Department of the Treasury | Internal Revenue Service | Office of Chief Counsel

Notice

CC-2012-002

December 02, 2011

Subject: Whether Federal Common Law or State Law Governs Alter Ego Status

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Purpose

This Notice sets forth the position that a federal common law analysis to prove alter ego status is legally correct and consistent with the important principle of uniformity of federal tax enforcement.

Background

In cases concerning the alter ego status of a party with respect to a taxpayer, recent decisions have emphasized that a federal court must 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. See, e.g., Old West Annuity and Life Insurance Co. v. Apollo Group, 605 F.3d 856 (11th Cir. 2010); United States v. Scherping, 187 F.3d 796 (8th Cir. 1999); Floyd v. IRS, 151 F.3d 1295 (10th Cir. 1998). The result has been a growing reliance on a two-step analysis for determining alter ego liability: (1) analysis of state law to determine what rights a taxpayer has in property that the Government seeks to reach, and (2) analysis of federal law under I.R.C. § 6321 to determine whether a state-law right constitutes "property or rights to property." See Drye v. United States, 528 U.S. 49, 58 (1999). This two-step analysis erroneously 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, an outcome which cuts against the uniform enforcement of federal tax laws.

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Discussion

1. The Alter Ego Analysis under Federal Common Law

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 Service may levy on all of the property or rights to property of an alter ego entity (e.g., 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); see also G.M. Leasing Corp., 429 U.S. at 351. 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 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). In other words, 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 doctrine focuses on the taxpayer's relationship to particular property or rights to property.

Federal common law governs the application of the alter ego doctrine in a variety of contexts outside of tax administration. See, e.g., Board of Locomotive Eng'rs v. Springfield Terminal Ry. Co., 210 F.3d 18, 25-26 (1st Cir. 2000) (labor dispute under Railway Labor Act); NLRB v. West Dixie Enterprises, Inc., 190 F.3d 1191, 1194 (11th Cir. 1999) (labor dispute under the National Labor Relations Act); Thomas v. Peacock, 39 F.3d 493 (4th Cir. 1994) (breach of fiduciary liability under ERISA), rev'd on other grounds, 516 U.S. 349, 353-54 (1994); NLRB v. Greater Kansas City Roofing, 2 F.3d 1047 (10th Cir. 1993) (liability for unfair labor practices); United States v. Pisani, 646 F.2d 83 (3d Cir. 1981) (liability for Medicare fraud); EEOC v. MacMillan Bloedel Containers, Inc., 503 F.2d 1086, 1089-92 (6th Cir. 1974) (liability under Title VII of Civil Rights Act); cf. United States v. Golden Acres, Inc., 702 F. Supp. 1097, 1103 (D. Del. 1988) (default on a HUD-held loan), aff'd without opinion, 879 F.2d 857 (3d Cir. 1989). These federal decisions are generally 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," and in United States v. Kimbell Foods, Inc., 440 U.S. 715, 726 (1979). In Kimbell Foods, 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." 440 U.S. at 726.

Whether federal common law or state law should govern the question of alter ego liability depends on: (i) whether there is a need for a nationally uniform body of law to apply in situations like the one presented; (ii) whether application of state law would frustrate important federal policy; and (iii) what impact the application of federal law would have on existing relationships under state law. Id. at 728-29 (priority of liens stemming from federal lending programs must be determined with reference to federal law). The use of federal common law is not precluded by Commissioner v. Stern, 357 U.S. 39 (1958). Stern, which was decided before Kimbell Foods, held that transferee liability under the precursor to section 6901 is to be determined under state law rather than federal common law. Id. at 44-45. The Court leaned heavily in Stern on legislative history reflecting the strictly procedural role of the federal transferee liability statute coupled with reliance on the substantive role of state laws concerning fraudulent transfers – state laws which do not vary extensively from state to state. In contrast, state variations on alter ego doctrine will often lead to disparate results on the same set of facts. Moreover, unlike section 6901, the alter ego doctrine does not impose a defaulting taxpayer's liability on another person, but treats an entity as the taxpayer for tax collection purposes.

The use of state law as the alter ego rule of decision in federal tax collection cases frustrates the important federal policy of uniform imposition of federal tax liability. In analogous circumstances, federal courts apply federal law to federally created claims. See Anderson v. Abbott, 321 U.S. 349, 365 (1944) ("the question of liability for these [non-tax, federal] assessments is a federal question. The policy underlying a federal statute may not be defeated by such an assertion of state power."); Pisani, 646 F.2d at 87 (adopting a federal standard where state law "might be more restrictive" than federal law because "we believe it is undesirable to let the rights of the United States in this area change whenever state courts issue new decisions"); Golden Acres, 702 F. Supp. at 1103 ("[i]f Delaware courts are indeed as reluctant to pierce the corporate veil as defendants allege . . . then application of Delaware law in cases such as this one would frustrate the national housing policy behind the HUD program which insured Golden Acres' mortgage").

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." That statute may be analogized to section 10(c) of the Labor Management Relations Act ("LMRA"), 29 U.S.C. § 160(c), which authorized quasi-judicial proceedings in which the NLRB could take such actions as would effectuate the policies of the LMRA. On the basis of this provision, and beginning with Textile Workers Union of America v. Lincoln Mills of Alabama, 353 U.S. 448, 456 (1957), the Court gradually expanded the application of federal common law in enforcing the LMRA. The Court later held that a successor could be compelled to arbitrate, John Wiley & Sons, Inc. v. Livingston, 376 U.S. 543, 549 (1964), then held that federal law controlled whether a successor was liable to remit back wages to an employee who won that relief against its predecessor, when the successor (who had notice of the claim) had acquired all of the predecessor's assets but had not assumed its liabilities. Golden State Bottling Co., Inc. v. NLRB, 414 U.S. 168, 171-74 (1973). In upholding the use of federal law, the Court held that "the Board's remedial powers under § 10(c) include broad discretion to fashion and issue the order before us as relief adequate to achieve the ends, and effectuate the policies, of the Act." Id. at 176. Under I.R.C. § 7402(a), the courts may be said to have similar powers in the area of federal tax collection. 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.

Those federal appellate decisions that have applied state law to determine the alter ego question for purposes of federal tax collection have done so without analysis concerning the identity of the taxpayer and the alter ego entity. See, e.g., Old West Annuity, 605 F.3d at 861; Scherping, 187 F.3d at 802; Floyd, 151 F.3d at 1298; Zahra Spiritual Trust v. United States, 910 F.2d 240, 242 (5th Cir. 1990); Wolfe v. United States, 798 F.2d 1241, 1244 n.3 (9th Cir. 1986). In the majority of cases, the courts never address this choice-of-law question because the answer would be the same under both state and federal law. See, e.g., Shades Ridge Holding Co. v. United States, 888 F.2d 725, 728 (11th Cir. 1989) ("the standards are so similar that the distinction is of little moment"); United States v. Jon-T Chemicals, Inc., 768 F.2d 686, 690 n.6 (5th Cir. 1985) ("we find no need to determine whether a uniform federal alter ego rule is required, since the federal and state alter ego tests are essentially the same"). Some courts, such as the Eleventh Circuit in Old West Annuity, have relied mistakenly upon the Supreme Court's decision in Aquilino v. United States, 363 U.S. 509, 512-13 (1960) and subsequent decisions applying Aquilino that did not present an alter ego issue. Few courts cite arguments based on Kimbell Foods or Clearfield Trust, and if they do so, they fail to substantively address the merits of such arguments. See, e.g., Old West Annuity, 605 F.3d at 861.

The issue in Aquilino was whether a taxpayer's legal interest in the proceeds from a building contract was a "property" interest to which the federal tax lien could attach, when the proceeds were subject to a *statutory* trust for unpaid laborers, subcontractors, and materialmen. The Court clarified its Aquilino holding in its later decision in Drye v. United States, 528 U.S. 49 (1999). According to Drye, 528 U.S. at 59 n.6, Aquilino set forth the rule that when the Government seeks to enforce a federal tax lien, the courts are to look first to state law to determine the nature of the legal interest a taxpayer has in property the Government seeks to reach, but that federal law determines whether the taxpayer's interests are sufficient to constitute property or rights to property subject to the lien.

Unlike the lien attachment issue in Aquilino or Drye, the alter ego question does *not* concern property rights. 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. See also Scherping, 187 F.3d at 801-02 ("Alter ego means 'other self' – where one person or entity acts like, or for, another to the extent that they may be considered identical.") 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 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.

A two-step state/federal alter ego analysis is not consistent with the state courts' approach to choice-of-law issues in alter ego cases. Recognizing that the alter ego doctrine is about whether a shareholder or other entity should be regarded as the taxpayer for tax collection purposes, not about who owns what property, state courts themselves vary on whether to apply the law of the state of incorporation or the law of the state where the liability arose (and generally do not focus on the situs of property that might become the subject of a judgment lien for the liability). E.g., compare United States v. Clinical Leasing Serv., Inc., 982 F.2d 900, 902 n.5 (5th Cir. 1992) (applying Louisiana law rather than the law of Delaware, the state of incorporation, to decide an alter ego claim, and citing the Restatement) with Fletcher v. Atex, Inc., 68 F.3d 1451, 1456-57 (2d Cir. 1995) (relying on New York choice of law principles to decide an alter ego claim under Delaware law as the state of incorporation). Thus, in traditional shareholder liability or "veil piercing" cases, many state courts apply the law of the state of incorporation because that state has the greater interest in determining when the insulation of corporate limited liability will be stripped away. See Restatement (Second) of Conflicts of Laws ["Restatement"] § 307 (1971) (and cases cited therein). But other courts recognize that another state may have the greater interest. See Restatement § 309 ("[t]he local law of the state of incorporation will be applied . . . except where, with respect to the particular issue, some other state has a more significant relationship . . . to the parties and the transaction").

2. Identifying the Federal Common Law Alter Ego Analysis in the Appellate Courts

Courts have not consistently identified the factors of a federal common law alter ego analysis in the federal tax context. For example, the Eighth Circuit in Loving Saviour Church v. United States identified the material facts of a federal common law alter ego analysis in a tax case as (i) the taxpayer treating the alter ego's property and assets as his own; (ii) the carrying of the alter ego's insurance in the taxpayer's name; (iii) the lack of internal controls in the alter ego; (iv) the use of alter ego funds to pay the taxpayer's expenses; (v) the close family relationship between the taxpayer and the alter ego's officers; (vi) the transfer of property between the taxpayer and the alter ego for little or no consideration; (vii) the personalized license plate of alter ego's car bearing the taxpayer's surname; and (viii) the alter ego's funds fully supporting the taxpayer in whatever manner the taxpayer instructed. 728 F.2d 1085, 1086 (8th Cir. 1984). The

Tenth Circuit, on the other hand, summarized the factors of a federal alter ego test into two broad prongs: (i) whether there is such a unity of interest and lack of respect given to the separate identity of the corporation by its shareholders that the personalities and assets of the corporation and the individual are indistinct, and (ii) whether adherence to the corporate fiction sanctions a fraud, promotes injustice, or leads to an evasion of legal obligations. Greater Kansas City Roofing, 2 F.3d at 1052. See also Minnesota Laborers Health and Welfare Fund v. Scanlon, 360 F.3d 925, 928 (8th Cir. 2004) (adopting the same standard in a non-tax context); InterGen N.V. v. Grina, 344 F.3d 134, 148-49 (3d Cir. 2003) (adopting a substantially similar standard using three prongs in a non-tax context); NLRB v. West Dixie Enterprises, Inc., 190 F.3d 1191, 1194 (11th Cir. 1999) (adopting the same standard in a non-tax context). The Second Circuit noted, in LiButti v. United States, 107 F.3d 110, 119 (2d Cir. 1997), that a court considering an alter ego claim in the context of tax collection should "avoid an over-rigid preoccupation with questions of structure . . . and apply the preexisting and overarching principle that liability is imposed to reach an equitable result." .

To the extent that the applicable circuit lacks any case law analyzing alter ego under federal common law and in light of the lack of consistency between the courts, attorneys should present the Tenth Circuit's broadly defined factors set forth in NLRB v. Greater Kansas City Roofing and further note 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, for example the Eleventh Circuit as held in Old West Annuity, supra, 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.

3. Application of Alter Ego Analysis on Cases in Inventory

Attorneys should argue that a federal common law alter ego analysis is the appropriate and best way for courts to resolve alter ego claims in federal tax collection cases. Attorneys should still undertake, however, the two-step state/federal alter ego analysis as an alternative argument. Suit letters, defense letters, and any Tax Court briefs addressing an alter ego analysis in the collection context should be submitted to Branch 3 or 4 of Procedure and Administration prior to referral to the Department of Justice or filing with the Tax Court.

Please direct all questions concerning this Notice and how to proceed with an alter ego case to Branch 3 or 4 of Procedure and Administration at (202) 622-3600 or (202) 622-3630, respectively.

________/s/___________
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