What *Diebold Foundation* Means For Transferee Liability Cases

By Robert W. Wood • Wood LLP • San Francisco

In *Dodging the Boomerang Tax Problems of Intermediary Transactions*, I reported on Midco transactions wending their way through the courts. [21 The M&A Tax Report 2 (2012).] These cases are distressing for taxpayers, since, by definition, a transferee liability case involves the IRS pursuing one person for *someone else's* taxes. The cases are distressing for the government too, since frequently the government loses.

There are several hurdles to collecting money from a third party. Taxpayers like the fact that the courts have often been hard for the IRS to convince in those cases. One particular type of transferee liability case involves so-called Midco transactions. In one sense, they are simple M&A deals.

In another sense, they are tax shelters. These Midco transactions were long ago listed and disfavored. Nevertheless, the large number of deals that were consummated in their heyday left extant tax liabilities. That means transferee liability.

Midco in the Middle

Shareholders owning stock in a C corporation that holds appreciated property have a dilemma if they want or need to sell. In an asset sale, the shareholders cause the company to sell the appreciated property, which triggers a tax on the built-in gain. The company then distributes the remaining proceeds to the shareholders.

In a stock sale, of course, the shareholders sell the stock to a third party. The corporation continues to own the appreciated assets, and a built-in gain tax is not triggered. Buyers generally prefer to purchase assets and receive a new purchase price basis, thus eliminating the built-in gain. Sellers do not want to sell assets because of the built-in tax liability.

Midco transactions involve a seller making a stock sale, and a buyer making an asset purchase. The shareholders sell their appreciated C corporation stock to an intermediary Midco entity. The intermediary sells the assets to the buyer, who gets a purchase price basis in the assets.

The intermediary gives the buyer and seller what they want because it has tax losses or credits it uses to absorb the inherent tax liabilities it acquires. The IRS has long ago successfully attacked such transactions in Notice 2001-16, 2001-1 CB 730. It has pursued the promoters and participants in the deals wherever it can.

Bad Actors?

In many cases, the party that both the government and taxpayers want to attack is the intermediary. In some cases, the intermediary can fairly be called a promoter. One case I covered in my prior article was *D.R. Diebold.* [100 TCM 370, Dec. 58,374(M), TC Memo. 2010-238 (2010), vacated by, remanded by *Diebold Found., Inc.*, CA-2, 736 F3d 172, 2013 US App. LEXIS 22964 (2013).] There, the Tax Court held that the IRS failed to make its transferee liability case.

The government appealed to the Second Circuit, which vacated the Tax Court decision. What's more, the appeals court remanded the case to the Tax Court to decide the remaining transferee liability issues. It goes without saying that the government is happy with this outcome. Taxpayers inside and outside the realm of Midco transactions should pay attention.

The Second Circuit applied a different standard of review than it had in previous cases involving mixed questions of law and fact. The case is not only important to the government's Midco search, but to other transferee liability cases as well. And as every transferee knows, while it is painful to pay your own taxes, it is far more painful to have to pay the taxes of someone else.

Transferee Liability Then and Now

Internal Revenue Code Section ("Code Sec.") 6901 does not define a substantive tax liability but does provide the IRS a way to assess and collect it. It is the transferor's existing tax liability, but the transferee of money or property can be forced to pay it. The existence and extent of a transferee's liability is determined by the law of the state in which the transfer occurred.

If this makes your head hurt, it likely will not help to think about chains of transferees. The tax law is clear that transferee liability can be asserted against a *transferee* of a transferee. In *Diebold*, the IRS issued a notice of transferee liability against Mrs. Diebold as a transferee of Double D Ranch, Inc. ("Double D"). However, she did not own the stock of the corporation. How could that be, you might ask, if Mrs. Diebold was not a Double D shareholder?

The stock was owned by a marital trust formed under New York law, and it was the marital trust that received the sale proceeds the IRS wished to acquire. There was no suggestion that the trust was *not* a duly formed and valid trust with independent significance. Nonetheless, to support its transferee liability claim, the IRS argued that Mrs. Diebold was either a direct transferee from the corporation or that she was a transferee of a transferee (that is, *via* the trust).

Essentially, the IRS contended that the trust was a mere conduit. Yet the Tax Court in *Diebold* refused to disregard the trust, noting that the transferee liability question was governed by state law. In Mrs. Diebold's case, that meant the court had to evaluate the IRS's claims under the substantive law of the State of New York.

According to New York law, properly created marital trusts are independent legal entities. Here, unless the marital trust could be disregarded under New York law, 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 Mrs. Diebold as the grantor/owner of the trust. As such, she should be treated as the owner of the marital trust assets for purposes of federal income tax and transferee liability, urged the IRS.

Nevertheless, the Tax Court found no case law (in New York or elsewhere) that imposed transferee liability to a trust grantor merely because the trust was a grantor trust. Besides, Mrs. Diebold's marital trust was *not* a grantor trust. But the IRS also had other arguments for the Tax Court.

First, the IRS argued that Mrs. Diebold was the beneficial owner of trust assets because she exercised full control over them. Getting the co-trustees to approve any action was a mere formality, claimed the IRS. However, the Tax Court found that Mrs. Diebold did not exercise *sole* authority over the trust or its assets. In fact, the co-trustees were notified of her reasonable disbursal requests in writing.

Second, the IRS claimed that the trust should be disregarded because it participated in a fraudulent transfer. According to the IRS, there was a *de facto* liquidation plan in place, and that made the transfer fraudulent. But once again, the Tax Court was unmoved.

Indeed, even if there were a plan of liquidation, the IRS failed to prove that Mrs. Diebold had engaged in a fraudulent conveyance of the stock. The IRS failed 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. The Tax Court refused to disregard the trust for purposes of transferee liability and held that Mrs. Diebold was not a transferee.

Second Circuit Reprieve

The Second Circuit enunciated what it said are the two independent prongs of Code Sec. 6901. First, the IRS can collect against a transferee only if the party is a transferee under Code Sec. 6901. Second, the party must be subject to liability at law or in equity.

Under the first prong, a court must look to federal tax law to determine whether the party in question is a transferee. The second prong is

whether the party is liable at law or in equity. That is determined by the applicable state law.

According to New York law, a transferee can be held liable if the transferor makes a conveyance that is without fair consideration and that renders the transferor insolvent. Under New York law, a conveyance is a payment of money, assignment, release, creation of a lien, *etc*.

The IRS claimed that the two portions of Code Sec. 6901 are not independent. The IRS asked the court to first determine whether the party is a transferee. The IRS urged the court to invoke the substance-over-form doctrine to recharacterize the transaction. At that point, argued the IRS, the determination of state law liability must be made based on the recharacterized transaction.

Mrs. Diebold contended that the two prongs of Code Sec. 6901 are independent. Thus, even if the court were to recharacterize the transaction under the economic substance doctrine and find the first prong to be met, it must separately consider the second prong and state law. Under this formulation, if a court has determined that one of the two prongs does not apply to the party at issue, it need not consider the other prong of Code Sec. 6901.

Other Circuits

The First and Fourth Circuit Courts of Appeal have considered the independence rules of Code Sec. 6901. In fact, both courts ruled that the two prongs of the statue are independent. [*See Frank Sawyer Trust of May 1992*, CA-1, 2013-1 USTC ¶50,253, 712 F3d 597; *A.J. Starnes*, CA-4, 2012-1 USTC ¶60,380, 680 F3d 417 (2012).] In evaluating these cases and *Diebold*, the Second Circuit recognized that the independence point could make a pivotal difference in the results of transferee liability cases.

Even so, the Second Circuit ruled that it could not agree with the IRS. Code Sec. 6901 is purely a procedural statute, said the court. It does not actually create a new tax liability. It merely is a way of collecting an existing liability.

What is Fraud?

Turning to the second prong of the Code Sec. 6901 test, the Second Circuit toured New York state law. The Tax Court had concluded that these shareholders were not transferees. But on this point, the Second Circuit saw the facts differently and ruled that they were transferees after all.

If the company had sold its assets and made liquidating distributions to shareholders *without* holding back enough to pay taxes on the sale of assets, the transaction would plainly be a fraudulent conveyance under New York law. However, in *Diebold*, a Midco entity was interposed. In that way, the company did not *directly* make a conveyance to the shareholders.

But could this series of transfers be collapsed? The Second Circuit thought so. The court cited *Orr v. Kinderhill Corp.* [CA-2, 991 F2d 31 (1993)], noting that it could integrate the steps if two tests were met. First, the consideration from the first transferee must be reconveyed to the second transferee for less than fair consideration, with an intention to defraud creditors.

Second, the transferee in the leg of the transaction sought to be voided must have actual or constructive knowledge of the entire scheme that renders the exchange with the debtor fraudulent. In *Diebold*, there was no question about the first requirement being met. One transferee received Double D's property. The shareholders received the consideration, leaving Double D with nothing.

However, did the shareholders have actual or constructive knowledge of the entire scheme? Constructive knowledge does not mean actual knowledge. It is enough if a person *should* have known about the scheme, or if the transferees were aware of circumstances that *should have* led them to inquire further into the circumstances of the transaction.

The Second Circuit listed a number of facts supporting the conclusion that the shareholders met that requirement. They knew they had a significant C corporation tax problem. They specifically sought help to deal with—and avoid—that tax liability.

They even interviewed three different firms who said they could help the shareholders avoid the tax. Plus, these were extremely sophisticated people, said the court. They deployed a veritable stable of tax attorneys from two different firms. The goal for all was to limit their tax liabilities.

In collapsing the transactions, the Second Circuit concluded that, in substance, Double D sold its assets and made a liquidating

distribution to its shareholders, which left Double D insolvent. With the liquidating distribution, Double D did not receive anything from the shareholders in exchange. With no fair consideration, the New York state law definition of a fraudulent transfer was clearly satisfied.

The Second Circuit then remanded several issues to the Tax Court, including whether Code Sec. 6901's second prong was met.

Future Cases

Finally, the Second Circuit addressed the appropriate standard of review. The court said that the question of whether the shareholders had actual or constructive knowledge of the entire scheme was a mixed question of law and fact. Clarifying its standard of review, the court said that Code Sec. 7482 applied.

That meant that the standard of review should be *de novo* to the extent that the alleged error is in the misunderstanding of a legal standard and clear error to the extent the alleged error is in a factual determination.

Conclusion

It is hard to read any of the Midco cases without waxing longingly about the obvious planning that could have prevented the Midco transaction from being so alluring in the first place. A timely S election could usually have avoided the underlying fact patterns. That means it could also usually have avoided the Midco deal.

It is hardly unique or innovative to suggest that if you have appreciated assets in a closely held C corporation, you should consider whether you might sell or liquidate. The shareholders may want to do so. They may need to do so. And sometimes a transaction may be thrust upon them by health or economic circumstances.

While scrambling for a quick fix can perhaps be understood, it is never a position in which one wants to find clients. Nor, it must be emphasized, is being in a transferee liability case. One of the few sources of comfort to the person facing transferee liability assessments is that the IRS often has a hard time making its case. After the Second Circuit's *Diebold* decision, it should get a little easier for the IRS and a little more distressing for taxpayers.

Article Submission Policy

THE M&A TAX REPORT welcomes the submission of unsolicited articles. Submissions should be 2,000 words or less and use textual citations, rather than footnotes. All submissions should be made via email attachment in either Microsoft Word or WordPerfect format to Robert W. Wood, Editor-in-Chief, at *wood@woodLLP.com.* THE M&A TAX REPORT reserves the right to accept, reject, or edit any submitted materials.

TO SUBSCRIBE TO THE M&A TAX REPORT CALL 1-800-638-8437.

PRESORTED
FIRST-CLASS MAIL
U.S. POSTAGE
PAID
CCH

4025 W. Peterson Ave.
Chicago, IL 60646