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IRS Commits Fraudulent Transfer

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Usually when we hear a discussion about fraudulent transfers, it is in the context of a client who has just been sued and now wants to protect his or her assets.

A good lawyer will tell the client that the time to protect assets is long before there is a problem. Therefore, now that a problem has occurred, any transfer is susceptible to being viewed as fraudulent.

Then there will be a scholarly dissertation about the fact that there are two types of fraudulent transfers: (i) "actual" or "intentional" fraudulent transfers, those done with the "actual intent to hinder, delay or defraud any creditor of the debtor"; and (ii) "constructive" fraudulent transfers, those done "without receiving reasonably equivalent value...when the debtor...intended to incur...debts beyond his or her ability to pay as they became due." Finally the lawyer and the client will discuss what planning might still be available under the circumstances.

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So it is unusual and interesting to read United States of America v. Equipment Acquisition Resources, Inc., Bankruptcy No. 09 B 39937 (N.D. Illinois – January 4, 2013). The background of the case is fascinating: Equipment Acquisition Resources (EAR) purported to finance refurbished semi-conductor making machinery. It was so profitable that, as an S corporation, between October 2007 and December 2008, it made nine payments to the Internal Revenue Service on behalf of three shareholders, totaling almost $5,000,000.

In fact, the profits were based on double- and triple-financing imaginary equipment to about 20 equipment lessors, including some of the most sophisticated investors in the country: U.S. Bancorp, SunTrust, IBM Credit, and Comerica. For the lessors it proved to be a $175,000,000 Ponzi scheme. The bankruptcy trustee filed suit against "winning investors" on behalf of "losing investors" just as we have seen in the Madoff, Stanford and other recent Ponzi schemes.

For our purposes the case is interesting because the bankruptcy trustee sued the IRS to recover the funds that EAR paid to cover the shareholders' tax liabilities. (The bankruptcy court dismissed all counts against the individual taxpayers and approved a settlement agreement reached by the bankruptcy trustee and the IRS on certain claims.) The United States of America, on behalf of the IRS, moved to dismiss the bankruptcy trustee's action on the ground of "sovereign immunity."

The "sovereign immunity" doctrine is from the law we inherited from medieval England and means that "the monarch

can do no wrong." As a result, you cannot sue a federal agency unless Congress "unequivocally" expresses a "clear intent" to waive its immunity.

As it turns out, the intent to waive immunity in this area is—despite the government's assertions in this case to the contrary—unequivocal. Section 106(a)(1) of the Bankruptcy Code provides that despite "an assertion of sovereign immunity, [it] is abrogated as to a governmental unit to the extent set forth in this section with respect to...Section...544." Section 544 is the provision of the Bankruptcy Code which refers, in this case, to the Illinois Uniform Fraudulent Transfer Act. The federal district court had to go no further than the "plain meaning rule": "Where the statutes are unambiguous, courts must give effect to their plain meaning." The court held simply that "...there is no ambiguity. Section 106(a)(1) eliminates the sovereign immunity defense with respect to any Section 544 claims."

The government next argued that the bankruptcy trustee's action was time barred under the rules applicable to tax refunds, citing Internal Revenue Code Sections 7426 and 7422(a). In other words, the government tried to move the dispute from Title 11 of the U.S. Code—the Bankruptcy Code, where it was on a losing streak in front of this federal district court—to Title 26 of the U.S. Code, the Internal Revenue Code, which has precise rules generally slanted in favor of the IRS. IRC Section 7426 waives sovereign immunity for suits by non-taxpayers to recover money or property wrongfully levied by the IRS on the condition that it is filed within a nine-month period. IRC Section 6532(c). However, the federal district court held that IRC Section 7426 does not apply to this bankruptcy issue: voluntary tax payments made by third parties.

Under IRC Section 7422(a), an administrative claim for a tax refund must be filed before a claimant may bring suit in a federal district court. Generally a refund claim must be submitted to the IRS within two years of the contested payment. IRC Section 6511(a). The federal district court held that EAR's state law fraudulent transfer claim to recover a federal tax payment is not a "refund" claim under the Internal Revenue Code: "The premise of EAR's claim is not that the shareholders overpaid their tax, but that the moneys used to pay the tax were fraudulently transferred." As a result, in another blow to the IRS, the federal district court held that IRC Section 7422(a) does not apply.

The government's third and final argument was that the fraudulent transfer rules do not apply to EAR's payment because it was made on behalf of a third party and was accepted by a good faith creditor. Under the Illinois Fraudulent Transfer Act, that is a defense only if the claim is based on "actual" fraud. Instead, in this situation, the claim was based on "constructive" fraud, and the court refused to expand the exception's applicability.

The lesson of the case is that the fraudulent transfer rules do not care whether you are an individual, a corporation or the United States of America. No matter who you are, you cannot benefit from a fraudulent transfer. The lesson for our clients, however, as always, is that they should do their creditor planning long before they have a need.

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