Transferee Liability for Shareholders, Even Innocent Ones? (Part 1)

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As presidential campaign ads exhort, where there's a tax, someone must pay. It is the IRS's job to go after people who don't, sometimes even if it wasn't their liability. There's no better example than the notorious—but profitable—"midco" transactions of the late 1990s and early 2000s.

For almost a decade, the IRS has been fighting to impose transferee liability on shareholders who participated in these deals. The transactions themselves have been retired to the Tax Avoidance Hall of Fame, but the judicial decisions just keep on coming. Midco cases can involve some pretty egregious facts and the IRS litigates them vigorously.

Even so, the IRS has met with only mixed success. To win, the IRS generally needs to persuade the court to collapse the several steps in a midco transaction into something simpler—a corporate asset sale followed by a liquidating distribution.

The problem is that the First, Second, Fourth and Ninth Circuits have refused to permit the recast unless the IRS demonstrates that the shareholders *knew*, either actually or constructively, that the tax due on the corporate asset sale would be left unpaid. That's a major hurdle for the IRS. It must undertake an exhaustive (and exhausting) factual inquiry into what shareholders knew or should have known about a transaction that closed five or 10 years before.

The results in the Tax Court have been predictably unpredictable. So whenever a midco case comes up in a new circuit, the IRS doggedly argues that it should be allowed to recast the transaction without worrying about what was going on inside the shareholders' heads. The IRS's persistence finally paid off in *R. Feldman* [CA-7, 2015-1 USTC ¶50,210, 779 F3d 448, *aff'g* TC Memo. 2011-297]. In *Feldman*, the Seventh Circuit permitted the IRS to re-characterize a midco transaction as a liquidation without regard to what the selling shareholders knew or should have known.

According to the court of appeals, the shareholders' "due diligence and lack of knowledge of illegality [are] simply beside the point." So far, the Seventh Circuit's decision has not attracted much comment. Perhaps, it is because a seemingly endless stream of midco decisions has left potential commentators a bit glassy-eyed.

But the Tax Court has already followed *Feldman* in two cases. [*See S.K. Shockley*, 109 TCM 1579, Dec. 60,329(M), TC Memo. 2015-113; *T.L. Weintraut*, 112 TCM 122, Dec. 60,659(M), TC Memo. 2016-142.] The elimination of the shareholder-knowledge requirement is an IRS dream come true. A nightmare for shareholders, *Feldman* could become a focus of the IRS's litigation strategy going forward.

Midco Refresher

When shareholders of a C corporation with appreciated assets want to cash out their investment, they can sell assets or stock. In an asset sale, the C corporation sells its appreciated assets, which triggers corporate-level tax on the built-in gain. The corporation can then distribute the *after-tax* proceeds to the shareholders.

In a stock sale, the shareholders sell their C corporation stock to the buyer. This avoids triggering built-in gain, which sounds good. But there's a catch—a stock sale does not increase the basis of the corporation's assets to reflect the price the buyer paid for the shares.

Without that basis step-up, the built-in gains will still be waiting to be taxed whenever the corporation sells an appreciated asset. And even if the corporation holds on to its assets, the absence of a step-up will deprive it of a valuable tax shield in the form of increased depreciation and amortization deductions. Knowing this, the buyer will demand a major discount before it agrees to purchase stock.

Promoters of midco transactions claimed that they had solved this classic planning dilemma. They would arrange for an intermediary company (the "midco") to purchase the shareholders' stock and then cause the target corporation to sell its assets to the intended buyer. The asset sale would still trigger corporate-level gain, but the promoters said this wouldn't be a problem.

Trust me, they said. The midco had—or would promptly generate—a large pool of tax losses. The midco and its new subsidiary would file a consolidated return, which would allow these losses to offset the sub's gain from the asset sale. No net income means no corporate-level tax. Voila.

Pointing to this feat of tax alchemy, midco promoters would offer to purchase the shareholders' stock for the discounted price that a regular buyer would be willing to pay *plus* a percentage of the projected tax savings from the midco's loss strategy (the "premium"). The exact percentage was a matter of negotiation—typically, the *only* real matter of negotiation—between the selling shareholders and the promoters.

Enter the Taxman

A few years after the stock sale, the IRS would get around to auditing the consolidated return. With wearisome regularity, the midco's large losses would turn out to be bogus. The IRS would disallow the losses and send the corporation a notice of deficiency for the tax incurred in the asset sale, plus penalties and interest.

Good luck with that. The corporation and its midco parent would have long since been reduced to empty corporate shells—often within days of the closing. Unable to collect, the IRS would notify the selling shareholders that their midco transaction was actually a liquidation, and that they were liable for the unpaid taxes as transferees under Code Sec. 6901(a)(1).

Stern Lessons Under the UFTA

Code Sec. 6901(a)(1) authorizes the IRS to assess and collect unpaid income tax from a transferee of a taxpayer's property using the same administrative procedures that it would use against the taxpayer itself. However, under *M.J. Stern* [SCt, 347 US 39 (1958)], the IRS must first satisfy a two-pronged test: (1) the person in question must be a "transferee" within the meaning of Code Sec. 6901(h), and (2) the transferee must be substantively liable for the transfer under applicable state law.

The principal source of substantive liability to satisfy the second prong of the *Stern* test is state fraudulent conveyance law. These days, this generally means the Uniform Fraudulent Transfer Act ("UFTA"). Under the UFTA, creditors can invalidate a property transfer by their debtor if: (1) the debtor did not receive reasonably equivalent value, and (2) the debtor was insolvent at the time of the transfer or was left in a notably perilous financial condition.

The UFTA can be a powerful weapon. However, applying it to the selling shareholders in a midco transaction is usually problematic. If the transaction is taken at face value, the corporate debtor *did not transfer anything* to the selling shareholders. They just sold their stock to the midco for cash.

Without a transfer of property from the corporation to the selling shareholders, there is nothing to attack using the UFTA. Under the second prong of the *Stern* test, that would be fatal to the IRS's attempt to impose transferee liability under Code Sec. 6901(a)(1).

De Facto Liquidation

The IRS's standard strategy has been to assert that the midco transaction should *not* be taken at face value. Instead, it should be recast in accordance with its substance as a corporate asset sale, followed by a distribution of the sale proceeds to the shareholders. The cash diverted to the midco is simply its fee for facilitating a tax-avoidance transaction. Everything else, the IRS argues, is just camouflage.

If the transaction is re-characterized in this way, the corporation has made a transfer of property (cash) to the shareholders in the form of a distribution. A distribution of property to a shareholder is not a transfer for "reasonably equivalent value." It simply drains assets out of the corporation at the expense of its creditors—including the IRS. That's the kind of transaction the UFTA can really sink its teeth into.

Justifying the Recast

The IRS has plenty of experience re-characterizing transactions. The overlapping doctrines of substance over form, step transaction, business purpose, economic substance and sham transaction have played critical roles in federal tax jurisprudence for close to a century.

Armed with these doctrines, the IRS can generally persuade a court to recast a midco deal as an asset sale and liquidation for federal tax purposes. That makes the selling shareholders transferees for purposes of Code Sec. 6901(a)(1). So much for the first prong of the *Stern* test.

The problem is the second prong. The IRS acknowledges that, under *Stern*, its substantive rights must be determined under state fraudulent conveyance law. In circuit after circuit, however, the IRS has contended that the UFTA and similar statutes should be applied to midco transactions *as recast for federal tax purposes*.

If federal tax law says the selling shareholders have received a distribution of corporate assets, shouldn't they also be considered transferees of the debtor's property for purposes of applying the UFTA? Well, that would certainly be convenient for the IRS. But every circuit that has considered the issue has rejected the Service's position.

The second prong of the *Stern* test stands on its own. If the IRS wants to recast a transaction to establish its rights under state fraudulent conveyance law, it must do so using *state-law* principles. [*See A.J. Starnes*, CA-4, 2012-1 USTC ¶50,380, 680 F3d 417; *Frank Sawyer Trust of May 1992*, CA-1, 2013-1 USTC ¶50,253, 712 F3d 597; *Diebold Foundation, Inc.*, CA-2, 2013-2 USTC ¶50,590, 736 F3d 172; *Salus Mundi Foundation*, CA-9, 2015-1 USTC ¶50,120, 776 F3d 1010; *R. Feldman*, *supra*, CA-7, 2015-1 USTC ¶50,210, 779 F3d 448.]

Midco Meets LBO

Rebuffed by the courts, the IRS has had to fight to recast midco transactions using state-law equitable principles. But why is that a problem? One of the fundamental maxims of equity, after all, is that it looks to *substance*, not to *form*. [*See, e.g.*, *Pepper v. Litton*, SCt, 308 US 295, 305 (1939).]

Unfortunately for the IRS, however, it was not litigating on a clean slate. Remember the leveraged buy-out craze of the 1980s? One of the hottest issues in debtor-creditor law was whether unsecured creditors could recast complex corporate transactions in order to attack them as fraudulent conveyances.

The prototypical target was the security interest of the LBO lender, which had financed the corporate debtor's distribution of huge piles of cash to its shareholders. The LBO lender was protected by its security interest, which left the unsecured creditors to take the hit for the distribution when the debtor turned out to have been insolvent. [*See, e.g.*, *Wieboldt Stores, Inc. v. Schottenstein*, DC-IL, 94 BR 488 (1988).]

The rule that emerged in the LBO cases was that the unsecured creditors could not recast the transactions unless the transferee of the security interest (the LBO lender) had actual or constructive knowledge of the entire scheme, including the features that rendered it a fraudulent conveyance. [*See A.J. Starnes*, 101 TCM 1283, Dec. 58,573(M), TC Memo. 2011-63, *aff'd*, CA-4, 2012-1 USTC ¶50,380, 680 F3d 417 (discussing LBO cases and other nontax authorities).]

One may seriously question whether a rule developed to deal with secured lenders in LBOs should decide whether to subject shareholders to liability in a midco transaction. But the federal courts plunged ahead, adopting the LBO precedents in midco cases as an article of faith. [*See A.J. Starnes*, *supra* (North Carolina law); *Diebold Foundation, Inc.*, *supra* (New York law), *Salus Mundi Foundation*, *supra* (New York law); *N.L. Slone*, CA-9, 2015-2 USTC ¶50,457, 810 F3d. 599 (Arizona law); *M.A. Tricarichi*, 110 TCM 370, Dec. 60,427(M), TC Memo. 2015-201 (Ohio law); *J.M. Alterman Trust*, 110 TCM 507, Dec. 60,460(M), TC Memo. 2015-231 (Florida law); *R.L. Marshall Est.*, 111 TCM 1579, Dec. 60,634(M), TC Memo. 2016-119 (Oregon law).]

The result has been a large number of cases decided on their specific facts. This includes the credibility of the selling shareholders' testimony that they did not know or have reason to know that the midco was up to no good. The IRS wins some and loses others. Either way, having to litigate about state of mind drives up the cost to the government of pursuing midco shareholders.

Feldman and "No-Cost Liquidation"

In 2002, the descendants of William Feldman decided it was finally time to sell the dude ranch their enterprising ancestor had founded in rural Wisconsin back in the 1920s. The ranch was owned by Woodside Ranch Resort, Inc. ("Woodside"). Naturally, Woodside was a C corporation.

The Woodside shareholders (Mr. Feldman's descendants) tried to negotiate a stock sale, but the potential buyer dismissed it out of hand. So they were forced to sell the corporate assets for $2.3 million in cash. The corporate asset sale generated combined federal and state income tax liability of $750,000.

While the sale was still pending, the corporation's accountant introduced the shareholders to MidCoast Credit Corp. ("MidCoast"). MidCoast and its confederates were leading promoters of midco transactions. In *Feldman*, MidCoast offered to purchase 100 percent of Woodside's stock *after* the asset sale.

But the economics were unchanged. MidCoast would pay the shareholders the net asset value of the company ($1.4 million) plus a percentage of the company's tax liabilities. MidCoast billed the transaction as a "no-cost liquidation."

The dude-ranch shareholders liked what they heard. They didn't drive a very hard bargain—they settled for a premium equal to just 30 percent of the tax liabilities. But this was still $225,000 of free money as far as they were concerned.

The shareholders obtained a Dunn & Bradstreet report on MidCoast and called a few references, presumably to check on whether MidCoast was a solvent and reliable contractual counterparty. The shareholders made no real effort to evaluate MidCoast's strategy for making Woodside's tax liability disappear.

Follow the Money

The acquisition closed on July 18, 2002. Woodside first redeemed 20 percent of its stock from the shareholders using cash from the earlier asset sale. That left Woodside with $1.8 million, which was transferred into an escrow controlled by MidCoast's lawyers.

About 90 minutes later, one of the promoters wired $1.4 million into the escrow. This was purportedly a loan to MidCoast, although its terms were undocumented. Two hours after that, $1.35 million was wired out of the escrow to pay the shareholders for their stock. Literally one minute later, $1.4 million was wired back to the promoter, repaying the putative loan.

After expenses, this left $450,000 in escrow. The funds were transferred to a newly created Woodside account controlled by MidCoast. That was convenient, because MidCoast charged Woodside a $250,000 "professional service fee" for everything it had done.

Woodside was also supposed to pay MidCoast $30,000 a month as a "management fee." Nice work if you can get it. But MidCoast was in no mood to wait around. Only four days after the closing, it had drained all but about $10,000 from the account.

At this point, Woodside might have struck the untutored eye as profoundly insolvent. Its $10,000 in assets was not going to cover the $750,000 tax liability from the asset sale. Woodside may have had this in mind when it made an accounting entry indicating that it was due $1.2 million from MidCoast.

Apparently, the idea was that Woodside's cash had been used to repay the promoter's loan to MidCoast. It didn't really matter because the loan was marked "paid" even though Woodside never saw a cent.

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