The Boomerang Tax Problems of Midco Acquisitions — Part 2

By Robert W. Wood


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Robert W. Wood practices law with Wood LLP in San Francisco (http://www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* (2009 with 2012 supplement), *Qualified Settlement Funds and Section 468B* (2009), and *Legal Guide to Independent Contractor Status* (2010), all available at http://www.taxinstitute.com. This discussion is not intended as legal advice and cannot be relied on for any purpose without the services of a qualified professional.

Intermediary (or midco) transactions were marketed to eliminate — or at least reduce — the double tax on business sales. Wood looks at midco transactions and considers IRS attacks that have focused on transferee liability assertions against participants. Part 1 of this article appeared in *Tax Notes*, Oct. 8, 2012, p. 211.

IRS Loss in *Diebold*

In *Diebold*,[1] the IRS issued a notice of transferee liability. Dorothy Diebold did not own the stock of the corporation. Instead, the stock was owned by a marital trust formed under New York law, and it was the marital trust that received the side proceeds. There was no suggestion that the trust wasn't valid or legitimate.

Nevertheless, the IRS argued that Diebold was either a direct transferee from the corporation or a transferee of a transferee (through the trust). Essentially, the IRS claimed the trust was a ''mere conduit.'' The court disagreed, refusing to disregard the trust.

The Tax Court in *Diebold* noted that the IRS's assertion of transferee liability was governed by state law — in this case, New York's. Under New York law, properly created marital trusts are independent legal entities. Unless the marital trust could be disregarded under New York law — which the IRS failed to show — the Tax Court had to respect its separate legal existence.

Arguing that the trust was a conduit, the IRS noted that the trust's fiduciary tax returns listed Diebold as the ''grantor/owner.'' She should be treated as the owner of the marital trust assets for purposes of federal income tax and transferee liability, the IRS asserted. However, the Tax Court found no case law (in New York or elsewhere) that would place transferee liability on the grantor on the basis of the trust's being a grantor trust. In any event, this marital trust was not a grantor trust.

The IRS also argued that Diebold was the beneficial owner of the trust's assets because she exercised full control over them and that approval of the trust's co-trustees was a mere formality. But the Tax Court found that Diebold did not exercise sole authority and that the co-trustees were notified of her reasonable disbursal requests in writing.

The IRS even claimed that the trust should be disregarded because it participated in a fraudulent transfer of assets under a de facto liquidation plan. The Tax Court didn't buy it. Even if there was a plan of liquidation, the IRS did not prove that Diebold had engaged in a fraudulent conveyance of the stock.

The Tax Court held that the trust should not be disregarded for purposes of transferee liability and that Diebold was not a transferee. The burden was on the IRS to prove that Diebold was a transferee of the trust. The IRS had to prove that the distributions caused the trust to become insolvent when made and that the distributions should be treated as fraudulent under New York law. In *Diebold*, these high standards just weren't met.

Despite the difficulty the IRS has with transferee liability cases, some taxpayers may give in. In *MDC Credit Corp.*,[2] MidCoast stipulated to a liability of $672,000 plus interest as a transferor of SBP Michigan Inc. Before the sale of SBP Michigan, the alleged

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[1] *Diebold v. Commissioner*, T.C. Memo. 2010-238, *Doc 2010-23203*, *2010 TNT 207-16*.

[2] *MDC Credit Corp. v. Commissioner*, No. 26922-08 (T.C. 2010) (stipulated decision).

transferees owned a company with a value of approximately $1.8 million and a potential tax liability of approximately $1.1 million. With penalties and interest, the total was $2.1 million and the IRS was casting about to collect it.

The alleged transferees ended up with approximately $1.1 million in cash. That meant MidCoast "saved" approximately half of the tax liability. Because this case was decided by stipulation, it does not reveal whether the selling shareholders knew of MidCoast's plan to avoid paying tax. However, this counts as at least a partial IRS victory.

Fourth Circuit in *Starnes*

The most recent midco litigation vehicle was *Starnes*.[3] Tarcon Corp. had $3.1 million in cash and about $880,000 in liabilities (mainly the expected corporate tax on its gain from selling its warehouse). That gave it a net worth of approximately $2.2 million. An intermediary (MidCoast) paid Albert Starnes and three other shareholders (the Tarcon shareholders) $2.6 million for their stock.

At the time, they thought MidCoast would continue operating Tarcon as a going concern. The Tarcon shareholders testified that they did not understand what MidCoast planned to do or what the "asset recovery business" even was. Still, they made no inquiries and seemed happy enough to get the deal closed. One even testified he didn't *want* to understand. MidCoast could do as it desired, it seemed.

Rather than operating Tarcon, MidCoast sold its Tarcon stock to Sequoia Capital (a Bermuda company) 11 days after closing for $2,861,466. Two days later, all of the funds in Tarcon's SunTrust account were transferred to an account with Deutsche Bank under Tarcon's name. Then, $2,960,000 was transferred from Deutsche Bank to an account in the Cook Islands in the name of Delta Trading Partners, and $126,822 was transferred to a MidCoast bank account.

Thereafter, Tarcon never had more than $132,320 in any account. Tarcon filed its 2003 federal tax return in July 2004, reporting capital gains of $1,009,483 and ordinary income of $1,557,315, principally from the sale of the warehouse and related grounds. Tarcon also reported a short-term capital loss of $1,010,000 from a purported December 2003 interest rate swap option. It also reported an ordinary loss of $1,950,000 from a transaction involving an asset denominated "DKK/USD BINA." This was purportedly acquired December 29, 2003, and purportedly sold December 31, 2003.

Consequently, the 2003 return stated that Tarcon's only asset was $132,320 in cash. Thus, the return reported an overall loss and no tax due. In 2005, Tarcon filed its 2004 federal tax return, marked as final, reporting no tax due and no assets. When the IRS disagreed but found no one to pursue, the Tarcon shareholders were logical suspects under the transferee liability theory.

The Tax Court asked whether the Tarcon shareholders had *actual* knowledge. Did they know facts that would have led a reasonable person concerned about Tarcon's solvency to inquire further into MidCoast's post-closing plans?

Would an inquiry undertaken by a reasonably diligent, similarly situated person have revealed MidCoast's plan to leave Tarcon unable to pay its 2003 taxes? Asking it this way suggests that the standard to trigger inquiry notice is not terribly high.

However, the Tax Court answered these points in favor of the Tarcon shareholders, holding that they were not liable. The Fourth Circuit agreed. Although the IRS is pursuing other transferee liability cases, most of the opinions handed down so far have not been to the IRS's liking. Perhaps for that reason, the cases reveal some experimentation in legal arguments.

In *Diebold*, the IRS pursued the initial seller (although the Tax Court ultimately ruled that Diebold was not the seller). In *LR Development*,[4] the IRS attacked the transaction from the perspective of the ultimate purchaser who bought the seller's assets. When the sole shareholder of a company died, his estate wanted to sell the stock. The ultimate buyer, LR Development Co., introduced Fortrend as an intermediary.

Fortrend offered to purchase the stock and then sell the assets to the buyer. Fortrend was to pay any taxes resulting from the asset sale, and that obligation was assumed by the buyer. Fortrend said it had ways to minimize the tax liabilities from the asset sale.

The buyer made an escrow payment into an account controlled by Fortrend, and those funds were applied against a loan Fortrend received to buy the target's stock. The target reported no tax liability for the year because gain from the asset sale was offset by a $17.2 million loss from currency arbitrage, which the IRS later disallowed.

The Tax Court held that the buyer was not a transferee. Illinois law had a strong presumption against binding third-party beneficiaries to contracts. Moreover, to show that the parties had

[3]*Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012), *Doc 2012-11787*, *2012 TNT 106-17*.

[4]*LR Development Co. LLC v. Commissioner*, T.C. Memo. 2010-203, *Doc 2010-20330*, *2010 TNT 180-9*.

contemplated insolvency, the IRS would have had to show that the target had reason to believe it would incur debts beyond its ability to pay. The IRS did not present *any* evidence of that here. Interestingly, however, the buyer apparently had knowledge of the intermediary's plan to avoid paying the taxes and therefore negotiated a lower purchase price.

In *Griffin*,[5] Douglas Griffin owned HydroTemp Manufacturing Co. Pentair Corp., its largest customer, wanted HydroTemp's assets and bought them for $8.3 million. HydroTemp's expected tax bill from the sale was $2.6 million.

HydroTemp retained unrelated equipment, inventory, and accounts receivable, as well as five to 10 employees. The corporation agreed to change its name following the sale but encountered delays. To facilitate the investment of corporate funds pending the name change and the opening of an account under the new name, $5 million of the sale proceeds were lent to Griffin for an interest-bearing demand note payable to HydroTemp.

HydroTemp also lent $300,000 to Griffin on a non-interest-bearing basis, but it retained approximately $500,000 in cash in its own non-interest-bearing account. Griffin was approached by MidCoast, which, according to its representatives, was engaged in an asset recovery business. MidCoast proposed purchasing the stock of HydroTemp for its cash, minus 52 percent of its estimated tax liability, plus $25,000 for reimbursement of expenses.

Griffin conducted due diligence, including visiting the offices of MidCoast, examining its books, and getting advice from a lawyer. After the sale to MidCoast, Griffin had no further involvement with HydroTemp until he found the IRS pursuing him. MidCoast caused HydroTemp to extinguish Griffin's liability for the $5 million note as part of the purchase of Griffin's stock. MidCoast had committed to cause HydroTemp to pay its tax liability and agreed to indemnify HydroTemp for the $2.4 million of accrued taxes.

Griffin reported the gain from the sale of his HydroTemp stock on his individual income tax return and paid the tax shown on the return. HydroTemp's tax return showed no tax liability because of a $7 million short-term capital loss, which the IRS later disallowed. The IRS was unable to collect from HydroTemp, so it asserted transferee liability against Griffin.

Griffin sued MidCoast in a Florida district court, obtaining a judgment that MidCoast was liable for HydroTemp's tax liability. However, the IRS argued that the asset sale to Pentair and the subsequent stock sale to MidCoast were part of an integrated plan that Griffin entered into solely to reduce his tax liability. The IRS claimed that the court should collapse the two transactions based on substance over form.

The Tax Court rejected the IRS's arguments, finding that the asset sale and stock sale had independent legal significance and were not part of a preconceived plan. Griffin had no knowledge that MidCoast would avoid paying HydroTemp's tax liability. The court also found that neither transaction was a fraudulent conveyance under Florida law.

Interestingly, the Tax Court granted Griffin's motion for an award of litigation costs based on the IRS's pursuit of him despite his lack of knowledge of MidCoast's tax-avoidance scheme. The Tax Court awarded him $183,019.42. The case is on appeal to the Eleventh Circuit.

Occasionally, the IRS has succeeded in its quest to collect in these transactions. For example, in *CHC Industries*,[6] the IRS asserted transferee liability not against the buyer or seller, but against the promoter that introduced the buyer to MidCoast. The allegedly fraudulent transfer was the payment of a finder's fee of approximately $275,800.

CHC Industries Inc. introduced Fortrend to MidCoast. Fortrend acquired the stock of the Town and Checker Taxi Co., which then acquired a holding company (St. Augustine) that held only cash ($5,255,258) following the redemption of its interest in another venture. When the cash from St. Augustine was distributed to various entities (including CHC), St. Augustine became insolvent and unable to pay its taxes.

Because CHC was paid by St. Augustine instead of MidCoast or Fortrend, the Tax Court determined that the payment was a fraudulent transfer. The Tax Court treated CHC as having constructive knowledge of the tax-avoidance scheme, given the source of its payment and its close relationship with Fortrend.

Wisdom of Hindsight

It is hard to read any of the so-called midco cases without waxing longingly about the obvious planning that could have prevented the various transactions from being so alluring. A timely S election could usually have avoided the underlying fact patterns and thus also avoided the midco deal. It is hardly unique or innovative to suggest that if you

[5]*Griffin v. Commissioner*, T.C. Memo. 2011-61, *Doc 2011-5492*, *2011 TNT 51-14*.

[6]*CHC Industries v. Commissioner*, T.C. Memo. 2011-33, *Doc 2011-2324*, *2011 TNT 23-12*.

have appreciated assets in a closely held C corporation, you should consider whether you might sell or liquidate in the future.

It is best to evaluate these matters sooner rather than later. Presumably no one would do a transaction similar to a midco transaction today, notwithstanding the cases that have generally gone badly for the IRS. But if you or your client were at some point lured by the promise of midco money, the generally taxpayer-friendly case law may favor pushing back — if and when the IRS comes calling.