The Tax Club

MIDCO Transactions and the Expanding Universe of Transferee Liability

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The Internal Revenue Service's determination of transferee liability, essentially secondary liability, resulting from transactions involving the taxable sale and disposition of corporate stock, is being litigated with increasing frequency in the federal courts. The outcome of these disputes varies as they are highly fact determinative. Thus, not surprisingly, Taxpayers have experienced mixed results in court. Although there are lower courts that have held in favor of the putative transferee, selling shareholders, three recent Tax Court decisions have been reversed on appeal.[1] In fact, to date only one taxpayer victory has been affirmed on appeal.[2] The IRS's recent successes have emboldened it to utilize transferee liability more frequently as a tax collection mechanism, most notably against corporate shareholders who engaged in so-called Midco or middle-company transactions,[3] primarily during the late 1990s to early 2000s. Generally, a Midco transaction is one in which the seller engages in a stock sale (thus avoiding the triggering of built-in gain in appreciated assets) while the buyer engages in an asset purchase (thus allowing a purchase price basis in the assets), through use of an intermediary company. Taxpayers involved in these Midco transactions, and taxpayers who may be contemplating transactions that could be construed as Midcos, should be cognizant of their potential exposure as transferees under Code section 6901.[4] They could potentially be subject to liability for their

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[1] *See Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013); *Frank Sawyer Trust v. Commissioner*, 712 F.3d 597 (1st Cir. 2013); *Slone v. Commissioner*, 778 F.3d 1049, *modified* 116 AFTR2d 2015-5962 (9th Cir. 2015).

[2] *See Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2013).

[3] *See* Notice 2001-16.

[4] Unless otherwise indicated, all references in this article to "Section" and "Sections" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" are to regulations issued thereunder (the "Treasury Regulations" or "Regulations"). Reference to the "IRS" or "Service" are to the Internal Revenue Service.

counterparty's unpaid taxes, interest and potential penalties related to the disposition of the property. Generally, the salient issue in these Midco transferee cases is whether the selling shareholder knew or should have known that the Midco intermediary would incur a tax liability that it could not and would not pay and thus would not be collected. Practitioners should be forewarned consequently that it would be prudent to give appropriate consideration to Section 6901 and evaluate their client's potential exposure to transferee liability before the transaction is completed. Part I of this paper evaluates Section 6901 on several fronts, with particular emphasis on recent decisions involving Midco transactions. Part II of this paper considers whether there are any limitations or defenses to the statute's reach. Since transferee liability of a taxpayer is derived from statutory authority, it is proper to begin by looking at the Code.

Legislative History of Section 6901 and Transferee Liability

In 1926, as part of an effort to assist in the collection of taxes, Congress enacted a provision that enabled the United States for the first time to proceed against those secondarily liable in the same manner as against those primarily liable.[5] The purpose of Section 280 was to provide a summary and expeditious method of collecting income taxes in situations in which a taxpayer disposed of his assets, leaving himself unable to meet his tax liability. Prior thereto, the only avenue of redress open to the Government in such a case was to proceed against the transferee in equity upon a trust fund theory or at law if the debts of the transferor had been assumed. However, in practice, this was difficult and expensive, and was seldom attempted. Consequently, Congress established the alternative summary method of collection by notice to the transferee and extended to the taxpayer the opportunity either to pay and sue for a refund, or

[5] *See* Section 280 of the Revenue Act of 1926.

else to proceed before the Tax Court.[6] No new obligation was created by the statute against the transferee, but merely a new procedure for enforcing the existing tax liability.[7] Section 280 followed the enactment of Section 209 of Act of Congress in 1916, which created a liability at law for certain transferees of estates.[8] A similar provision was subsequently enacted in 1932 for gift taxes.[9]

Section 311 of the Internal Revenue Code of 1939 followed as the successor to Section 280.[10] The courts also recognized that Section 311 neither created nor defined a substantive

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[6] The summary transferee liability procedures of Section 6901 do not replace the trust fund doctrine or other federal statutes, such as the Federal Debt Collection Procedures Act of 1990.

[7] *See Hatch v. Morosco*, 50 F.2d 138 (2d Cir. 1931).

[8] *See* Ch. 463, S 209, 39 stat. 756, 780 (1916). The provisions of Section 280 of the Revenue Act of 1926, providing the new remedy for collection of income taxes, are almost identical to the provisions applicable to estates. *See* Section 6324. In the context of estate taxes, a transferee's personal liability is derived from Section 6324(a)(2) which provides, "(i)f the estate tax imposed by chapter 11 is not paid when due, then the . . . transferee . . . or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax." The "value" of the property is its fair market value.

[9] *See* Ch. 209, S 510, 47 stat. 245, 249-501 (1932). In the context of gift taxes, if a donor fails to pay his annual gift tax liability the second sentence of Section 6324(b) provides that "the donee of any gift shall be personally liable for such tax to the extent of the value of such gift" as of the time the gift was completed. The "value" of a gift is the fair market value of the property received from the donor. In addition to the personal liability of the transferee, the liability is also secured by a lien on the property received.

[10] Section 311 of the Internal Revenue Code of 1939 provided, in part:

(a) Method of collection. The amounts of the following liabilities shall, except as hereinafter in this section provided, be assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by the chapter (including the provisions in case of delinquency in payment after notice and demand, the provisions authorizing distraint and proceedings in court for collection, and the provisions prohibiting claims and suits for refunds):

(1) Transferees. The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax (including interest, additional amounts, and additions to the tax provided by law) imposed upon the taxpayer by this chapter.

(f) Definition of 'transferee'. As used in this section, the term 'transferee' includes heir, legatee, devisee, and distributee.

liability but provided merely a new procedure by which the Government may collect taxes.[11] The U.S. Supreme Court has long since confirmed that this section "neither creates nor defines a substantive liability but provides merely a new procedure by which the Government may collect taxes."[12]

In 1954, the collection provisions for transferee liability in the areas of income, estate and gift taxes were collapsed into the current version of Section 6901.[13] Section 6901(a) provides that the liability of a transferee of a taxpayer's property may be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred in the case of income, estate and gift taxes.[14] In other words, "Section 6901 allows the IRS to assess and collect from the transferee the tax liability of the transferor as though the transferee was the taxpayer."[15] A "transferee" includes a

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[11] *See e.g., Phillips v. Commissioner*, 283 U.S. 589 (1931); *Hatch v. Morosco*, 50 F.2d 138 (2d Cir. 1931); *Weil v. Commissioner*, 91 F.2d 944 (2d Cir. 1937); *Tooley v. Commissioner*, 121 F.2d 350 (9th Cir. 1941).

[12] *Commissioner v. Stern*, 357 U.S. 39, 42 (1958) (discussing the predecessor transferee liability statute under the Internal Revenue Code of 1939, 26 U.S.C. § 311).

[13] In 1954, legislative history indicates that the amalgamation of the three separate provisions into a single section was not intended to change existing law. *See* S. Rep. No. 1622, 83rd Cong., 2 Sess., reprinted in 1954 U.S.C.C.A.N. 4793, 5225.

[14] Section 6901(a) provides:

(a) Method of Collection – The amounts of the forgoing liabilities shall, except as hereinafter in this section, be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred:

a. (1) Income, Estate, and Gift Taxes – (A) Transferees – The liability, at law or in equity, of a transferee of property –

(i) of a taxpayer in the case of [income] tax.

(b) Liability – Any liability referred to in subsection (a) may be either as to the amount of tax shown on the return or as to any deficiency or underlayment of any tax.

[15] *See* William W. Han, *The Scope of Transferee Liability in Estate and Gift Tax Cases*, TAXES (Jan. 1, 1996).

"donee, heir, legatee, devisee, [or] distributee."[16] Transferee liability under Section 6901 does not create a separate or new liability – it merely provides the IRS with a secondary method for collecting the transferor's tax liability.[17]

Although the language adopted in Section 6901 differs from that used in the earlier versions, the intent and purpose of the underlying collection provision of transferee liability remained unchanged. The legislative history that accompanied the progeny of Section 6901 indicated that the new collection procedure was intended to be a "substitute for" the trust fund equitable proceedings.[18] But some courts interpreted the provision as providing an alternate method of enforcing a transferee's obligation.[19] Regardless of which interpretation is correct, the enactment of Section 6901 did not change the extent of the transferee's liability under existing law.[20] The Conference Report to Section 280 stated that "(w)ithout in any way changing the extent of such liability of the transferee under existing law, the amendment enforces such liability . . . in the same manner as the liability for a tax deficiency is enforced."[21] It is also important to note that Section 6901 is strictly procedural in nature, it does not grant the Government any substantial rights.[22]

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[16] *See* Section 6901(h).

[17] The trust fund doctrine is another legal theory utilized by the IRS to collect tax from a transferee. The doctrine has been sparingly invoked by the IRS since the enactment of Section 6901 and is beyond the scope of this article.

[18] *See* H.R. Conf. Rep. No. 356, 69th Cong. 1st Sess. (1926), reprinted in 1939-1 C.B. (Part 2) 361, 372.

[19] *See Phillips v. Commissioner*, 283 U.S. 589 (1931); *United States v. Geniviva*, 16 F.3d 522 (3d Cir. 1994).

[20] *See* H.R. Rep. No. 356, 69th Cong., 1st Sess. (1926), reprinted in 1939-1 C.B. (Part 2), 361, 371.

[21] *Id.*

[22] *See Starnes v. Commissioner,* 680 F.3d 417 (4th Cir. 2012).

For nearly thirty years following the passage of Section 280, courts and taxpayers struggled with the issue whether the transferee liability Code provision should be determined by reference to federal law or state fraudulent conveyance law. In 1958, the Supreme Court settled the debate in *Commissioner v. Stern*.[23] In *Stern*, the Supreme Court ruled that transferee liability must be determined by reference to state law. The Supreme Court recognized that the procedures in place prior to the enactment of Section 6901's predecessor statute "proved unduly cumbersome."[24] The statute was enacted in order to do away with the procedural differences between collecting taxes from one who was originally liable and from someone who received property from the original tax owner.[25] The statute was not enacted to expand the Government's reach as creditor in collecting taxes. Rather, the Supreme Court recognized that "[t]he Government's substantive rights in this case are precisely those which other creditors would have under [state] law."[26] As such, Section 6901 was never intended to place the Government in a better position than any other creditor under state law. Thus, the existence and extent of the transferee's liability are determined by the law of the State in which the transfer occurred.[27]

In Tax Court, the Commissioner bears the burden of proving that a taxpayer is liable as a transferee.[28] To successfully assert transferee liability, the IRS must both identify a substantive basis (state law) beyond Section 6901 and assert liability via the procedures mandated by Section

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[23] 357 U.S. 39 (1958)

[24] *Id.* at 43.

[25] *Id.* at 43; *John Ownbey Co. v. Commissioner*, 645 F.2d 540, 543 (6th Cir. 1981), citing *Delia v. Commissioner*, 362 F.2d. 400, 402 (6th Cir. 1966)

[26] *Id.* at 47.

[27] *Id.* at 45.

[28] *See* Section 6902(a); Tax Court Rule 142(d). However, in a tax refund suit, the taxpayer bears the burden to show that plaintiff is not liable as a transferee. *See e.g. Andrew v. United States*, 91 F.Supp.3d 739 (D NC 2015).

6901. The IRS may assess transferee liability under Section 6901 against a party only if two distinct prongs are met: (1) the party must be a transferee under Section 6901; and (2) the party must be subject to liability at law or in equity.[29] Under the first prong of Section 6901, the court will look to federal tax law to determine whether the party in question is a transferee.[30] The second prong, whether the party is subject to liability at law or in equity, is determined by the applicable state law.[31] If there is no "conveyance" under state law, then there is no need to determine whether the taxpayer is a transferee under federal law.[32] Because transferee liability rests on the principle of equity, nexus to the transaction is paramount to secondary collection against a transferee. A transferee can also be liable for interest[33] and penalties.[34]

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[29] *See Rowen v. Commissioner*, 215 F.2d 641, 643 (2d Cir. 1954) (discussing predecessor statute, 26 U.S.C. § 311).

[30] *Id.* at 644.

[31] *See Stern*, 357 U.S. at 45. In *Stern*, the Government argued, unsuccessfully, that the court reject the applicability of state law in favor of having the federal courts fashion a unified federal rule to determine transferee liability. Since *Stern*, the First and the Fourth Circuits have both addressed the relationship between the transferee prong and the liability prong of Section 6901. Both of these circuits concluded that the two prongs of Section 6901 are independent, and that the Tax Court did not err by only addressing the liability prong under state law. *See Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597, 605 (1st Cir. 2013); *Starnes v. Commissioner,* 680 F.3d 417, 428 (4th Cir. 2012). The Second Circuit recently joined the First and Fourth Circuits in their interpretation of Section 6901. *See Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2d. Cir. 2013).

[32] *See Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597, 605 (1st Cir. 2013)("if the Trust was not a transferee of the companies for purposes of Massachusetts fraudulent transfer law, then whether or not it was a 'transferee' for purposes of Section 6901 is irrelevant.")

[33] In *Stein v. Commissioner*, the Tax Court stated that federal law governs the running of interest when the value of the transferred assets exceeds the transferor's total liability. 37 T.C. 945, 961 (1962). ("In cases where the transferred assets exceed the total liability of the transferor, the interest being charged is upon the deficiency, and is therefore a right created by the Internal Revenue Code.") The Code provides that the transferee is liable for interest from the date of the fraudulent transfer. *See* Section 6601; *Lowy v. Commissioner*, 35 T.C. 393, 395-96 (1960) ("[W]here the tax liability [is] greatly in excess of the amount received by the transferees in distribution . . . the transferee [is] liable to the full extent of the amounts received by them with interest from 'the fair average date of receiving' the sums distributed."). However, state law governs the running of interest when the value of the transferred assets is "insufficient to satisfy the transferor's tax liabilities." *Stein*, 37 T.C. at 961. Under New York law, "interest on a conveyance voidable because of constructive fraud runs from the date of demand by the creditor, but where actual fraud exists, interest runs from the date of fraudulent conveyance." *Id.* at 692 (citing *MacIntyre v. State Bank of Albany*, 307 N.Y. 630 (1954)).

[34] The Code and Treasury Regulations do not explicitly state that transferees shall be liable for penalties. Nevertheless, courts have held that "the Internal Revenue Code . . . spells out the right of the Government to

Transferee Liability at Law or in Equity

Transferee liability may be established "at law or in equity."[35] Transferee liability at law is generally based on contract when a transferee expressly assumes to pay the federal tax liability of the transferor.[36] Most often, the substantive basis of transferee liability rests on the equitable remedy of fraudulent conveyance, first recognized under the common law and now generally found in that state's fraudulent transfer or fraudulent conveyance statute. Currently, most states have enacted some version of the Uniform Fraudulent Transfer Act ("UFTA"). Although numerous versions of the UFTA have been adopted by the separate states, the most common version requires that the transferor did not receive "a reasonably equivalent value in exchange for the transfer" and "that the transferor was insolvent at the time or became insolvent as a result of the transfer."[37]

In New York, the common law doctrine has been codified in the Uniform Fraudulent Conveyance Act ("NYUFCA"). The NYUFCA defines a "conveyance" as "every payment of money, assignment, release, transfer, lease, mortgage or pledge of tangible or intangible

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[collect] the so-called penalties" from transferees. *Lowy v. Commissioner*, 35 T.C. 393, 395 (1960). The courts have reached this conclusion summarily. *See, e.g.*, *Mizrahi v. Commissioner*, T.C. Memo 1992-200; *Swinks v. Commissioner*, 51 T.C. 13, 17 (1968). Presumably, they do so by looking to the statutory structure of Section 6901, which provides that the transferee's liabilities "shall . . . be assessed, paid, and collected in the same manner . . . as in the cases of the taxes with respect to which the liabilities were incurred." Subsection (b) adds that "[a]ny liability . . . may be either as to the amount of tax shown on a return or as to any deficiency or underpayment of any tax." Together, these subsections provide that the amount of the transferee's liability is measured "as to any deficiency or underpayment" that created the transferor's liability. *See* Section 6902. In other words, the transferee steps into the shoes of the transferor. *See* Saltzman, *IRS Practice & Procedure,* pt. 17.05 ("Because the amounts of tax, penalty, and interest constitute the claim of the United States against the taxpayer/transferor, they also measure the claim against the transferred assets followed into the hands of the transferee."); *see also* I.R.M. pt. 4.10.13.3.2.1 (stating that transferee liability should "include liability . . . for penalties").

[35] *See* Section 6901(a)(1).

[36] *See Eddie Cordes, Inc. v. Commissioner*, T.C. Memo 2001-265 (82 T.C.M (CCH) 714).

[37] *See e.g,*. N.C. Gen Stat. § 39.23.

property, and also the creation of any lien or encumbrance."[38] It further establishes liability for a transferee if the transferor, without regard to his actual intent, (1) makes a conveyance, (2) without fair consideration, (3) that renders the transferor insolvent.[39] The knowledge and intent of the parties is irrelevant.[40] In New York, if both the procedural requirements of Section 6901 and the substantive law governed by the NYUFCA are satisfied, a transferee may be liable for the transferor's unpaid taxes, including penalties and interest owed by the transferor.[41]

Transferee Liability and the Statute of Limitations

Before turning to the substantive nature of transferee liability, a word is required on the often sticky question regarding the statute of limitations where a transferee is involved. The statute of limitations relating to the assessment of income taxes is generally three years from the date the taxpayer's return is filed.[42] However, there is no period of limitation when a taxpayer

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[38] NY Debt. & Cred. Law § 270.

[39] *See* NY Debt. & Cred. Law § 273. Under New York law, intent to defraud does not need to be shown to establish a fraudulent conveyance. *See Sklaroff v. Rosenberg*, 125 F. Supp. 2d 67 (S.D.N.Y. 2000); *Schmitt v. Morgan*, 98 A.D.2d 934 (3d Dept. 1983).

[40] Constructive knowledge is sufficient. Concluding that a party had constructive knowledge does not require actual knowledge of a scheme; rather, it is sufficient if, based upon the circumstances, the party "should have known" about the entire scheme. *See HBE Leasing Corp. v. Frank*, 48 F.3d 623, 636 (2d Cir. 1995). Constructive knowledge also includes "inquiry knowledge" that is, where transferees "were aware of circumstances that should have led them to inquire further into the circumstances of the transaction but . . . failed to make such inquiry." *Id.* In New York, there is ambiguity as to the precise test for constructive knowledge. Some courts have required "the knowledge that ordinary diligence would have elicited" (*United States v. Orozco-Prada*, 636 F. Supp. 1537, 1543 [S.D.N.Y. 1986], *affd*, 847 F.2d 836 [2d Cir. 1988]), and other courts have required a "more active avoidance of truth." (*HBE Leasing*, 48 F.3d at 636). The application of constructive knowledge in a transferee case was recently decided in *Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013), where the Second Circuit, applying New York law, collapsed a series of transactions and found that there was a conveyance under the NYUFCA. *Diebold* was remanded to the Tax Court for further proceedings.

[41] In transferee "in equity" cases, the transferee's liability is capped at the value of the assets transferred, plus interest if allowed under State law. *See Phillips v. Commissioner*, 283 U.S. 590 (1931).

[42] *See* Section 6501(a).

files a false or fraudulent return or where no return is filed.[43] In addition, if a taxpayer files his return but omits gross income in excess of 25 percent of the amount of income stated in the return, the period of limitations is extended to six years from the date the return is filed.[44] A taxpayer may also voluntarily agree to extend the period of limitations by executing a consent.[45]

In the case of an initial transferee, the Code grants the IRS one additional year beyond the expiration of the period for assessment against the transferor to assess transferee liability.[46] Accordingly, the timeliness of an assessment against a transferee can only be determined with reference to the period of limitations applicable to the transferor. Moreover, if the transferor litigates the tax matter in the Tax Court, the period of limitation against the transferee remains suspended until the date the Tax Court's decision becomes final.[47] In the case of an additional transfer, a transferee of a transferee, the Service must assess liability against the successor transferee within one year from the expiration of the period of limitation against the preceding transferee, but not later than three years from the expiration of the period of limitation for assessment against the initial transferor.[48]

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[43] *See* Section 6501(c).

[44] *See* Section 6501(e).

[45] *See* Section 6501(c)(4).

[46] *See* Section 6901(c)(1); Treas. Regs. § 301.6901-1(c)(1).

[47] A Tax Court decision becomes "final" 60 days after the period for an appeal expires, which is generally 90 days after a decision. *See* Section 7483.

[48] *See* Section 6901(c)(2).

The Midco Transaction

When a shareholder seeks to sell a C Corporation, the tax law creates competing interests between the buyer and the seller. The buyer generally desires to buy the assets and not the stock of the C Corporation, so as to get a stepped-up basis in those assets (to avoid or reduce later tax on the sale of those assets). On the other hand, the seller, holding appreciated assets in the corporation, would prefer to sell the stock of the corporation to avoid paying tax on two levels - first to the corporation on the sale of the assets, and then to the shareholders on the distribution of the proceeds. The issue for tax planners is how to solve these competing interests. The asset sale is unattractive to a seller, to whom a stock sale would make better sense.

The Midco transaction, a listed transaction preemptively attacked by the IRS as an "Intermediary Transaction Tax Shelter[49], enabled the shareholder to sell stock of the corporation to an intermediary that would then convey the appreciated assets to the buyer and avoid the tax burden on an asset sale. The "Midco" transaction obtained its name after MidCoast Credit Corporation. It became popular in the late 1990s and early 2000s to sell appreciated property owned in a C Corporation while attempting to avoid the double tax inherent in causing a C Corporation to sell stock and then distribute the proceeds to shareholders. To solve the double taxation issue, parties sought to engage an intermediary (" Midco") that would convey the target's assets to the buyer without incurring a tax liability. In the arrangement, the seller sells the target stock to the Midco, which then sells the target's assets to the buyer. In principle, the

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[49] *See* IRS Notice 2001-16.

Midco is able to sell the target's assets without incurring tax because it has net operating losses or some other characteristics that would shield the gain from tax. By selling the corporate stock to a Midco entity—i.e., an entity that has favorable tax attributes such as tax losses or tax credits—the parties hoped to avoid a least one level of the double tax. Typically, the sellers of the corporate stock and the Midco would agree to split the resulting tax savings.

For example, assume a sale of a $15,000,000 asset with $10,000,000 gain arising from the sale. Assume a tax liability that likely would arise from the sale of $2,000,000. The net value of the corporation is $13,000,000 - i.e., $15,000,000 cash (the net sales proceeds) less $2,000,000 tax. The shareholders can realize the $13,000,000 by liquidating the corporation after paying the tax. Or the shareholders can sell the stock to a third party who would be willing to pay only $13,000,000 because that is all the buyer would realize by taking the cash out of the corporation, provided that the corporate level tax was paid. But in the Midco transaction, the buyer would pay the shareholder a premium - something more than the $13,000,000. Why? Maybe the buyer has NOLs, or could put an asset into the corporation that has a built-in loss and then use that loss to offset the gain. That would eliminate the corporate level tax and thus there is $15,000,000 cash available for the buyer.

Unfortunately, in many cases, the Midco's beneficial tax attributes (which may be unknown to the seller) proved to be illusory or nonexistent, leaving the Midco with a large tax liability when it ultimately sold the property. Often, these Midco transactions took place over several months and could be difficult to identify. Moreover, the seller (transferee) and ultimate buyer (transferor) may have had no interaction with each other or no knowledge of the loss-sheltering transaction. In fact, many unsuspecting sellers learned after the stock sale that the

Midco was just a newly formed shell corporation with no income or assets that distributed all of the money it received from the transaction, leaving it insolvent when the federal tax bill arrived. The linchpin to the Midco transaction was that the Midco entity never intended to pay the federal tax on its sale of the assets because it claimed tax losses or tax credits that would shield the gain from tax. But sellers learned that the claimed tax losses often arose from tax shelters or loss-generating transactions lacking economic substance that later were disallowed. In the more egregious cases, the Midco simply transferred all the assets, became insolvent and disappeared, leaving unpaid the tax liability on the sale of the assets. As a result, the IRS had to look elsewhere to recoup the fisc's lost taxes. Having failed to collect the corporate level tax from the transferor, the Service looked to the former shareholder - transferee to pay the corporate level tax.

Midco transactions have been the subject of an evolving series of IRS notices and internal directives. On February 26, 2001, the IRS issued Notice 2001-16 to alert taxpayers that the Service had become aware of certain marketed transactions involving the use of intermediary companies for tax avoidance purposes and declared those transactions and "substantially similar" transactions to be "listed transactions" under Section 6011.[50] The IRS warned taxpayers and tax practitioners of its intention to challenge the purported tax results of the transaction and that it could assert monetary penalties against taxpayers and/or their advisors.[51] Under the Notice, the

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[50] 2001-1 C.B. 730.

[51] *Id.* The Notice provided that "[t]he Service may impose penalties on participants in these transactions, or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701."

IRS announced that it may seek to recast the transaction, depending on the facts and particular case, under one of the following theories:

- Midco is an agent for the sellers, and consequently the target sold assets while still being owned by the sellers.
- Midco is an agent for the buyers, and therefore the buyer purchased stock rather than assets (thus receiving no step-up).
- The transaction is otherwise characterized to treat the shareholders as selling assets; or to treat the target as selling assets while still owned by the selling shareholders.

In 2002, the IRS issued its "Intermediary Transaction Tax Shelter Coordinated Issue Paper," which directed examiners to evaluate all of the facts and circumstances of the case to determine whether the proper characterization of the transaction should be as a stock sale or an asset sale.[52] The issue paper identified a number of factors to consider. A key factor focused on which party (buyer or seller stockholder) had brought the intermediary into the transaction and paid its fees. In addition, auditors were told to consider the economic substance and step transaction doctrines to disallow any of the offsetting losses claimed.

The Service's issue paper was followed by a memorandum by the Service dated January 12, 2006, entitled "Examination of Multiple Parties in Intermediary Transaction Tax Shelters as described in Notice 2001-16."[53] IRS examiners were told that IRS made a "management decision" to refocus attention "on the potential liability of parties other than just the intermediary entities, which will almost certainly be inadequate sources for collection."[54] In examining Midco

[52] *See Coordinated Issue: All Industries: Intermediary Transaction Tax Shelters* (Effective December 19, 2002).

[53] *See* www.irs.gov/Businesses/Examination -of-multiple-parties-in-intermediary-transactions-tax-shelters-as -described-in-Notice-2001-16 (January 12, 2006).

[54] *Id.*

transactions, the IRS became aware that the intermediary selling the corporate assets often filed a "final" return for the year of the transaction, stripped the entity of all assets and terminated its existence, which left the IRS with a deficiency determination, but no taxpayer able to pay the tax liability. Thus, the only pockets remaining to pick were those of the selling shareholders, leaving the IRS to assert transferee liability against them. To address this problem, the IRS issued Notice 2008-111 to notify taxpayers of potential transferee liability.[55]

In a typical Midco transaction, the selling shareholder may have had no idea what the intermediary company did with their formerly-owned entity after the transaction closed. The selling shareholder might not have ever seen the "final" return filed by the purchaser or ever have known it claimed improper losses or deductions to offset the tax due. However, the IRS rejected these claims in Notice 2008-111.[56] In Notice 2008-111, which was intended to clarify Notice 2001-16, not replace the prior notice, the IRS stated that a person (*e.g.*, X, a selling shareholder of T) is part of the Plan for tax avoidance and potentially liable as a transferee for the unpaid corporate level tax of T if:

> the person knows or has reason to know the transaction is structured to effectuate the Plan. Additionally, any X that is at least a 5 percent shareholder of T (by vote or value) or any X that is an officer or director of T engages in the transaction pursuant to the Plan if any of the following knows or has reason to know the transaction is structured to effectuate the Plan:[57]

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[55] 2008 -2 C.B. 1299.

[56] *Id.*

[57] The "Plan" is defined in Notice 2008-111 as follows: "An Intermediary Transaction involves a corporation (T) that would have a Federal income tax obligation with respect to the disposition of assets the sale of which would result in taxable gain (Built-in Gain Assets) in a transaction that would afford the acquiror or acquirors (Y) a cost of fair market value basis in the assets. An Intermediary Transaction is structured to cause the tax obligation for the taxable disposition of the Built-In Gain Assets to arise, in connection with the disposition by shareholders of T (X) of all or a controlling interest in T's stock, under circumstances where the person or persons primarily liable

(i) any officer or director of T;

(ii) any of T's advisors engaged by T to advise T or X with respect to the transaction; or

(iii) any advisor of that X engaged by that X to advise it with respect to the Transaction.

In Notice 2008-111, the IRS conceded that where there are more than five officers of T, the term "officer" shall be limited to the chief executive officer of T and the next four most highly compensated officers. However, ignorance is not a defense. The Service stated in the Notice that, in its view, "[a] person can engage in the transaction pursuant to the Plan even if it does not understand the mechanics of how the liability purportedly might be offset or avoided, or the specific financial arrangements, or relationships of the other parties or of T after the Stock Disposition."[58] But the fact that a taxpayer may have been offered attractive pricing terms by the buyer will not be treated as a transaction pursuant to the Plan.[59]

While Notice 2008-111 indicated that the IRS may seek to attack a Midco transaction to assess the former shareholder with the tax that should have been paid on the transaction by the transferor (and interest and penalties), the IRS is required to establish transferee liability under the strict technical requirements of Section 6901 and state law. For example, absent proof of actual fraud, in most "transferee-in-equity" cases, the existence of a transfer for inadequate consideration from the transferor to the transferee is a requirement for transferee liability, as is

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for any Federal income tax obligation with respect to the disposition of the Built-in Gain Assets will not pay that tax (hereafter, the Plan)."

[58] See Notice 2008-111.

[59] *See* Notice 2008-111 (Section 4).

the fact that the underlying tax liability of the transferor must have existed at the time the transaction between the transferee and transferor occurred.

Section 6901 - Transferee Liability Cases Involving Midcos

The transferee issues noted above have been presented before various trial and appellate courts, which have seen disparate results. In each of these cases, an intermediary was engaged to create a Midco transaction with the intent to provide a benefit to both the buyer and seller to achieve a desired result. However, as a result of actions taken by the intermediary after the transfer of the corporate stock, the corporate tax liability that would have otherwise been due was either eliminated or offset. In several cases, the IRS has successfully employed Section 6901 to hold the selling shareholders liable as transferees for the unpaid corporate taxes. In most of these cases, the IRS was able to establish that the selling shareholders knew or should have known that the intermediary Midco to whom they sold the stock was going to have a tax liability that it would not pay.

The leading transferee liability case in New York involving a Midco transaction is the Second Circuit's decision in *Diebold Foundation, Inc.*[60] Diebold involved Double D Inc. ("Double D"), a New York C corporation with two shareholders: the Dorothy R. Diebold Marital Trust and the Diebold Foundation, Inc. Double D was a holding company containing substantially appreciated assets of $319 million, which consisted of $291.4 million of publicly traded securities.[61] The shareholders agreed to sell all of the Double D stock to Shap Acquisition Corp. II ("Shap II"), a newly formed corporation created by Sentinel Advisors for $309 million,

[60] *Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013).

[61] *Id*. at 176.

which was funded through a bank loan. Immediately afterwards, Shap II sold the securities to Morgan Stanley and repaid the Rabobank loan, netting a $10 million profit.[62] Shap II reported all of the gain from the asset sales with Double D, but the gain was entirely offset by losses (from a Son-of-BOSS tax shelter), resulting in no net tax liability.[63]

The IRS issued a notice of deficiency against Double D for the $81 million tax on its built-in gain and also asserted an accuracy-related penalty based on a determination that the shareholders' sale of Double D stock was in substance an asset sale followed by a liquidating distribution.[64] But Double D had been dissolved and its assets were gone. Double D did not contest the tax liability, but the Service was unable to collect the tax. Deciding that any additional efforts to collect from Double D would be futile, the Commissioner then proceeded against the former shareholders as transferees under Section 6901. The IRS pursued the selling shareholders in Tax Court. The Tax Court held that one of the shareholders, a marital trust, was not a transferee of the Midco but that the other shareholder, a foundation and its successor foundations, was a transferee. However, the Tax Court concluded that the foundations were not liable for the unpaid tax liabilities under New York's fraudulent conveyance law because Double D Ranch representatives' level of awareness about Shap II's plan to engage in some sort of tax strategy did not require the representatives to make further inquiry into the circumstances of the transaction.[65] The Tax Court concluded that *Diebold's* facts closely resembled the facts in

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[62] *Id*. at 181.

[63] *Id*.

[64] *Id*.

[65] *See Salus Mundi Foundation v. Commissioner*, T.C. Memo 2012-61, *17 (103 T.C.M. (CCH) 1289).

Starnes[66] and *Frank Sawyer Trust*[67] - both cases where the Tax Court decided not to collapse various transactions under the uniform fraudulent conveyance statute.[68]

On appeal, the IRS acknowledged that it may assess transferee liability under Section 6901 against a party only if two independent prongs are met: (1) the party must be a transferee under Section 6901, and (2) the party must be subject to liability at law or in equity.[69] As to the first prong of Section 6901, the court must look to federal tax law to determine whether the party in question is a transferee.[70] The Service argued that the two questions were not independent - that the court must first make a determination as to whether the party in question is a transferee, looking to the federal tax law doctrine of "substance over form" to re-characterize the transaction.[71]

The Second Circuit rejected the IRS's argument that transferee liability should be determined by applying the "substance over form" doctrine to re-characterize the transaction and then assessing liability with respect to the re-characterized transaction.[72] Instead, the court adopted a two-prong framework followed by the First Circuit in *Frank Sawyer*[73] and the Fourth

[66] *See Starnes v. Commissioner*, T.C. Memo 2011-63 (101 T.C.M. (CCH) 1283).

[67] *See Frank Sawyer Trust v. Commissioner*, T.C. Memo 2011-298.

[68] *Salus Mundi Foundation v. Commissioner,* T.C. Memo 2012-61, *18, *affd* 776 F.3d 1010 (9th Cir. 2014).

[69] *See Rowen v. Commissioner*, 215 F.2d 641, 643 (2d Cir. 1954).

[70] *Id.* at 644.

[71] *Diebold Foundation, Inc. v. Commissioner,* 736 F.3d 172, 184 (2d Cir. 2013).

[72] *Id.*

[73] *See Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013).

Circuit in *Starnes*[74] that determines: (1) whether the taxpayer is a transferee under Section 6901, and (2) whether the taxpayer is liable under state law due to a fraudulent transfer.[75]

The Second Circuit looked to the New York Uniform Fraudulent Conveyance Act (NYUFCA) to determine whether the shareholders knew or should have known of "the entire scheme" that rendered the sale transaction fraudulent - a conveyance without consideration that rendered the transferor insolvent.[76] The court held that the shareholders should have inquired further into the supposed tax attributes that allegedly would have allowed Shap II to absorb the tax liability on the appreciated assets.[77] Accordingly, the court concluded that Double D's shareholders evinced "constructive knowledge" because the facts "plainly demonstrate that the parties 'should have known' that this was a fraudulent scheme, designed to let both the buyer of the assets and the seller of the stock avoid the tax liability inherent in a C Corp holding appreciated assets and leave the former shell of the corporation, now held by a Midco, without assets to satisfy the liability."[78] The *Diebold* court relied primarily on the fact that "[t]he parties to this transaction were extremely sophisticated actors, deploying a stable of tax attorneys from

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[74] *See Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012).

[75] *See also, Salus Mundi Foundation v. Commissioner*, 776 F.3d. 1010 (9th Cir. 2014) The Ninth Circuit noted that although the IRS's argument was a plausible reading of *Stern*, three other circuits had rejected its position: *Diebold Foundation, Inc. v. Commissioner*, 736 F.3d 172 (2nd Cir. 2013), *Frank Sawyer Trust v. Commissioner*, 712 F. 3rd 597 (1st Cir. 2013), and *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012). The Ninth Circuit agreed with the 2nd, 1st and 4th Circuits that *Stern* is "best interpreted as establishing that the state law inquiry is independent of the federal law procedural inquiry."

[76] *Diebold, supra* , at 187.

[77] *Id.*

[78] *Id.* at 189.

two different firms in order to limit their tax liabilities."[79] The Second Circuit listed a number of other facts:

- The shareholders recognized a significant tax "problem" inherent in the appreciated assets;
- The shareholders actively sought a tax solution - seeking out parties that could avoid the inherent tax liability;
- The shareholders viewed presentations from three different firms that purported to deal with the tax liability problem;
- The shareholders' advisors knew that Shap II borrowed funds to purchase the stock and intended to sell its assets immediately after closing to repay the loan; and
- The shareholders knew that Shap II was a newly formed entity.

The Second Circuit also cited to the purchase agreement, where the buyer's plan to sell the target's assets was apparent to the sellers because it was mentioned in the draft purchase agreement.[80] The court concluded that "[c]onsidering their sophistication, their negotiations with multiple partners to structure the deal, their recognition of the fact that the amount of money they would ultimately receive for an asset or stock sale would be reduced based on the need to pay the C Corp. tax liability, and the huge amount of money involved, among other things, it is obvious that the parties knew, or at least should have known but for active avoidance that the entire scheme was fraudulent and would have left the target corporation unable to pay its tax liability."[81]

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[79] *Id.* at 188.

[80] *Id.* at 179.

[81] *Id.* at 188. The same facts were raised in *Salus Mundi Foundation v. Commissioner*, 776 F.3d 1010 (9th Cir. 2014). The Ninth Circuit therefore looked to the Second Circuit's decision. The Second Circuit had concluded that under substantive state law, the Double D shareholders had constructive knowledge of the tax avoidance scheme since (1) they knew an asset sale by the corporation would create a large tax liability from the built-in

Upon determining that the shareholders had constructive knowledge, the court collapsed the sale and post-sale transactions, applying New York law, and concluded that Double D made a fraudulent conveyance. The case was remanded to the Tax Court to consider, among other questions, whether the foundation was a transferee under Section 6901. Briefs have been submitted to the Tax Court, but the matter remains undecided since remand from the Second Circuit.

The Fourth Circuit Rules for Taxpayer Starnes

In *Starnes v. Commissioner*[82] the Fourth Circuit, faced with facts similar to *Diebold*, applied North Carolina law and upheld the Tax Court's decision that the selling shareholders were not liable as transferees because they did not know, nor did they have reason to know, that the Midco would cause the target corporation to fail to pay its taxes.[83] The Starnes transaction was entered into after issuance of Notice 2001-16, but that fact did not appear to influence the court's decision.[84]

In Starnes, the shareholders had worked at the trucking company they owned (Tarcon, Inc.) for over forty years. In 2003, the shareholders decided to retire and liquidate their interests. At that point, Tarcon had ceased its business operations, and its sole remaining non-cash asset

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gain, (2) they had a sophisticated understanding of the structure of the transaction, and (3) they knew that Shap was formed to facilitate the transaction and did not have assets to meet its obligation to purchase the stock to sell to Morgan Stanley or to compensate Morgan Stanley if it could not meet its obligations. Since "absent a strong reason" the Ninth Circuit will not create a direct conflict with another circuit, and the Second Circuit addressed the same facts, issues and applicable law, the Ninth Circuit adopted the Second Circuit's reasoning and held that the shareholders had constructive knowledge. As in *Diebold*, the Ninth Circuit remanded the case to the Tax Court to determine Salus Mundi's status as a transferee of a transferee under federal law and whether the IRS asserted transferee liability within the statutory period.

[82] *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012).

[83] *Id.* at 439.

[84] *Id.* at 435.

was an industrial warehouse that it leased to others.[85] After considering various options and consulting with their real estate broker, accountant and attorneys, the shareholders sold Tarcon's only asset, a warehouse, to one company, ProLogis, Inc., which left Tarcon with only cash. The shareholders then sold their Tarcon stock to another company, MidCoast Investments. MidCoast was introduced to the shareholders through a commercial real estate broker. MidCoast represented that it was in the "asset recovery business." MidCoast met with the shareholders and contractually agreed to operate Tarcon as a going concern; MidCoast would not dissolve, liquidate or merge into another company; MidCoast would cause Tarcon to file all tax returns related to the federal and state income taxes owed by the company from selling the warehouse on a timely basis, and MidCoast represented that Tarcon's tax liabilities would be satisfied.[86] The shareholders made no inquiries and did not understand what was meant by the "asset recovery business," but they had no reason to believe MidCoast would not honor these commitments. The parties agreed that the price of the stock would be $2.6 million, equal to the amount of Tarcon's cash ($3.1 million) less 56.25 percent of Tarcon's $880,000 income tax liability.[87]

According to the stock purchase agreement, Tarcon's $3.1 million was supposed to be transferred into Tarcon's "post-closing" bank account, but that did not occur. A few days after the closing and without prior notice to the former shareholders, MidCoast sold its Tarcon stock to Sequoia Capital, a Bermuda company, for $2.9 million and transferred the cash to an account in the Cook Islands in the name of Delta Trading Partners.[88] Tarcon filed its 2003 federal tax

[85] *Id.* at 423.

[86] *Id*. at 421.

[87] *Id*. at 423.

[88] *Id*. at 424.

return, but never paid its taxes, claiming large offsetting losses for certain transactions that occurred after MidCoast acquired Tarcon. The IRS audited Tarcon and disallowed and assessed Tarcon with a deficiency of $1.5 million including penalties and interest, which Tarcon did not pay. Looking for a pocket to pick, the IRS sent notices of transferee liability to Tarcon's former shareholders under the theory that the transaction was substantially similar to an intermediary transaction (a Midco tax shelter) and was, in substance, a sale of Tarcon assets followed by a distribution of the proceeds to its shareholders. The IRS asserted the former shareholders were liable as transferees under Section 6901. The former shareholders filed petitions in the Tax Court contesting the notices of transferee liability. The Tax Court ruled in favor of the former shareholders, finding that the IRS had failed to carry its burden of proof.[89] The IRS appealed that decision in the U.S. Court of Appeals for the Fourth Circuit.

The Fourth Circuit addressed and rejected the Service's various claims for transferee liability under state law, specifically under North Carolina's version of the Uniform Fraudulent Transfer Act (the "NCUFTA") and North Carolina common law. With respect to the arguments advanced by the IRS under the NCUFTA, the threshold question for the court was "what transfer or combination of transfers should be considered to determine whether Tarcon received reasonably equivalent value and/or was rendered insolvent?"[90] The IRS argued that the sale and post-sale transactions, which would include MidCoast's transfer of cash to the Cook Islands, should be "collapsed."[91] But the court refused to collapse the transactions because it found the IRS failed to prove that the former shareholders had the requisite knowledge to impose transferee

[89] *Id*. at 425.

[90] *Id*. at 431.

[91] *Id*. at 429, 432, 437.

liability under North Carolina law.[92] The test applied by the court was whether the former shareholders knew or should have known that Tarcon would fail to pay its taxes under its new owner.[93]

The Service argued that the Tax Court's findings were clearly erroneous and that the shareholders "knew or should have known" that MidCoast had tax avoidance intentions because "MidCoast's promotional materials stated that it targeted corporations that had only cash and offered shareholders a way to minimize their tax burden" and that the "negotiations revolved largely around the percentage of the amount of Tarcon's 2003 taxes that MidCoast would pay the Former Shareholders as a "premium."[94] In further support of its position, the Service argued that the shareholders' inquiry was not reasonably diligent based on the fact that one shareholder acknowledged that paying cash for a corporation that held only cash "did sound strange," and that another shareholder stated that he did not understand the deal and did not want to understand it.[95] Even the shareholders' accountant questioned whether the sale was "2001-16 reportable."[96] But the Circuit Court concluded that while this evidence supported the Service's position it did not persuade the court that the Tax Court's findings were clearly erroneous. The court noted the taxpayers' lack of sophistication and explained that although the selling shareholders had experience in the freight and warehousing business, none of the shareholders had ever sold a business before and "none had any education, training or experience in accounting, taxes or

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[92] *Id*. at 437.

[93] *Id*. at 439.

[94] *Id*. at 435.

[95] *Id*. at 422.

[96] *Id*.

finance."[97] In addition, MidCoast represented to the shareholders that Tarcon would not be "dissolved or consolidated," but rather Tarcon would be "'reengineered into the asset recovery business' and become an 'income producer' for MidCoast going forward."[98] MidCoast "repeatedly represented that it would ensure that Tarcon would pay its . . . taxes,"[99] and MidCoast had been in business since 1958, and represented that it had recently transitioned to asset recovery involving credit card debts. Notably, MidCoast's attorney testified that he had no reason to believe that MidCoast would not ensure that Tarcon's corporate taxes would be paid.[100]

Based on these facts, the court held that the Tax Court did not commit clear error in finding that the IRS was required but failed to prove that "no reasonably diligent person in the Former Shareholders' position would have failed to discover that MidCoast would cause Tarcon to fail to pay its 2003 taxes."[101] The court also rejected an argument that the former shareholders were liable under North Carolina's "trust fund doctrine" because the IRS was unable to demonstrate the transaction amounted to a winding up or dissolution of the company.[102]

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[97] *Id*. at 436.

[98] *Id*.

[99] *Id*. at 422.

[100] *Id*. at 421-422.

[101] *Id*. at 434.

[102] *Id*. at 438 -439.

The IRS is Victorious in Frank Sawyer

A year after the loss in *Starnes*, the Service notched a win in *Frank Sawyer*[103] where the First Circuit recognized that something suspicious occurred in a Midco transaction. The patriarch, Frank Sawyer, died in 1992 at age 97. His wife Mildred died in 2000. Included in her estate was the Frank Sawyer Trust of 1992 ("Trust"). The taxable estate was $138,480,721 and there were four C corporations (taxi companies) with highly appreciated assets. All four corporations sold their assets to unrelated third parties. Each of the corporations recognized gain on the sale and were left holding large amounts of cash. A representative of the Trust received an unsolicited promotional letter from MidCoast Credit Corp, which indicated that MidCoast was interested in purchasing the corporate stock. Because of the size of the stock sale, MidCoast brought in Fortrend, described as an investment bank, who had greater access to capital. Representatives of the trust met with Fortrend. Fortrend indicated that it would pay a purchase price for the stock equal to value of the cash and other assets less 50 percent of the amount of the income tax liability - the purchase price represented a significant premium above the amount that the Trust would have received if the companies paid the federal and state tax themselves and then distributed the remainder to the Trust. The offer was too good to pass, so the Trust decided to sell to Fortrend.

As we have seen in earlier Midco cases, Fortrend was not the purchaser. Instead, Fortrend formed a new Delaware LLC, Three Wood, which borrowed $30 million from

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[103] *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013).

Rabobank.[104] Following the sale, Three Wood used the loan to pay the former shareholders, and cash received from the corporation was used to repay the loan.[105] Three Wood then transferred the stock of the C corporations to two shell companies. What assets remained, Three Wood transferred to accounts held by other Fortrend entities. A year later, the Trust agreed to sell two other corporations to Fortrend. As before, Fortrend used controlled subsidiaries to consummate the deals, with Rabobank providing the financing.[106] With all deals, Fortrend had agreed to assume the tax liabilities, but Fortrend claimed unrelated stock losses to offset the gain recognized from the Trust corporations. The IRS subsequently examined all of the companies' tax returns and disallowed the deductions.[107]

When the transaction proceeded apace and the attempted tax offset was unwound, the IRS started looking for other suspects from whom it could collect. The problem the IRS had was that the Trust did not receive corporate distributions. In fact, Fortrend had borrowed from a bank to pay the Trust. The loan was transitory, but the Trust appeared not to know. With arguments similar to those in *Diebold,* the IRS wanted to collapse everything together. Yet under the Uniform Fraudulent Transfer Act, the burden was on the IRS to prove that the Trust knew Fortrend's schemes were illegitimate. The court didn't find that the Trust had actual knowledge. In fact, the IRS had stipulated that at the time of the stock sales the Trust representatives didn't

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[104] *Id.* at 600-601.

[105] *Id.* at 600-601.

[106] *Id.* at 600-602.

[107] *Id.* at 600-604.

know about the post-closing merger or the contribution of inflated-basis stock contemplated by Fortrend.[108]

The Government argued that the combination of Section 6901 transferee liability (the procedural tool) and the Massachusetts Fraudulent Transfer Act (the remedial tool) permitted the IRS to assert transferee liability. The Tax Court rejected transferee liability because it read the Massachusetts Fraudulent Transfer Act requiring knowledge of the buyer's maneuvers to underpay the tax liability and strip the cash out of the corporation.[109] The Tax Court, concluding that the IRS had not shown enough to invoke the knowledge or constructive knowledge requirement, refused to collapse the transaction.[110]

The First Circuit approved the Tax Court's key fact findings and declined to apply a collapsing theory. But it came up with another theory - apparently not argued by the parties - that essentially amounts to the same thing. It called this theory a "transferee-of-transferee liability,"[111] where liability may be found regardless of whether the trust had constructive knowledge of Fortrend's intentions.

Essentially, the theory is that the IRS having rejected Fortrend's attempt to offset the taxi companies' tax liabilities - became a creditor of those companies, then it had a fraudulent transfer claim against Three Wood.[112] The court then recognized that "[i]f the IRS had a fraudulent transfer claim against Three Wood, then the IRS is also a creditor of Three Wood

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[108] *Id.* at 600-601.

[109] *Id.* at 599.

[110] *Id.* at 606.

[111] *Id.* at 606.

[112] *Id.* at 607.

under Massachusetts UFTA. And if the IRS is a creditor of Three Wood, the IRS can recover not only from Three Wood, but also from parties who received fraudulent transfers from Three Wood."[113] Three Wood made a transfer to the Trust: it paid the Trust $32.4 million in exchange for the taxi companies with a net book value of only $25.3 million. The First Circuit remanded the case to the Tax Court to "determine in the first instance whether the value of the companies transferred by the Trust to Three Wood was 'reasonably equivalent' to the value of the cash transferred by Three Wood to the Trust."[114] And if not, whether the Fortrend acquisition vehicle's inability to satisfy the tax liability was reasonably foreseeable.

On remand, the Tax Court concluded that Three Wood overpaid for the taxi corporations because it believed it could avoid the corporations' tax liability - it did not receive equivalent value when it transferred cash to the Trust to pay the purchase price.[115] As to the second prong of the analysis, the Tax Court found that Three Wood should have known that its tax avoidance strategy would fail.[116] Consequently, Three Wood engaged in a fraudulent transfer to the Trust because Three Wood should have known that purchasing the taxi companies would cause it to incur debts beyond its ability to pay.[117] Accordingly, the Trust was liable as a transferee.

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[113] *Id.* at 607-608.

[114] *Id.* at 609.

[115] *Frank Sawyer Trust of May 1992 v. Commissioner*, T.C. Memo. 2014-59, *5 (107 T.C.M. (CCH) 1316).

[116] T.C. Memo. 2014-59, *4.

[117] T.C. Memo. 2014-59, *5.

The Tax Court Rules Against the Taxpayer in *Cullifer*

Just a few months after the Tax Court decided *Frank Sawyer*, Judge Laro decided *Cullifer v. Commissioner.*[118] In *Cullifer*, the taxpayer had been an officer and shareholder of Neches, a C corporation in Texas that rented storage space for ammonia and other chemicals. Cullifer desired to sell Neches, but the corporation had a large built-in gain and low stock basis. Following a lengthy negotiation process, Neches sold its assets for $26 million to one of its tenants. Opting not to dissolve Neches, Cullifer offered to sell the corporate stock in an auction to one of several bidding "NOL companies" interested in acquiring target entities with "post-sale cash and tax liabilities."[119] Three bidders presented offers, including MidCoast, who Cullifer selected as the winning bid. Cullifer understood that MidCoast offered a premium for Neches' stock because of tax benefits that could be used in MidCoast's asset recovery operation.

The taxpayer did minimal due diligence for the stock sale. Cullifer did retain tax counsel, but he did not instruct any of his advisers to research the bidders' financial situation, their history or operations, how the desired tax outcome would be achieved, or the legality of the stock enhancement concept. Despite concerns raised by his tax counsel, Cullifer agreed to sell Neches to MidCoast.[120] As one might guess, the purchaser was not MidCoast, but a new entity, Neches

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[118] *Cullifer v. Commissioner*, T.C. Memo. 2014-208 (108 T.C.M. (CCH) 408).

[119] T.C. Memo. 2014-208, * 4.

[120] Cullifer's tax advisor, Robert Thomas, Esq., sounded concerned. Thomas stated: "I still have the same feeling that any buyer of the stock may not be able to get the tax benefits they think they will get if they ever get audited. But, that won't be OUR issue as long as we carefully limit our reps and warranties in the sale agreement. * * *"

Mr. Thomas concluded:

Holdings LLC, created by MidCoast to acquire Neches. Following the stock sale and unbeknownst to Cullifer, MidCoast and Neches Holdings engaged in a number of transactions which removed all assets Neches owned and manufactured a bad debt loss to offset its taxable gain.[121] The IRS eventually assessed deficiencies against the Neches, but found that most of the liabilities were uncollectible, so it sent Cullifer a notice of transferee liability.

The court held that the taxpayer was a transferee under Section 6901(a), which was also not disputed by the taxpayer.[122] The court then looked to state (Texas) law to assess transferee liability, including the Uniform Fraudulent Transfer Act of 1984 (UFTA), which was adopted by Texas.[123]

The Service argued that the court should collapse the post-closing transactions executed by Neches Holdings and MidCoast with the closing transaction with Cullifer and treat these transactions as a single transaction under the Texas UFTA. The court declined to collapse the stages in the transaction and to recast the stock sale proceeds as a liquidating distribution to

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"DO NOT SIGN ANY LETTER OF INTENT OR ANYTHING ELSE REGARDING A POTENTIAL * * * STOCK SALE UNTIL YOU LET ME REVIEW/BLESS IT FROM THE LEGAL END. WE DON'T WANT TO GET TRAPPED HERE."

Mr. Thomas wanted guarantees, etc., from MidCoast, but the final purchaser wasn't MidCoast, so Mr. Thomas raised concerns again, stating:

"One thing right off the top that should be a deal killer - where the hell did Midcoast go? * * * The business risk to you without Midcoast or other party with money is that there is no one there to step up and honor the indemnity for tax liabilities fye [(for year ending)] 9/30/04 which would otherwise be due on corp asset sale * * * if IRS comes calling in 2005, or [the shell-shill] does something screwey post stock sale that gets us in trouble with IRS or whoever. Seems to me Midcoast must be a party or at least guarantee the performance of all obligations, etc of [shell-shill] under the agreement."

[121] T.C. Memo. 2014-208, * 10.

[122] T.C. Memo. 2014-208, * 17.

[123] T.C. Memo. 2014-208, * 17-18.

Cullifer.[124] As the court viewed the transaction, both before and after the sale by Cullifer, Neches held the same amount of cash and owed the same amount of taxes.[125] Although MidCoast and Neches Holdings later removed the cash from Neches, these distributions occurred after the stock sale and without Cullifer's knowledge. The court concluded that even if Cullifer had constructive knowledge of these post-sale distributions, Cullifer was not a recipient of those distributions.[126] However, although the taxpayer was not found to be a transferee of Neches' cash holdings, Cullifer nonetheless had liability as a transferee of a transferee.[127]

The transferee in this case was Neches Holdings, who received Neches' cash in exchange for worthless demand notes. A following transfer took place when Neches Holdings transferred Neches' cash to MidCoast. At the time that Neches transferred cash to Neches Holding, the intermediary company, Neches was insolvent, the IRS was a creditor of Neches, and Neches did not receive any value in exchange (it received demand notes which were valueless because the intermediary, Neches Holdings, never intended to repay Neches). The transfers were, therefore, fraudulent under the Texas UFTA, and, as a result, the IRS became a creditor of Neches Holdings.[128] As a creditor of Neches Holdings, the IRS can recover not only from Neches Holdings, but also from parties who received fraudulent transfers from it.[129] Thus, the issue was whether the cash that Neches Holdings transferred to Cullifer constituted a fraudulent transfer.

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[124] T.C. Memo. 2014-208, * 22.

[125] *Id.*

[126] *Id.*

[127] T.C. Memo. 2014-208, * 23.

[128] T.C. Memo. 2014-208, * 25.

[129] *Id.*

Under the Texas UFTA, a transfer "is fraudulent as to a creditor, whether the creditor's claim arose before or within a reasonable time after the transfer was made" if (1) the debtor did not receive reasonably equivalent value in exchange for the transfer, and (2) the debtor "intended to incur, or believed or reasonably should have believed that the debtor would incur, debts beyond the debtor's ability to pay as they became due."[130] The court concluded that the transfer of cash from Neches Holdings to Cullifer was fraudulent because (1) the IRS became a creditor of Neches Holdings within a reasonable time after the transfer to petitioner, (2) Neches Holdings received an asset of negative value in exchange for the transfer, and (3) Neches Holdings knew or should have known that its purchase of Neches would cause it to incur debts beyond its ability to pay.[131] The court also held that in addition to being constructively fraudulent, the transfer of funds from Neches Holdings to Cullifer constituted actual fraud, because Neches Holdings had actual intent to "hinder, delay, or defraud" the IRS.[132]

Finally, the IRS made reasonable efforts to collect from the corporation, which was a prerequisite to a finding of secondary transferee liability on the part of the taxpayer. In addition, the IRS was not required to make efforts to collect from other parties to the transaction who were also transferees of the corporation. As a transferee, the taxpayer was severally liable for the unpaid tax of the transferor, and retained his rights of contribution with respect to those other transferees. The taxpayer was liable for the lesser of (1) the amount of fraudulent transfers he

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[130] *Id.*

[131] *Id.*

[132] T.C. Memo. 2014-208, * 26.

received from the corporation and (2) the amount of the corporation's deficiencies, penalties, and interest.[133]

Four Midco Cases Are Decided in 2015 starting with Andrew Decision

In 2015, courts decided four transferee cases involving Midco transactions.[134] The *Andrew* decision, which followed *Cullifer*, was decided by the United States District Court in North Carolina favorably for the taxpayer.[135] *Andrew* involved an investment club, GNC Investors Club, Inc., that had been formed as a C Corporation; it decided to liquidate due to the double taxation associated with that form.[136] Ultimately, a local attorney put one of the shareholders in touch with MidCoast Credit Corporation.[137] MidCoast proposed that it or its designee would acquire the GNC shareholders' stock as an alternative to the shareholders liquidating GNC. MidCoast offered a 10 percent premium above what the GNC shareholders would obtain in liquidation. Following background and reference checks, a transaction closed on

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[133] T.C. Memo. 2014-208, * 25.

[134] *See Andrew v. United States*, 91 F. Supp.3d 739 (D NC 2015); *Tricarichi v. Commissioner,* T.C. Memo 2015-201; *Alterman Trust u/a/d May 9, 2000 v. Commissioner*, T. C. Memo. 2015-231; *Shockley v. Commissioner*, T.C. Memo 2015-113. In prior years, taxpayers had previously defeated transferee liability in *Griffin v. Commissioner*, T.C. Memo. 2011-61 and *LR Development v. Commissioner*, T.C. Memo. 2010-203. The IRS was successful in asserting transferee liability in *CHC Industries v. Commissioner*, T.C. Memo. 2011-33 and in *Feldman v. Commissioner*, T.C. Memo. 2011-297 *affd,* 779 F.3d 448 (7th Cir. 2015). Currently pending in the Tax Court is *Slone v. Commissioner,* which was remanded by the Ninth Circuit. The Ninth Circuit found that the Tax Court had applied the wrong legal standard to the question of transferee liability. *See Slone v. Commissioner*, 788 F.3d 1049 *modified,* 116 AFTR2d 2015-5908 (9th Cir. 2015). The case was remanded to the Tax Court to determine whether the shareholders are substantively liable under the test supplied by *Stern v. Commissioner* (357 U.S. 39 (1958)).

[135] *Andrew v. United States*, 91 F. Supp.3d 739 (DC NC 2015)(appeal dismissed pursuant to Federal Rule of Appellate Practice 41(a)).

[136] *Id*. at 742.

[137] *Id*.

November 28, 2000, with the investment club shareholders selling their GNC shares to Battery Street, a MidCoast affiliate.[138]

On the closing day, Battery Street wired the purchase price of $3,818,000 to the escrow account of the club's lawyer.[139] The investment club's assets had previously been reduced to cash, and GNC wired most of its cash to a new bank account that Battery Street had established in GNC's name, while writing a check to Battery Street for less than $4,000 to close out a brokerage account.[140] Unbeknownst to GNC, Battery Street had obtained a loan to pay the purchase price, which was required to be repaid within 24 hours. None of the GNC shareholders knew the terms of the loan or how Battery Street would come up with the money to buy GNC's stock.

GNC later filed tax returns that reflected no tax liability, but the IRS assessed a deficiency of over $1.2 million and an accuracy-related penalty of over $500,000 in 2004.[141] When the government was unable to collect the deficiency, it turned to the former GNC shareholders, issuing transferee assessments in September 2008.[142] The former shareholders ultimately elected to pay the disputed amounts and seek a refund, giving rise to the district court case.

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[138] *Id*. at 743.

[139] *Id*. at 744.

[140] *Id.*

[141] *Id*. at 745.

[142] *Id.*

Applying North Carolina's Uniform Fraudulent Transfer Act, the district court promptly concluded that the initial transfers involving the sale of the GNC shares were not subject to attack.[143] The court reasoned that when the investment club transferred the bulk of its cash from its existing bank account to a new one (controlled by Battery Street), GNC retained control of its cash and therefore received reasonably equivalent value.[144] GNC was also not rendered insolvent, as it had ample cash to pay its tax liabilities.[145] Finally, the court concluded that a variety of factors demonstrated that the initial transfers were not made with the intent to hinder or defraud creditors, including the fact that the investment club retained ample assets to pay its liabilities, and no plaintiff had knowledge of MidCoast or Battery Street's tax strategy. The court noted that "several of plaintiffs credibly testified that they were familiar with legitimate business reasons for selling a company at a premium, and the plaintiffs received favorable business references concerning MidCoast."[146]

The court's focus then shifted to a variety of transactions that the Government contended occurred later, at the direction of Battery Street, after the alleged transferees no longer controlled GNC.[147] The government alleged that on November 29, 2000, GNC (now owned by Battery Street) transferred roughly $3.8 million to a lender that had financed Battery Street's acquisition

[143] *Id*. at 747.

[144] *Id*.

[145] *Id*.

[146] *Id.*

[147] The district court rejected the Government's argument, in part, because the documents (bank records) used to establish the post-closing transactions were "hearsay and are not admissible to prove that the transactions reflected in these records occurred as the Government describes them." *Id*. at 751-752.

of the shares.[148] The government also contended that GNC made two other transfers to pay fees that Battery Street incurred in the transaction.[149] The Government argued that these post-closing transfers along with the transfer of cash to the former GNC shareholders should be collapsed and treated as one "transfer" - the result is that the former GNC shareholders would be liable as transferees of GNC because GNC transferred all of its cash to the transferees, received nothing in return, leaving GNC unable to meet its tax obligations.[150] Citing *Starnes*[151] the district court noted that the transfers can be collapsed only if the "plaintiffs had actual or constructive knowledge of Battery Street's post-closing plans, that is, if the plaintiffs 'knew or should have known before the deal closed that [Battery Street] would cause [GNC] to fail to pay its * * * taxes'".[152] There was no evidence that any of the plaintiffs had actual or constructive knowledge of Battery Street's post-closing plans.

Another Win for the Service in *Tricarichi*

In October 2015, Judge Lauber decided *Tricarichi v. Commissioner,*[153] which handed a win to the Internal Revenue Service, concluding that the transferee of a cellphone company's assets was on the hook for a more than $21 million tax liability under Ohio law.

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[148] *Id*. at 748.

[149] *Id*.

[150] *Id*.

[151] *Starnes v. United States,* 680 F.3d 417 (4th Cir. 2012).

[152] *Id.* at 748-749, citing *Starnes*, 680 F.3d at 433.

[153] T.C. Memo. 2015-201. (110 T.C.M. (CCH) 370).

Tricarichi was the former president and sole shareholder of West Side Cellular Inc. ("West Side"). He incorporated West Side in 1988 as a C corporation because he thought it might ultimately have more shareholders than an S corporation would be permitted to have.[154] Although Tricarichi had no formal tax training, the Tax Court noted that he spoke easily about C corporations and S corporations, corporate tax rates, and other tax matters.[155] West Side's telecommunication activities in Ohio ran from 1991 until 2003. The company ended its operations in June 2003 after an anti-competitive practices battle against major cell service providers. West Side netted a more than $65 million settlement—a development that spurred Tricarichi to investigate tax strategies.

Following the large settlement, Tricarichi recognized that the C corporation would subject him to two-levels of tax on the settlement proceeds, so he contacted a tax attorney to "maximize whatever after tax proceeds were available" from the anticipated settlement.[156] He was introduced to MidCoast, but shortly thereafter Tricarichi met with Fortrend; he subsequently had several conference calls and at least one face-to-face meeting with Fortrend representatives. He understood that both Fortrend and MidCoast were both involved with "distressed debt receivable" and had the same business model.[157] Fortrend told Tricarichi that it would purchase his West Side stock and would offset the taxable gain with losses, thereby eliminating West Side's corporate income tax liability.[158] Fortrend proposed a structure where an intermediary

[154] T.C. Memo. 2015-201, *2.

[155] *Id.*

[156] *Id.*

[157] T.C. Memo. 2015-201. *3.

[158] *Id.*

company would borrow to purchase the stock. The cash held by West Coast would be used immediately to repay the loan. The cash petitioner received from the intermediary company would substantially exceed West Side's net asset value. The intermediary company would receive a fee equal to a negotiated percentage of West Side's tax liabilities. After the sale closed, the intermediary company, after merging into West Side, would use bad debt deductions to eliminate those tax liabilities. Tricarichi retained PwC to review the proposed transaction. PwC gave Tricarichi oral advice, but a PwC internal memorandum on the transaction concluded that "'a position can be taken' that the stock sale would not be a reportable transaction."[159] Ultimately, Tricarichi inked a deal with Fortrend.

As part of the agreement, Fortrend affiliate Millennium Recovery Fund LLC created Nob Hill Inc., a shell company to act as the "intermediary company" purchasing West Side's stock. Nob Hill later merged back into the company. The strategy and later actions led West Side to report a total income of slightly more than $66 million and total deductions of more than $67 million for 2003. But the IRS later cited tax avoidance in nixing roughly $44 million in deductions claimed by West Side for bad debt and legal and professional fees. The underlying tax liabilities of West Side included a more than $15 million tax deficiency and roughly $6 million in penalties under section 6662. West Side did not petition the Tax court and the IRS assessed the tax and penalties. In 2012, the IRS issued a notice of transferee liability to Tricarichi, with transferee Tricarichi later found liable by the IRS.

In his unsuccessful challenge, Tricarichi argued that he was not liable as West Side's transferee since Nob Hill purchased his stock before it received West Side's assets (and the source of Nob Hill's funds were bank loans), and that he received no "transfer" that would

[159] T.C. Memo. 2015-201, * 12.

trigger his liability under Ohio's Uniform Fraudulent Transfer Act—but Judge Lauber rejected Tricarichi's claims, stating "[w]e hold that petitioner is liable for West Side's tax under the Ohio Uniform Fraudulent Transfer Act and that the IRS may collect West Side's tax liabilities in full from petitioner . . . as a direct or indirect transferee of West Side."[160] "In sum, we find that the IRS claim arose before West Side's assets were transferred to petitioner; that West Side made this transfer without having received 'a reasonably equivalent value in exchange'; and that this transfer caused West Side to become insolvent," the opinion said. "Petitioner is thus liable for West Side's tax debts under [Ohio's] UFTA."[161]

Two in a Row – Service Wins Shockley

A similar result was reached by the Tax Court in *Shockley v. Commissioner,*[162] which involved the sale of the Shockley's telecommunication company, Shockley Communications Corp. ("SCC"). SCC owned television and radio stations in Wisconsin. The Shockleys, shareholders of SCC, desired to retire and sell SCC. After meetings with advisors and analyzing various options, the Shockleys sold their SCC stock to an affiliate of Integrated Capital Associates ("ICA"). The taxpayers were represented by counsel and accountants and were aware that the transaction was similar to a Midco (Notice 2001-16 was issued a few months before the sale), and were told that there was a risk that the IRS might recharacterize the transaction as an asset sale. Within hours after the stock sale, the assets of SCC were sold by ICA's affiliate.

[160] T.C. Memo. 2015-201, * 60

[161] T.C. Memo. 2015-201, * 24.

[162] T.C. Memo. 2015-113 (109 T.C.M. (CCH) 1579). The case had been remanded from the Court of Appeals for the Eleventh Circuit (686 F.3d 1226), after reversing the Tax Court's decision for the Taxpayers on statute of limitations grounds.

As the transaction took place in Wisconsin, the Tax Court applied Wisconsin's Uniform Fraudulent Transfer Act ("WUFTA") to determine whether the Shockleys were liable as transferees for the unpaid tax of SCC. But for the WUFTA to apply, the Service had to first show that there was a transfer of some kind made from SCC (transferor) to the Shockleys (transferee). Looking at the substance of the overall transaction, the court concluded that the substance of the transaction was different from its form - "that the only purpose of the ICA Midco transaction was tax avoidance," that it lacked economic substance and had no business purpose.[163] Based on these facts, the court disregarded the Midco transaction and deemed the Shockleys "to have received consideration for their shares from SCC pursuant to a *defacto* liquidation."[164]

Having established that the transfers were deemed to have occurred between SCC and the Shockleys, the court considered whether the Shockleys were liable as transferees under Section 242.5 of the WUFTA. A creditor under the Wisconsin statute must satisfy three requirements: (1) the creditor's claim arose before the transfer was made; (2) the debtor made the transfer without receiving a reasonably equivalent value in exchange for the transfer, and (3) the debtor either was insolvent at the time of the transfer or became insolvent as a result of the transfer.[165] The Tax Court concluded that the Service satisfied the three requirements and concluded that the Shockleys were transferees under Section 242.5 because "SCC made transfers to petitioners and others without having received anything of value in exchange, those transfers caused SCC to

[163] T.C. Memo. 2015-113, *46.

[164] T.C. Memo. 2015-113, * 41.

[165] T.C. Memo. 2015-113, * 48.

become insolvent, and respondent's claims arose before the transfers were made."[166] The Shockleys' motion for reconsideration under Rule 161 was denied.[167]

IRS comes up short - *Alterman Trust* Wins

Less than two months after the *Tricarichi* decision, in December 2015, the Tax Court decided the *Alterman Trust* case[168] - another replay of the fraudulent conveyance-transferee liability - Section 6901 drama arising from a MidCoast transaction. But surprisingly, the Tax Court, a decision by Judge Buch, found for the taxpayer and concluded that the IRS did not carry their burden of proof to establish transferee liability.

Here, MidCoast bought up the Alterman Corporation ("AC"), a family trucking business, claiming they would reengineer the company into a debt collector and lay off the built-in gain in the Altermans' C Corporation with bad debts. The Altermans retained a group of attorneys experienced in business succession and tax to evaluate and negotiate the transaction with MidCoast.[169] Negotiations took place over six months and included several meetings with MidCoast representatives. MidCoast described its plan for a viable business and provided significant representations, warranties and covenants to the shareholder. MidCoast represented that it had been in the financial services business for many years and that it was one of the "largest purchases of delinquent consumer receivables in the United States."[170] MidCoast

166 T.C. Memo. 2015-113, *51.

167 T.C. Memo. 2016-8.

168 *Alterman Trust u/a/d May 9, 2000 v. Commissioner*, T. C. Memo. 2015-231.

169 T. C. Memo. 2015-23, *3 (110 T.C.M. (CCH) 507).

170 T. C. Memo. 2015-231, *4.

explained that it desired to purchase the shares because it wanted to enter in to a joint venture agreement to purchase distressed credit card receivables.[171] MidCoast described its business plan as a deferral of tax and not an elimination of AC's putative tax.[172] The Altermans believed that MidCoast would operate AC and that it was a "g[o]ing concern that was solvent that could pay the taxes."[173]

What distinguished the sale of AC from other MidCoast deals were the terms contained in the purchase agreement. The final share purchase agreement included the following:

- MidCoast would not allow AC to be dissolved or liquidated for at least four years and had no intention of allowing that after four years either.
- MidCoast would reengineer AC into an asset recovery business.
- MidCoast would ensure that AC invested at least $1,450,000 into delinquent receivables and would reinvest the proceeds into more delinquent receivables for the next 10 years.
- MidCoast would ensure that AC maintained a net worth of at least $1.5 million for at least four years.
- MidCoast would cause * * * [AC] to pay the Deferred Tax Liability to the extent that the Deferred Tax liability is due given the Company's post-closing business activities and shall file all federal and state income tax returns on a timely basis related thereto."
- MidCoast would indemnify the former shareholders against any and all claims, including any damages, losses, deficiencies, liabilities, costs, and expenses resulting from and relating to any "misrepresentation, breach of warranty or nonfulfillment of any agreement or covenant on the part of any Purchaser under this Agreement."

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[171] *Id.*

[172] *Id.*

[173] T. C. Memo. 2015-231, *5.

- MidCoast would represent that the "combined net worth of Purchasers exceeds $10,000,000 as of the date hereof and as of the Closing Date."[174]

Of course, MidCoast did nothing of the kind. MidCoast misled the Altermans and their advisers. Unbeknownst to the Altermans and their advisers, MidCoast immediately sold the AC shares to Sequoia Capital - Sequoia had loaned MidCoast the acquisition funds. In addition, following the stock purchase, AC claimed a deduction for losses from interest rate swap options sales, which offset the deferred gain that MidCoast had promised to pay under the share purchase agreement.[175]

To establish liability, the court required the Service to prove that the transferees had constructive knowledge of the entire scheme.[176] Constructive knowledge is either the "knowledge that ordinary diligence would have elicited" or a "more active avoidance of the truth."[177] The Tax Court recognized that there are two inquires for constructive knowledge: (1) whether the former shareholders had a duty of inquiry, and (2) if so, what that inquiry would have revealed.[178] After reviewing the evidence, the Tax Court concluded that the Altermans lacked constructive knowledge because (1) the AC shareholders took reasonable steps to investigate MidCoast and took reasonable steps to ensure that MidCoast would honor the promise to pay the putative tax by placing significant covenants, representations and warranties in the share purchase agreement, and (2) further inquiry would not have revealed that the tax

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[174] T. C. Memo. 2015-231, *6-7.

[175] T. C. Memo. 2015-231, *10.

[176] T. C. Memo. 2015-231, *17.

[177] *See HBE Leasing Corp. v. Frank*, 48 F.3d 623, 636 (2d Cir. 1995); *Diebold Foundation, Inc. v. Commissioner,* 736 F.3d at 187.

[178] *See Starnes v. Commissioner*, 680 F.3d at 434.

liability would not be paid.[179] IRS argued that there should have been a post-closing audit by the Altermans, which was rejected by the court. No buyer lets the outgoing seller romp through her records post-closing.

IRS argued a violation of the FUFTA (Florida Uniform Fraudulent Transfers Act), but the Altermans demonstrated to Judge Buch that MidCoast's vehicle was not insolvent as the time of transfer, and IRS couldn't prove that the offshore to which cash was funneled was out of the control of MidCoast's vehicle. An important fact which weighted in Altermans' favor was the reps and warranties in the contract of sale.

Potential Defenses to Limit Transferee Liability

A. <u>Is Taxpayer a Transferee</u>

Under Section 6901, the Service can assess tax liability against a taxpayer only if the taxpayer is "the transferee of assets of a taxpayer who owes income tax."[180] This is often referred to as the first prong of the *Stern* test.[181] Treasury Regulations define the term "transferee" to include "the shareholder of a dissolved corporation."[182] If the stock sale is respected in the Midco arrangement, the shareholder can argue that it did not receive a liquidating distribution from a dissolved corporation, and therefore the shareholder should not be considered a transferee of the corporate assets. Thus, the critical question is whether the court

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179 *Alterman Trust v. Commissioner*, T.C. Memo 2015-231 * 18-20.

180 *Salus Mundi Found. v. Commissioner*, 776 F.3d 1010, 1017 (9th Cir. 2014); *Slone v. Commissioner*, 78 F.3d 1049, *modified* 116 AFTR2d 2015-5962 (9th Cir. 2015).

181 *Commissioner v. Stern*, 357 U.S. 39, 44 – 45 (1958).

182 Treas. Reg. § 301.6901-1(b).

should respect the form of the shareholder's stock sale for federal tax purposes under the first prong of the *Stern* test.

Generally, the Service has purported to attack the form of the Midco transaction, applying the substance over form doctrine. In other words, the Service has argued that the Midco intermediary did not pay the shareholders for their stock; instead, each shareholder received a pro-rata distribution of the corporation's cash on hand – the proceeds of an asset sale – making the shareholders "transferees" as that term is defined under the Code. Some courts have adopted this approach as applicable for determining whether a taxpayer is a transferee for purposes of Section 6901.[183] Consequently, when the Service claims that a taxpayer was "the shareholder of a dissolved corporation" for purposes of Treasury Regulation § 301.6901-1(b), but the taxpayer did not receive a liquidating distribution, a court will consider the relevant subjective and objective factors to determine whether the formal transactions "had any practical economic effect other than the creation of income tax losses."[184] Shareholders can overcome the substance over form/economic-substance analysis by demonstrating that the transaction was not all about creating tax avoidance. Thus, it is important to show that there was a business purpose to the transaction, that it was the intent of the shareholders that the corporation continue as a viable business, that the entity was more than just a shell, and that the entity held assets other than just cash.

[183] *See, e.g., Slone v. Commissioner, supra*; *Feldman v. Commissioner*, 779 F.3d 448 (7th Cir. 2015).

[184] *Reddam v. Commissioner*, 755 F.3d at 1051, 1060 ( ); *Slone v. Commissioner*, 116 AFTR2d 2015-5962; *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978_; *Helvering v. F&R Lazarus & Co*., 308 U.S. 2521 (1939). ("in the field of taxation, administrators of the law and the courts are concerned with substance and realties, and formal written documents are not rigidly binding.").

B. Judgment Liability Reduction

In *Frank Sawyer,* the court stated that "a good-faith transferee is entitled to a judgment liability reduction to the extent of the value it gave the debtor for the transfer" under Massachusetts law.[185] In *Frank Sawyer*, the transferor's tax liability was $20,306,597, plus penalties of $3,983,845, but the purchase price "premium" the transferee received was only $13,495,070. Massachusetts adopted section 8 of the Uniform Fraudulent Transfer Act ("UFTA"), which provides that "a good-faith transferee . . . is entitled, to the extent of the value given the debtor for the transfer or obligation, to . . . a reduction in the amount of the liability on the judgment."[186] Under Massachusetts' UFTA, the Tax Court capped the transferee liability at $13,495,070 - the amount of the premium. To the extent that other states have adopted a provision similar to Massachusetts' UFTA, the transferee could assert that it is entitled to a judgment liability reduction, because the transferee transferred assets to the transferor with value in exchange for the cash payment from the transferor. New York, however, has not adopted the UFTA, and its current fraudulent conveyance law, the Uniform Fraudulent Conveyance Act ("UFCA"), does not expressly recognize this defense.[187]

Notwithstanding the absence of an expressed statutory recognition of UFTA Section 8, New York Debtor and Creditor law, Section 280, states that "any case not provided for in this article" is governed, *inter alia*, by the rules of law and equity, including the application of

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[185] *See Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597, 611 (1st Cir. 2013).

[186] *See* Mass. Gen. Laws ch. 109A, sec. 9(d).

[187] *See* N.Y. Debt. & Cred. Law §§ 270-81.

bankruptcy law.[188] Reference to bankruptcy implies the application of the Bankruptcy Code, which recognizes the judgment liability reduction provision in Section 548(c). That section states that "a transferee or obligee of such a transfer or obligation that takes for value and in good faith has a lien on or may retain any interest transferred . . . to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation."[189] No New York court has addressed Section 280 in the transferee context.[190] The only case to address Section 280's scope found that it was limited to instances where no provision of the UFCA applied to the conveyance, and then only to invalidate a claim.[191] Arguably, New York law does not preclude the application of a judgment liability reduction, as codified in the Bankruptcy Code.[192]

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[188] Section 280 states: "[i]n any case not provided for in this article the rules of law and equity including the law merchant, and in particular the rules relating to the law of principal and agent, and the effect of fraud, misrepresentation, duress or coercion, mistake, bankruptcy or other invalidating cause shall govern."

[189] 11 U.S.C.A. § 548.

[190] Only one other state, Maryland, has adopted the UFCA. No Maryland court has addressed the principle underlying Section 8 of the UFTA.

[191] *See Posner v. S. Paul Posner*, 12 A.D.3d 177, 179 1st Dept. (2004). In *Posner*, the plaintiff received a "confession of judgment" in his favor, reportedly "to satisfy antecedent loans he had made to the Trust." However, the judgment was made "minutes before" one of the trust's creditors received a directed verdict against the trust on a promissory note. The creditor intervened in the plaintiff's action against the trust, and the court set aside the confession of judgment as fraudulent under section 273-a.[191] Plaintiff, who claimed to have given value for the confession of judgment, urged the court to apply "a bankruptcy-like pro rata distribution of the Trust's assets to plaintiff and the [creditor] Estate." The court refused, stating, "[b]y its terms, section 280 permits application of bankruptcy law only to cases not covered by the fraudulent conveyance article of the Debtor and Creditor Law, not the case here, and then only to invalidate a claim, also not the case here."[191] The court did not explain its holding, and no other New York case has addressed the application of section 280. In addition, the legislative history to New York's UFCA does not discuss the purpose, intent or design of section 280.

[192] Section 548(c) of the Bankruptcy Code is an equitable remedy. *See In re Bayou Group, LLC*, 439 B.R. 284, 309-10 (Bankr. S.D.N.Y. 2010) (stating that the outcomes in good-faith transferee cases "often appear 'influenced substantially by the equities of the particular fact situations before the courts'"); *In re Telesphere Communications*, 179 B.R. 544, 557 (Bankr. N.D. Ill. 1994) ("[I]n assessing the likelihood that the Lenders could successfully assert good faith under Section 548(c), it is important to consider the factual context of this case."); *see also Heiser v. Woodruff*, 327 U.S. 726, 732-33 (1946) (describing the equitable powers of bankruptcy courts).

C. Penalty Reduction: Penalty unrelated to the Transferor/Transferee Transaction

The legal justification of transferee liability is that collection of taxes has been prejudiced by a transfer of property by the taxpayer to the transferee made without full and adequate consideration.[193] Subject to the limitation that a transferee cannot be required to pay more than the value of the assets transferred, a transferee is generally liable for the entire deficiency, penalties and interest to the date paid.[194] However, for equitable reasons, some courts have refused to assess a penalty against a transferee unless there is nexus between the transaction giving rise to the penalty and the transaction giving rise to transferee liability.[195]

Two cases, *Frank Sawyer*[196] and *Stanko*[197] support the proposition that, to assess a penalty against a transferee, a nexus must exist between the transaction giving rise to the penalty and the transaction giving rise to transferee liability. Together, the decisions state that the transferee is only liable for penalties applicable to transactions, which occur after the initial transfer, if the initial transfer was made with actual intent to defraud future creditors.[198]

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[193] Michael Saltzman, *I.R.S. Practice & Procedures*, pt. 17.05 (2015).

[194] *See id.*; *see also Stuart v. Commissioner*, 144 T.C. No. 12, at 141, 155 (2015) (affirming transferee liability for transferor's accuracy-related penalty); *Ruderman v. United States*, 15 A.F.T.R. 2d 275, 280, 283 (1964) (fraud penalty); *Bryant J. Larson*, B.T.A Memo. 1941-471 (failure-to-file penalty).

[195] *See, e.g., Frank Sawyer Trust of May 1992 v. Commissioner*, T.C. Memo 2014-128; *Stanko v. Commissioner*, 209 F.3d 1082, 1087 (2000).

[196] T.C. Memo 2014-128 (2014) (107 T.C.M. (CCH) 1621).

[197] *Stanko v. Commissioner*, 209 F.3d 1082, 1087 (8th Cir. 2000).

[198] Courts have not addressed the application of the Eighth Amendment to a transferee's liability for penalties. The Eighth Amendment states, "excessive fines [shall not be] imposed." Fines are "payment[s] to a sovereign as punishment for some offense." *See United States v. Bajakajian*, 524 U.S. 321, 327-28 (1998) (*quoting* Austin v. United States, 509 U.S. 602, 609-10 (1993)). To satisfy the Eighth Amendment, "[t]he amount of the forfeiture must bear some relationship to the gravity of the offense that it is designed to punish." *Id.* at 334 (defining

In *Frank Sawyer*, the Tax Court found that the Frank Sawyer Trust (the "Trust") was not liable as a transferee for accuracy-related penalties assessed against four transferors. The Trust sold the stock of the C corporations to Fortrend International, LLC ("Fortrend"). Fortrend paid the Trust the difference between the value of the companies' assets and their Federal and State tax liabilities, totaling around $30 million.[199] Fortrend agreed to assume the tax liabilities of each of the four companies. However, Fortrend later executed a Son-of-Boss transaction, which generated losses to avoid paying tax resulting from the sale of the corporate assets.[200] When the corporations were unable to pay their unpaid tax, interest, and penalties, the Service proceeded against the Trust as transferee. The Tax Court found the Trust liable as transferee of a transferee, but the Trust challenged its liability for the corporations' accuracy-related penalties imposed on the transferor.

The Tax Court found the Trust not liable for the transferors' accuracy-related penalties. According to the court, the penalties applied to the Son-of-Boss transaction, which "occurred many months after the transfers" of petitioner-transferee's stock. The Tax Court stated that the Trust could not be liable for the penalties unless the Commissioner could show that the initial transfer, which gave rise to transferee liability, "was made with the intent to defraud future

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excessive as "surpassing the usual, the proper, or a normal measure of proportion"). Outside the transferee context, courts have found that section 6662 penalties are not excessive because they are remedial. *See, e.g.*, *Little v. Commissioner*, 106 F.3d 1445 (9th Cir. 1997); *Gorra v. Commissioner*, T.C. Memo 2013-254 (2013). In *Gorra*, the court found that "section 6662(h) does not violate the Excessive Fines Clause . . . [because it] is calculated as a percentage of an underpayment, so it bears a relationship to the gravity of the offense that is designed to remedy." T.C. Memo at 64-65; *see also Helvering v. Mitchell*, 303 U.S. 391, 401 (1938) (stating that "[penalties] are provided primarily as a safeguard for the protection of the revenue and to reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud").

[199] T.C. Memo. 2014-128 *3.

[200] T.C. Memo. 2014-128 *5.

creditors."[201] The Commissioner could not. In reaching its decision, the Tax Court relied on *Stanko v. Commissioner*,[202] an Eighth Circuit opinion. Applying Nebraska law, the *Stanko* court affirmed a Tax Court decision, which found Jean Stanko liable as a successor transferee of Rudy Stanko. However, the court would not allow the IRS to collect from the transferee the negligence and failure to file penalties, which were assessed against the transferor Rudy, in computing the amount of Jean's transferee liability. The court explained that, under Nebraska law, "[a] creditor whose debt did not exist at the date of the voluntary conveyance by the debtor cannot have the conveyance declared fraudulent" unless he or she shows that "the conveyance was made to defraud subsequent creditors whose debts were in contemplation at the time."[203] According to the Circuit Court, the Commissioner could seek to collect from the transferee "debts in existence at the time of the fraudulent conveyance," but not debts arising out of later, unrelated transactions. The Court found that the negligence and failure to file penalties were among those later arising debts, because the transactions giving rise to them occurred many months after the initial transfer.[204] "[P]enalties for negligent or intentional misconduct by the transferor that occurred many months after the transfer . . . are not, by any stretch of the imagination, existing at the time of the transfer."[205] Because the initial transfer was made without the intent to defraud future creditors, the transferees in *Frank Sawyer* and *Stanko* were not liable for penalties arising out of subsequent transactions.

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[201] *Id.*

[202] 209 F.3d 1082, 1087 (8th Cir. 2000).

[203] *Id.* at 1087 (internal quotation omitted).

[204] *See id.* at 1088.

[205] *Id.*

Conclusion

The cases discussed herein raise some fundamental questions: Must a selling shareholder concern himself with a buyer's intentions to pay or avoid paying corporate taxes following the stock sale? Should the selling shareholder be concerned if the buyer offers to pay a premium for the stock, who may then seek to eliminate an embedded tax gain with offsetting tax losses? How would the former shareholder know of such post-closing intentions and transactions? Regardless of how we answer these questions, the courts in *Diebold, Cullifer, and Tricarichi* have expanded the concept of transferee liability. They have imposed on the selling shareholders a duty to inquire and have charged them with constructive knowledge when they have been deemed not to have conducted sufficient due diligence. Additionally, even if there is an absence of constructive notice, the shareholder may be held liable as a transferee of a transferee, as in *Frank Sawyer*. Thus, at a minimum, to protect oneself, it would be prudent for the selling shareholders to obtain written representations and effective indemnification, as in *Alterman*, for post-closing transactions over which the selling shareholders have no control.