

Midco Acquisition Holding Seen as Win for Government

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Practitioners said the IRS scored a significant victory November 14 when the Second Circuit vacated and remanded to the Tax Court a decision in which the lower court held that subsequent transferees were not liable for tax under an intermediary (“midco”) transaction.

“I expect the government will be elated with some of the court’s language about the nature of these transactions and the tax issues the court suggests everyone claims not [to] have understood,” Robert W. Wood of Wood LLP said.

Calvin H. Johnson of the University of Texas School of Law said that the decision offered “plenty of clues” that the Tax Court would find for the government on the final decision, following remand.

In its decision (*Diebold Foundation Inc. v. Commissioner*, No. 12-3225 (2d Cir. 2013)), the Second Circuit held that a midco transaction was a fraudulent conveyance under state law and remanded the case to the Tax Court to determine transferee liability. The Second Circuit found that shareholders in the transaction had constructive knowledge of the fraud, contrary to the previous Tax Court holding (*Salus Mundi Foundation v. Commissioner*, T.C. Memo. 2012-61)).

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The Tax Court held that three foundations were not liable as subsequent transferees under section 6901 for a corporation’s unpaid federal tax liabilities stemming from a stock sale, finding that the IRS failed to establish that a fraudulent conveyance occurred under New York state law.

But the Second Circuit held that given the sophistication of the parties’ representatives and that the details of the case pointed to an “active avoidance of the truth,” the taxpayers should have known the conveyance from the corporation was fraudulent, even though the corporation did not actually make the conveyance to the shareholders itself as a result of the midco transaction. The court held that it was proper to collapse the multilateral midco transactions into a single transaction whereby liability could be established under state law.

“To conclude that these circumstances did not constitute constructive knowledge would do away with the distinction between actual and constructive knowledge, and, at times, the Tax Court’s opinion seems to directly make this mistake,” said Judge Rosemary S. Pooler, writing for the Second Circuit.

Pooler said that if taxpayers were allowed to shield themselves from liability by using a stock agreement to disclaim responsibility, they could “undermine the very concept of constructive knowledge, as it would allow an incantation of assignment of tax liability to magically relieve the parties of their duty to inquire based on all of the circumstances which they were aware.”

In the dispute, the IRS attempted to establish transferee liability after it determined the taxpayer’s transaction to be, in substance, an asset sale followed by a liquidating distribution to the shareholders. The Service tried to collect \$100 million owed in taxes, penalties, and interest, only to discover that the personal holding company corporation that had sold its stock in the midco transaction did not have any assets from which it could collect.

Johnson welcomed the Second Circuit’s decision in vacating and remanding the case to the Tax Court, but said he had expected legislation would be necessary to reach that result. “It is legal realism shaping the law to meet abuse, but given the economic value the shareholders got, it is good shaping of the law,” Johnson said. (Prior coverage: *Tax Notes*, Nov. 19, 2012, p. 847.)

No Circuit Split

The Second Circuit’s decision was not a full victory for the IRS, however.

Section 6901 allows the IRS to assess transferee liability against a party only if two distinct prongs are satisfied. First, the party must be a transferee, and second, the party must be subject to liability at law or in equity.

Pooler held, in agreeing with earlier decisions in the First Circuit (*Frank Sawyer Trust v. Commissioner*, No. 12-1586 (1st Cir. 2013)) and Fourth Circuit (*Starnes v. Commissioner*, No. 11-1636 (4th Cir. 2012)), that the two prongs of the test were independent. The IRS argued unsuccessfully that the court must first determine whether a party is a transferee by looking at the federal law doctrine of substance over form, and only then proceed to a determination of state law liability after the transaction is recharacterized under the doctrine. The taxpayer, by contrast, successfully asserted that the two prongs had to be examined independently to establish transferee liability under section 6901.

Concerned by the need to look at taxpayers’ motivations in establishing transferee liability, an official with the Justice Department previously ex-

pressed hopes that the government could create a circuit split from the Fourth Circuit and create a two-prong test that hinged first on a substance-over-form determination. (Prior coverage: *Tax Notes*, Sept. 24, 2012, p. 1553.)

But even though no split occurred in its holding, Wood said he still sees the Second Circuit’s decision as significant and something the IRS may use in the future to bolster its actions. “This is a transferee liability case, but I suspect the government may cite it more generally in other cases involving tax-motivated transactions,” Wood speculated.

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The court, before reaching the merits of the case, overruled its own prior precedent and held that Tax Court decisions involving mixed questions of law and fact are reviewed *de novo* regarding conclusions of law, rather than for clear error, as it had previously held. ■