

## **Transferee Liability: The Seventh Circuit Weighs In.**

The Government won another MidCoast transferee liability case last week, this time in the Seventh Circuit. *Feldman v. Comm’r*, 2015 U.S. App. LEXIS 3014 (7th Cir. Feb. 24, 2015).

The fact pattern is by this time a familiar one: shareholders of a corporation, Woodside Ranch Resort, Inc., are contemplating a liquidation. Their corporation will face substantial tax liabilities due to capital gains that will be triggered on sale of the corporate assets, and those taxes will ultimately reduce the amount the shareholders can recoup on the sale. *Feldman*, 2015 U.S. App. LEXIS 3014, slip op. at \*4-\*6. Then MidCoast Credit Corp. arrived on the scene offering to purchase the corporation’s shares at a premium over their liquidation value; MidCoast planned to use other bad debts to offset the tax liabilities. *Id.*, slip op. at \*6-\*7.

The deal was ultimately struck at Woodside’s cash on hand less seventy percent of its projected tax liabilities, and it closed July 18, 2002. *Id.*, slip op. at \*8-\*9. Following the closing, a series of transactions ensued in the relevant attorney trust account:

- First, at 12:09 pm, Woodside’s cash reserves of \$1.83 million were deposited;
- Second, at 1:34 pm, Honora Shapiro, one of MidCoast’s principals, deposited \$1.4 million, which was purportedly a loan to fund the acquisition;
- Third, at 3:35 pm, \$1,344,451 was disbursed to a newly formed LLC controlled by the former Woodside shareholders;
- Fourth, at 3:36 pm, \$1.4 million was returned to Shapiro, repaying the loan, which had no documentation;
- Fifth, the following day, \$452,728.84 was transferred from the trust account to a newly opened account established for Woodside that was controlled by MidCoast;
- Sixth, the lawyers were paid \$38,000 as fees for the transaction.

*Id.*, slip op. at \*10-\*11. This left Woodside with the \$452,728.84 in cash and tax liabilities of approximately \$750,000. *Id.*, slip op. at \*11. And then MidCoast took out significant fees. *Id.* At the end of the day, the taxes went unpaid, and the IRS decided to pursue the former Woodside shareholders.

The Seventh Circuit started its analysis by determining that the former shareholders were transferees within the meaning of Section 6901 of the Code and affirmed the Tax Court’s determination that the transactions should be recharacterized as a liquidation. *Id.*, slip op. at \*24. The court then turned to the question of liability, rejecting the government’s contention that the recharacterization of the transaction under federal law was sufficient to establish a “transfer” for purposes of state fraudulent transfer law. This was hardly remarkable since “[e]very circuit that has addressed this question has rejected the Commissioner’s position . . . .” *Id.*, slip op. at \*26 (citations omitted).

Accordingly the Seventh Circuit turned to a consideration of Wisconsin law to determine whether there was a conflict between the definition of “transfer” under state law and the relevant federal doctrines. Here the court concluded that none existed for several reasons. *First*, Wisconsin’s version of the Uniform Fraudulent Transfer Act defined the term “transfer” broadly. *Id.*, slip op. at \*27-\*28 (citing Wisc. Stat. § 242.01(12)). *Second*, the court noted that fraudulent transfer law is flexible and embraces concepts such as substance over form. *Id.*, slip op. at \*28 (citations omitted). *Third*, Wisconsin law expressly incorporated equitable principles, and

Wisconsin courts generally apply the principle of substance controlling over form. *Id.*, slip op. at \*28-\*29 (citing Wisc. Stat. § 242.10; *Cuneen v. Katscheuer*, 206 N.W. 917, 918 (Wis. 1926)). Finally, the court noted that Wisconsin courts apply the rule of substance over form in a variety of contexts, including tax cases. *Id.*, slip op. at \*29 (citations omitted).

With that as background, the Seventh Circuit had little difficulty sustaining the Tax Court's determination that the former Woodside shareholders were liable under the constructive fraud provisions of Wisconsin's Uniform Fraudulent Transfer Act. *Id.*, slip op. at \*30-\*32.

While the government would still prefer to recharacterize transfers under federal law, this opinion and other recent appellate opinions such as *Diebold Foundation v. Commissioner*, 736 F.3d 132 (2d Cir. 2013) demonstrate that the government is perfectly capable of prevailing under state law.

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