Shareholders Escape Transferee Liability in Big Midco Win

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In four consolidated midco cases, the Tax Court has handed a nice victory to taxpayers and a corollary defeat to the IRS. This news does not mean that midco cases are over, nor that transferee liability cases in other contexts are over. It does not even mean that taxpayers will win other midco cases.

However, it may well give some taxpayers hope that careful positioning can be rewarding, even where the underlying transaction is flawed. In that sense, it is a nice reminder that plodding along in good faith, making lists and checking them twice, can pay off. For tax litigators, it is also a reminder to be sure you know what your own witnesses will say. The IRS's own expert and percipient witnesses were helpful to the *taxpayers* more than they were to the government.

The four cases are reported as *J.M. Alterman Trust et al.* [110 TCM 507, Dec. 60,460(M), TC Memo 2015-231 (Dec. 1, 2015)]. They involved the sale of the Alterman family's trucking company that ended up having some $5.2 million in unpaid taxes, and another $2.1 million in penalties. In a practiced movement, the IRS said that the shareholders were responsible since they were the ones who benefited.

But the Tax Court was unwilling to call the transfers fraudulent. The IRS tried to collect from trusts set up in the sons' names, saying they were liable because they received transfers from their father's estate. But for this reason and others, the Tax Court said no.

The main reason was the fact that the Alterman family and their advisers did not know that the midco entity—MidCoast—would default on the tax payments. The shareholders and their advisers understood that MidCoast was legally able to defer the company's tax liabilities by writing off credit card receivables. That was the story MidCoast had spun.

The shareholders learned only much later that MidCoast immediately sold the Alterman shares to another buyer, and then quietly slipped away. The IRS could not establish transferee liability under Florida law because the sons did not know that the fraud was being committed and had done their due diligence. There was no fraud, and no actual or constructive knowledge by the shareholders that anything was amiss.

Midco Morass

The IRS and the Tax Court are tired of midco cases and tired of transferee liability. The question in these four cases was whether the taxpayers were liable for the company's unpaid 2003 taxes and penalties under Florida's Uniform Fraudulent Transfer Act. That required the court to once again examine whether the requirements of Code Sec. 6901 were met.

There were several constituent members of the Alterman family, including trusts and an estate. All were claimed by the IRS to be transferees. The redemption and stock sale of the family business should not be respected,

said the IRS. Instead, it should be treated as a sale of the assets of Alterman Corporation, followed by a distribution to its shareholders.

The taxpayers argued that this was not a fraudulent transfer under applicable Florida law, and that the procedural requirements that would allow the IRS to pursue them as transferees were not met. The IRS took a shotgun approach in the case, arguing fraud, substance over form, and just about anything else that might lead to collecting the taxes.

But a key point was the extent of the taxpayers' knowledge. The Tax Court was convinced that the Altermans and their advisers did not have actual knowledge that MidCoast would fail to do what it promised under the share purchase agreement. The court noted that the IRS did not even argue that they had actual knowledge. And for all the arguments to the contrary, the court was not convinced there was *any* constructive knowledge.

Damaging Evidence

The IRS's own experts and other witnesses seemed to support the taxpayers! Even the IRS revenue agent testified that MidCoast's plan was not reasonably discoverable. The court takes considerable pains to discuss the question of constructive knowledge, which is often one of the toughest elements of a transferee liability case.

In *A.J. Starnes* [CA-4, 2012-1 USTC ¶50,380,680 F3d 417, 109 AFTR 2d 2012-2326, *aff'g* 101 TCM 1283, Dec. 58,573(M), TC Memo 2011-63], the Fourth Circuit Court explained there are two inquiries for constructive knowledge: (1) whether the former shareholders had a duty to inquire; and (2) if so, what that inquiry would have revealed. The court relied on the same kind of analysis here. As if to recognize that the IRS would probably appeal, the Tax Court seemed to look with painstaking thoroughness at the evidence of due diligence.

The shareholders relied on their tax lawyers and financial advisers. Plus, everything seemed careful and above board. There were reputable lawyers on both sides, a reputable escrow agent and all the due-diligence boxes seemed to be checked.

Once again, the IRS's own expert made key admissions at trial that there were really no standards for this kind of thing, lending support to the taxpayers' position. The Alterman family and their advisers all behaved the way one would expect of parties trying to make the deal happen. They tried to make sure it was legitimate, even turning down another deal that was less secure, with fewer representations and warranties.

MidCoast, *the IRS's own expert suggested*, was the one defrauding them from the beginning. The tax reduction plans MidCoast had mentioned seemed reasonable. Plus, the Altermans and their advisers seemed reasonably to believe them. None of this was unreasonable.

The Tax Court also refused to collapse the arguably circular flow of funds. As in *Starnes*, the target shareholders lacked constructive knowledge, and the target shareholders were not liable as transferees. *Diebold Foundation, Inc.* [CA-2, 2013-2 USTC ¶50,590, 736 F3d 172, 112 AFTR 2d 2013-6901], a Second Circuit case, was different because the shareholders had constructive knowledge of the entire scheme. Here, there was no actual knowledge and no constructive knowledge.

No Constructive Fraud

State law is relevant in transferee liability cases. Here, that meant Florida law, although fraudulent transfer law is fairly similar across many states. A key issue for the IRS in transferee liability cases is the burden of proof. And that certainly played a part in these four consolidated *Alterman* cases.

The IRS had to prove that it was a creditor of the debtor, that a transfer was made by the debtor, that the debtor did not receive reasonably equivalent value in exchange for the transfer, and that either: (1) the debtor was engaged or about to engage in a business or transaction for which the debtor's assets were unreasonably small; or (2) the debtor intended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as the debts came due.

The IRS could not do that here. An alternative would be to show that the IRS was a creditor before the debtor made a transfer, that the debtor did not receive reasonably equivalent value in exchange for the transfer and that the debtor was insolvent or rendered insolvent by the transfer. Once again, the IRS failed.

And then there was the argument that this was actual fraud. Here, the IRS would have

to prove that the IRS is a creditor regardless of when the claim arose and that a transfer was made with actual intent to hinder, delay or defraud any creditor of the debtor. The prior portions of the Tax Court's opinion foreshadowed a negative result on this one.

The Tax Court had already shown an intolerance for the IRS positions that did not seem to be remotely supported by its own witnesses. Nevertheless, the Tax Court did methodically go through the authorities and the facts that could be seen as bearing on this question. An actual intent to defraud can be shown through these badges of fraud:

- The transfer or obligation was to an insider.
- The debtor retained possession or control of the property transferred after the transfer.
- The transfer or obligation was disclosed or concealed.
- Before the transfer was made or obligation was incurred, the debtor had been sued or threatened with suit.
- The transfer was of substantially all of the debtor's assets.
- The debtor absconded.
- The debtor removed or concealed assets.
- The value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred or the amount of the obligation incurred.
- The debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred.
- The transfer occurred shortly before or shortly after a substantial debt was incurred.

The IRS could not showcase these badges of fraud, and once again, had failed to move the Tax Court. But the IRS had alleged there were *extra* badges of fraud here, including unpaid state taxes and other purported red flags. The IRS said that these shareholders should have figured all this out and that any reasonable person would have.

The IRS even tried to argue that the Alterman family could be seen as transferees of transferees. That theory is best illustrated by *Frank Sawyer Trust of May 1992,*[CA-1, 2013-1 USTC ¶50,253, 712 F3d at 599]. There, the First Circuit said that one could be held liable for taxes and penalties regardless of knowledge.

To get this ultra-treatment, the Tax Court would need to find that: (1) at the time of the purchases, the acquisition vehicles did not receive reasonably equivalent value; and either (2) the transaction left the acquisition vehicles with unreasonably small assets or (3) the acquisition vehicles intended to incur a debt beyond its ability to pay. Here, the court did not agree and found to the contrary that the family had actually taken steps to try to see that the taxes were paid.

Conclusion

These transactions have had a surprisingly resilient life, sometimes going on for years and years. The acquisition here went back to 2003, and the transferee liability case was decided in 2015. If the IRS appeals it, the case is still not done.

Apart from the other lessons of the case, it helps to show just how painful and persistent such liability fights can be. And, unlike the lead up to a transaction and a closing, tax disputes after the fact rarely have a positive spin. Even if one prevails, as these taxpayers did (at least in Tax Court), the costs and risks can be large.

In that sense, they are one more reminder that spending time and money at the outset is often less costly than assuming one can fix it later if something blows up.