief counsel notice (CC-2012-002) dated Dec. 2, 2011, the Internal Revenue Service (IRS) instructed its attorneys to argue that a federal common-law alter-ego analysis is the most appropriate way for courts to resolve alter-ego claims in federal tax collection cases, emphasizing that the position is legally correct and consistent with the principle of uniformity of federal tax enforcement.

The notice instructs IRS attorneys, in their collection efforts, to undertake as an alternate argument a two-step analysis for determining alter-ego liability. This should include:

1. an analysis of state law to determine what rights a taxpayer has in the property the government seeks to reach; and
2. an analysis of federal law under Internal Revenue Code (IRC) section 6321 to determine whether a state law right constitutes property or rights to property.

In the notice, the IRS observes that in cases concerning the alter-ego status of a party with respect to a taxpayer, recent federal court decisions have emphasized that a federal court must first look to state property law concerning alter-ego (often referred to as "piercing the corporate veil") *before* it can determine whether a federal tax lien attaches to the alter-ego's property or rights to property. The result has been a growing reliance on an erroneous analysis for determining federal alter-ego liability.

The notice argues that this analysis falsely focuses on the taxpayer's relationship to the property at issue *rather than the relationship between the taxpayer and the other entity*. As suggested in *G.M. Leasing Corp. v. United States*, 429 U.S. 338, 351 (1977), if an entity is a taxpayer's alter-ego, then it is appropriate to "regard" *all of the entity's assets* as the taxpayer's property for federal collection purposes. The erroneous focus on the taxpayer's property rights, and the resulting emphasis on state property law, yields potentially different alter-ego determinations depending on the state in which the property is located. This outcome cuts against the uniform enforcement of federal tax laws.

IRC section 6321 creates a lien, in favor of the United States, upon a delinquent taxpayer's property and rights to property. Any property held in the name of a third party may fall within the ambit of section 6321 if the third party holds the property as the taxpayer's alter-ego or nominee. The IRS may levy on all of the property or rights to property of an alter-ego entity, such as a trust, corporation or LLC, to collect the liability of a taxpayer if, for example, "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 often involves piercing the corporate veil to hold an individual or shareholder liable for the debts of a business entity, although "reverse piercing" may also be used to recover a taxpayer's delinquent tax liability from his alter-ego business entity. *Towe Antique Ford Found. v. Commissioner*, 999 F.2d 1387, 1390 (9th Cir. 1993).

The alter-ego doctrine is often confused with the nominee doctrine, which goes to whether a person has placed formal ownership of property in the hands of another, while in substance retaining all or some of the benefits of being the true owner. See *Baum Hydraulics Corp. v. United States*, 280 F. Supp. 2d 910, 916-17 (D. Neb. 2003); *In re Richards*, 231 B.R. 571, 578 (E.D. Pa. 1999). The alter-ego doctrine involves the imposition of liability on an entity by treating that entity as the taxpayer for tax collection purposes, while the nominee

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doctrine focuses on the taxpayer's relationship to particular property or rights to property.

In the notice, the IRS recognized that federal common law governs the application of the alter-ego doctrine in a variety of contexts outside of tax administration, for example in:

- labor dispute under the National Labor Relations Act,
- breach of fiduciary liability under ERISA,
- liability for unfair labor practices,
- liability for Medicare fraud,
- liability under Title VII of Civil Rights Act, and
- default on a HUD-held loan.

These federal decisions are rooted in *Clearfield Trust Co. v. United States*, 318 U.S. 363, 367 (1943), in which the Court stated: "The application of state law [governing commercial paper] . . . would lead to great diversity in results by making identical transactions subject to the vagaries of the laws of the several states." They also stem from *United States v. Kimbell Foods, Inc.,* 440 U.S. 715, 726 (1979), wherein the Court said that "[t]his Court has consistently held that federal law governs questions involving the rights of the United States arising under nationwide federal programs."

The notice argues that the use of state law as the alter-ego rule of decisions in federal tax collection cases frustrates the important federal policy of uniform imposition of federal tax liability.

Use of federal common law for alter-ego determinations in federal tax collection matters is also supported by section 7402(a), which grants the district courts authority to issue "such judgments or decrees as may be necessary or appropriate for the enforcement of the internal revenue laws."

Indeed, given that withholding taxes "are part of the wages of the employee," *Gephart v. United States,* 818 F.2d 469, 472 (6th Cir. 1987), and that private employees may recover back wages using federal common law, it stands to reason that the United States may rely on federal common law to collect the tax.

The alter-ego doctrine goes to the identity of the taxpayer who is liable for the tax. As the Fifth Circuit has observed, once it has been determined that one corporation is the alter-ego of another, all of the assets of either corporation may be levied upon for the debts of the other because the law does not recognize the two corporations as having an independent existence for purposes of debt collection. *Oxford Capital Corp.,* 211 F.3d at 284.

A proper alter-ego analysis, therefore, does not focus on what property is liable for a debt or on who holds what rights to that property under state law, but rather the focus is on which entities are liable for the debt and whether two entities that are formally separate should be regarded as one. That is, the proper analysis should focus on whether the alleged alter-ego entity should be regarded as the taxpayer for tax collection purposes, and not on whether the taxpayer had a state-law enforceable property right in property.

The notice recognizes that there is a variety of interpretations of the alter-ego doctrine in various federal circuits and, in some circuits, none at all. To the extent that the applicable federal circuit lacks any case law analyzing alter-ego under federal common law, and in light of the lack of consistency among the courts, the notice instructs IRS attorneys to argue the 10th Circuit's broadly defined factors set forth in *NLRB v. Greater Kansas City Roofing,* 2 F.3d 1047 (10th Cir. 1993), and further notes that any other logically relevant factors should be examined.

If the law of the relevant circuit dictates that the state property-law approach should be used in an alter-ego case, IRS attorneys nonetheless should present the federal common-law alter-ego analysis as an additional argument, so as to preserve the issue for purposes of seeking to overturn the precedent. ■