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A Uniform Standard for Alter Ego and Nominee Tax Litigation

"If you don't like something change it; if you can't change it, change the way you think about it."[1] Our federal government has a long-standing goal to enforce federal tax laws fairly and consistently. Both the Internal Revenue Service (IRS) and the Department of Justice Tax Division's websites include variations of this goal in their mission statements. Consistent enforcement of tax laws becomes difficult, however, when the law applied to federal tax cases differs from state to state. When the government can reach a taxpayer's assets in Michigan to satisfy an unpaid tax liability but is prevented from reaching a taxpayer's assets in Florida because of limitations in Florida law, an uneven collection of outstanding federal tax liabilities is created. Evasive taxpayers in states with restrictive nominee and alter ego case law have an easier time keeping their assets beyond the government's reach than do the residents of other states. Besides being simply unfair, this uneven collection can undermine the public's confidence in the integrity of our federal tax system.

Diverging state laws are dictating the consequences in federal tax collection situations—a result that the Supreme Court is unlikely to endorse, should it ever rule on the issue. The standard for determining if an alter ego or nominee situation exists in a tax case is usually guided by a few heavily cited tax cases heard by the U.S. Supreme Court. However, these cases involve tax lien issues and do not address alter ego determinations. Because tax lawyers rarely distinguish between these theories, we have overstated the relevance of the Supreme Court's precedents related to tax liens to the alter ego determination. By changing the way we think about alter ego and nominee issues, we can expand our understanding of Supreme Court jurisprudence and consider steps leading toward a more uniform standard for federal tax cases.

Background on Alter Ego and Nominee Theories in Tax Law

When the government targets the assets of one person or entity to satisfy the tax liability of a second person or entity, practitioners of tax law refer to these factual scenarios as nominee or alter ego situations. Depending on the facts, these common law legal concepts are similar to theories of agency, instrumentality, and corporate veil-piercing.[2] Some tax cases merge the concepts of alter ego and nominee; other cases do not.

Typical nominee and alter ego scenarios start with people falling behind on their taxes. Facing the loss of their homes or businesses to the federal government some taxpayers take steps to try to separate themselves from their valuable assets. The taxpayer's house may be deeded to a friend, although the taxpayer continues to reside there. Or perhaps all the taxpayer's cash disappears, yet the taxpayer's personal bills are being paid by a closely-held and controlled corporation. The factual scenarios are as creative and varied as are taxpayers themselves. However, the tax collector's reaction is usually consistent: upon discovering that a third party is being used to thwart the IRS's collection efforts, the government will file a notice of a federal tax lien[3] identifying the third-party target as the taxpayer's nominee or alter ego and will attempt to satisfy the tax liability from assets held by the third party.

A Change in the Way We Think About Alter Ego and Nominee Issues

The Supreme Court has endorsed the government's use of nominee or alter ego theories to collect a taxpayer's unpaid taxes from assets held by another entity.[4] However, the Court has not directly addressed which law (state law or federal common law) courts should use to determine when a nominee or an alter ego situation exists. Often it makes little difference which law applies, and neither party spends much time or effort outlining the differences. In some cases, however, the court's choice between state law and federal common law essentially determines the outcome of the case. This is what happened recently in Florida.

In *Old West Annuity and Life Ins. Co. v. The Apollo Group Inc.*,[5] if The Apollo Group was found to be the alter ego of All Seasons Resorts Inc., then the large federal tax lien (more than $10 million) arising from the All Seasons' tax liability would attach to the property in dispute. If no alter ego situation was found, then the All Seasons' lien would not attach. The government argued that the alter ego question does not concern property rights but, rather, goes to the very identity of the taxpayer who is liable for the tax. Following this theory, the government urged the Eleventh Circuit to apply the Supreme Court's

Kimbell Foods three-part test (developed in a case that did not involve taxes) and analyze whether the federal common law should apply in the federal tax field and govern the alter ego inquiry.[6] The Eleventh Circuit declined to apply *Kimbell Foods* and upheld the lower court's application of Florida law in finding no alter ego, which resulted in no attachment of the All Seasons tax liability to the The Apollo Group property. Florida law has strict limits on when a corporate entity may be disregarded.[7] The circuit court's decision produced an interesting result—and one the government had warned the Eleventh Circuit about—for in California and Michigan, The Apollo Group's subsidiary and related entities were determined by courts there to be the alter egos of All Seasons under standards that were less restrictive than those in Florida.[8]

The government's characterization of alter ego as a determination related to the identity of the taxpayer is an interesting way to think about the issue. Certainly, the question in an alter ego or nominee dispute differs from the question posed in a lien dispute: asking which law applies when deciding if a corporation or an entity is so controlled by the taxpayer that the target should be considered the taxpayer's alter ego is a different inquiry than asking which law applies when trying to determine a taxpayer's interest in property. This difference is clearest in cases in which *both* alter ego issues and lien attachment issues are in dispute, because the court must engage in two separate analyses. The alter ego analysis determines whether the target corporation or entity is indeed the taxpayer's alter ego. The lien attachment analysis determines to what property interests of the alter ego the lien may attach and involves questions of which property right sticks are in the alter ego's bundle. Under *Aquilino v. United States*, it is clear that a combination of state and federal law governs the question concerning lien attachment to property.[9] However, it is unclear which law (state or federal) the Supreme Court would hold governs the determination of the existence of an alter ego or nominee situation.

Even though *Aquilino* did not address the alter ego question, courts usually rely on the two-part analysis in *Aquilino* to find the answer. In *Aquilino,* the Court held that determining what property a federal tax lien may reach requires courts to look to state law in order to determine the nature of a taxpayer's legal interest, then to federal law to determine whether that interest constitutes property or a right to property to which the lien may attach. Most subsequent cases interpreted this rule to mean that state law governs the alter ego analysis, after which the courts proceeded to ask whether the state law would allow a common creditor to reach the property at issue (for example, by piercing the corporate veil). Only when the answer to this first part was "yes" would the court then move to federal law to determine any lien priority issues.

But if a court were to actually follow *Aquilino* in an alter ego case, it should look at the state law property interests that a taxpayer enjoys in assets held in the name of a nominee or an alter ego. For example, a taxpayer who in actuality or substance (even though not in name or form) still enjoys the use of a former residence even though it is titled in another person's name or enjoys the income generated by a closely held corporation for support even though the taxpayer has no claim to that income under a technical reading of state law, is still exercising the rights of possession, control, and use of the property as well as the ability to exclude others from using it—rights that are created by state law. The state law inquiry about property rights under *Aquilino* would examine the property rights that the taxpayer is still exercising, even though the property is titled in the name of another. Then, whether these rights constitute property that the government can reach (over any claim of the nominee or alter ego) would be a question of federal law.

An alternative approach for courts is to acknowledge that *Aquilino* did not resolve the alter ego choice of law question but would also look at *Aquilino* in the context of other Supreme Court tax cases. Taking a broader view of these tax cases, it becomes clear that the Court considers the federal tax collector to be more than a normal creditor under state law. These cases underscore the point that the government's ability to reach certain property is determined not by asking whether a common creditor could successfully attach a lien under state law but, rather, by applying federal law, giving federal consequences to state-delineated rights.[10]

The Supreme Court does not hesitate to rely on the federal consequences component articulated in *Aquilino* to sweep aside state-created exemptions that would otherwise take property beyond the reach of the federal tax lien or levy. For example, in *United States v. Bess,* the Court held that a taxpayer's right to the cash surrender value of a life insurance policy qualified as property or right to property and was subject to the federal tax lien, even though state law prevented creditors' liens from attaching to it.[11] Similarly, a taxpayer's right under state law to withdraw the full amount of funds from a joint bank account constituted property or the right to property subject to levy for unpaid federal taxes, although state law would prohibit ordinary creditors from depleting the account.[12] In *Drye v. United States*, the Supreme Court found that the taxpayer's disclaimer of interest in his mother's estate did not prevent the federal tax lien from attaching, even though state law created the legal fiction that the taxpayer predeceased his mother, and the interest moved directly to the next heir in line.[13] More recently, the Court held that the rights Michigan law granted a husband as a tenant by the entirety qualified as property or rights to property

FOCUS ON *continued on page 40*

under federal law, even though under state law, tenancy by the entirety property is not subject to a creditor's attachment.[14] As in the above cases, the Supreme Court might take the view that stringent state law veil-piercing standards or rigid nominee tests unduly bind the federal tax collector. Even though, in a particular factual situation, state law might not permit an ordinary creditor to prove a nominee theory or pierce the corporate veil in order to attach assets titled in the name of another, the Court has a long history of upholding the federal government's right to sweep aside state-created limitations and exemptions in the area of federal taxation.[15]

Supreme Court action in the environmental field offers additional support for viewing the alter ego inquiry separately from the question of tax lien attachment. In *United States v. Bestfoods*, 524 U.S. 51 (1998), the Court established that a parent company can be responsible for a subsidiary's CERCLA liability only if the company qualifies as an operator of the facility, or if the standards for piercing the corporate veil are established. In note 9 of its opinion, the Court recognized that the standard for piercing the corporate veil could be determined under either state law or federal common law but declined to indicate which law should govern. There was no lien dispute in *Bestfoods*, and the alter ego inquiry focused on issues of control rather than property rights.[16]

Options for a Unified Standard

Even though the Supreme Court has held that restrictive state laws should not dictate the outcome or consequences in federal tax cases, it is unlikely that a lower court will make the leap to apply this principle to tax alter ego and nominee cases. As the Eleventh Circuit noted in *The Apollo Group*, other circuits appear to be uniformly applying state law to alter ego determinations.[17] Given that states have not only differing names for, and definitions of, alter ego, nominee, agency, corporate veil-piercing, and related theories, but also different standards for judging when such situations exist, if the issue is left up to the judiciary, we can expect more cases that have diverse results on similar facts.

This lack of uniformity across states should trouble both the legislative and executive branches. Citizens in California and Michigan should be assured that citizens in Florida not only will owe the same federal taxes as the former do, but that the taxes will be collected at the same rate if Florida residents fail to pay. If we desire uniform treatment for all taxpayers, then there should be a uniform standard for determining when a taxpayer is using an alter ego or a nominee to defeat federal tax collection, and when the government can reach assets held in the name of another.

The U.S. Congress could step in to clarify the law. Even though alter ego and nominee concepts are creatures of common law, Congress could codify a federal common law standard to be applied in federal tax cases. Congress has shown its willingness to codify common law tax principles by its recent adoption of 26 U.S.C. § 7701(o), which codifies the common law concept of economic substance. The codification of a unified federal law standard probably would get a positive revenue score and could be crafted to incorporate common law precedent that is not contrary to the statute (similar to what was done in the economic substance area).

Alternatively, the IRS could issue a regulation establishing that alter ego and nominee determinations should be made with reference to federal common law. If we accept the government's argument in *The Apollo Group* case—that alter ego determinations are really questions about the identity of the taxpayer—then a regulation that clarifies definition of a taxpayer in the alter ego or nominee context, as found in 26 U.S.C. § 7701(a)(14), should be found valid under the *Chevron* standard.[18] In addition, Congress' directive in 26 U.S.C. § 7805, which authorizes the Treasury Department to "prescribe all needful rules and regulations for the enforcement of this title" provides broad authority. Recently, the Supreme Court upheld a regulation imposed on medical residents that was promulgated under § 7805.[19] That case instructs us that there is nothing sinister about the IRS's use of the regulatory process to address unfavorable case law: the fact that a regulation was prompted by litigation is immaterial to the Court's analysis.

Conclusion

The first step toward a unified standard in alter ego and nominee tax law is to think about these issues as separate from tax lien attachment issues. Recognizing that *Aquilino* is not directly on point frees us to consider the Supreme Court's rulings on tax cases that demonstrate that limitations under state law do not automatically bar the federal tax collector from taking action. Even if the judiciary rejects a federal common law standard, the government has several available options that would provide more clarity, certainty, and consistency in tax alter ego and nominee cases. **TFL**

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Endnotes

[1]Mary Engelbreit, graphic artist, illustrator, and editor in chief of *Home Companion* magazine.

[2]The state of Texas is a notable exception to the common law status of alter ego law. The state legislature in Texas codified the requirement that actual fraud is necessary to pierce the corporate veil in order to limit the constructive fraud standard established in

Castleberry v. Branscum, 721 S.W.2d 270 (Tex. 1986). *See* Tex. Bus. Corp. Act Ann. art. 2.21 (Vernon 2007).

[3]*See* 26 U.S.C. §§ 6321–6323.

[4]*G.M. Leasing Corp. v. United States,* 429 U.S. 338 (1977), in which the Court said that, if the petitioner is the alter ego, the IRS could properly regard the petitioner's assets as the taxpayer's property subject to the lien under § 6321, and subject the petitioner's assets to levy to satisfy the taxpayer's income tax liability.

[5]*Old West Annuity and Life Ins. Co. v. The Apollo Group Inc.*, 605 F.3d 856 (11th Cir. 2010).

[6]*United States v. Kimbell Foods Inc.,* 440 U.S. 715, 728–29 (1979) (establishing a test that considers (1) whether there is a need for a uniform national law; (2) whether state law would frustrate federal objectives; and (3) whether federal law precedence would upset commercial expectations).

[7]Florida law involves a very stringent three-part test requiring domination and control by the shareholder and fraud or improper purpose or use elements. The federal common law discussed by the courts was the test set out in *Shades Ridge Holding Co. v. United States*, 888 F.2d 725 (11th Cir. 1989), which focuses on control and relationships.

[8]*The Apollo Group, supra* note 5, *see* Appellant's Opening Brief at 52 n.9, citing *Grass Lake All Seasons Resorts Inc. v. United States*, Case No. 789743, 2005 WL 2095890 (E.D. Mich. Aug. 29, 2005), and *Travel America Inc. v. Camp Coast To Coast Inc.*, Case No. 6028513, 2003 WL 558563 (Cal. App. Div. Feb. 27, 2003).

[9]*Aquilino v. United States*, 363 U.S. 509, 513–14 (1960) (look first to state law to determine the nature of the legal interest a taxpayer has in the property the government seeks to reach under its tax lien, then federal law determines whether the taxpayer's interests are sufficient to constitute property or rights to property subject to the government's lien).

[10]*United States v. Bess,* 357 U.S. 51, 55 (1958) (stating the federal tax lien statute itself "creates no property rights, but merely attached consequences, federally defined, to rights created under state law."). *See, e.g., Drye v. United States*, 528 U.S. 49, 58 (1999) (look initially to state law to determine what rights the taxpayer has in the property the government seeks to reach, then to federal law to determine whether the taxpayer's state-delineated rights qualify as property or rights to property within the compass of the federal tax lien legislation); *United States v. National Bank of Commerce*, 472 U.S. 713, 727 (1985) (whether a state law right constitutes property or rights to property is a matter of federal law).

[11]*Bess*, *supra* note 10, at 56–57.

[12]*National Bank of Commerce*, *supra* note 10, at 723-727.

[13]*Drye*, *supra* note 10, at 58.

[14]*United States v. Craft,* 535 U.S. 274 (2002).

[15]*United States v. Rodgers,* 461 U.S. 677 (1983); *see also Drye*, *supra* note 10, at 51.

[16]*United States v. Bestfoods*, 524 U.S. 51, 63 n.9 (1998). This issue remains unclear today.

[17]*The Apollo Group, supra* note 5 (citing Fifth, Eighth, Ninth, and Tenth Circuit Courts decisions).

[18]*Chevron U.S.A. Inc. v. Natural Resources Defense Council Inc.,* 467 U.S. 837 (1984).

[19]*Mayo Foundation for Medical Education and Research v. United States,* 562 U.S. ___ (2011) (upholding a Treasury Department regulation establishing that a full-time employee is not eligible for the FICA student exception).