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# Midco Litigation, Transferee Liability, and Civil Fraud Penalties

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In this article, Wood discusses midco transactions, the IRS's pursuit of transferee liability, and its recent move for civil fraud penalties.

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Midco transactions arose in response to 1986 tax reforms — or perhaps more accurately, in response to the people who failed to respond to the 1986 tax reforms. Up until 1986, the tax picture was rosy when the assets of a corporation were sold in connection with its liquidation. If the deal was properly planned, no corporate-level gain would be recognized.

In 1986 the rules changed dramatically, making the C corporation far less desirable. Of course, the basic mechanics of buying and selling businesses remained unchanged. In an asset sale, the C corporation sells the appreciated property, triggering a tax at the corporate level. Then the corporation distributes the remaining proceeds to the shareholders.

In a stock sale, the shareholders sell the C corporation stock to a third party. The tax hit at each level seems obvious. Yet some closely held businesses evidently missed the memo about the key 1986 tax changes. Many, in fact.

Over the following decades, many C corporation owners found themselves facing big double-tax bills on sales. That was where one of several facilitators of the midco deal came in.[1]

### Midcoast Middleman

Midco transactions involved shareholders selling their C corporation stock to an intermediary. That midco entity then sold the assets of the C corporation to the buyer, who took a purchase price basis in them. It was a kind of arbitrage.

Suppose that a C corporation just sold its assets and is holding $1 million of cash. But it now has a $400,000 liability for the sale. The net to distribute to shareholders would be $600,000. However, a midco might materialize and pay $800,000 or so for the corporate shell, complete with latent tax liability.

On these numbers, the seller might happily accept that deal, assuming that the midco entity had some kind of tax-exempt status or tax attributes allowing it to absorb the built-in gain tax liability.

That was the theory. The seller was happy, and the midco entity was left with the tax problems. Eventually, of course, the IRS shut this down.[2]

### Shelter Profiling

In Notice 2008-20, 2008-1 C.B. 406, the IRS identified four necessary components of what it called an intermediary tax shelter:

- built-in gain assets (in other words, a tax that would be triggered on an asset sale);
- 80 percent vote and value requirement (80 percent of the stock being sold within 12 months);
- assets versus stock (65 percent or more of the target's assets being disposed of within 12 months after the stock transaction); and
- tax avoidance (at least half the target's built-in gain ends up untaxed).

These four components made under a "plan" made a transaction suspect. The plan requirement is broad. In fact, it is arguably present almost anytime a target is selling built-in gain assets when that sale concerns a sale of stock designed to avoid tax.

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[1]*See* Robert W. Wood, "Midcos, *Diebold Foundation*, and Transferee Liability," *Tax Notes*, Apr. 28, 2014, p. 499; Wood, "The Boomerang Tax Problems of Midco Acquisitions — Part 1," *Tax Notes*, Oct. 8, 2012, p. 211; and Wood, "The Boomerang Tax Problems of Midco Acquisitions — Part 2," *Tax Notes*, Oct. 22, 2012, p. 443.

[2]*See* Notice 2001-16, 2001-1 C.B. 730.



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Nonetheless, a critical element identified in Notice 2008-111, 2008-2 C.B. 1299, is that a person must know or have reason to know that a transaction is structured to effectuate the plan. The IRS made its position on midco transactions clear with the issuance of Notice 2001-16 and later guidance. It has also litigated cases.

The IRS's first big success was in *Enbridge Energy Co. v. United States*,[3] in which the Fifth Circuit affirmed the district court's grant of summary judgment for the government.

**Transferee Liability Cases**

A major difficulty the IRS has had with midco transactions is whom to pursue. The most logical party to chase is the original seller of the stock. The seller avoided two layers of tax, getting a higher price than he should have.

Transferee liability under section 6901 against the selling shareholders or buyers seems like a natural for the IRS. However, transferee liability cases can be notoriously tough for the government to win. Nevertheless, in Notice 2008-111 the IRS said that any person who participates in an intermediary transaction under a plan may be subject to transferee liability for the target's unpaid corporate-level tax.

Because the liability is derivative, the IRS must first calculate the tax to the taxpayer. Only then can the agency turn its collection efforts toward the transferee. Plus, the burden of proof is on the IRS rather than the taxpayer to establish the technical requirements for transferee liability under section 6901.

To determine transferee liability, the IRS must resort to state law or the Federal Debt Collection Act.[4] Under California law,[5] for example, a transfer is considered fraudulent if the debtor undertook a transfer or obligation with an actual intent to hinder, delay, or defraud any creditor, without receiving a reasonably equivalent value in exchange for the transfer or obligation, if:

- the debtor was engaged or about to engage in a business or transaction for which his remaining assets were unreasonably small in relation to the business or transaction; or
- the debtor intended to incur, or believed or reasonably should have believed he would incur, debts beyond his ability to pay as they became due.[6]

***Diebold* Issue**

In *Diebold v. Commissioner*,[7] the IRS issued a notice of transferee liability to Dorothy Diebold. The facts involved a typical midco transaction. Moreover, Diebold clearly seemed to have benefited financially by the tax arbitrage the midco deal was designed to capture.

Nonetheless, Diebold did not personally 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 had received the sale proceeds. That nuance turned out to be critical.

The Tax Court held that the trust should not be disregarded for purposes of transferee liability and that Diebold herself was not a transferee. The Tax Court noted that the burden was on the IRS to prove that Diebold was a transferee of the trust.

Moreover, the IRS had to prove that the distributions caused the trust to become insolvent when the distributions were made. Finally, the IRS had to show that the distributions should be treated as fraudulent under New York law. The IRS could not meet those high burdens.

**Other Transferees**

Despite the difficulty the IRS has had with transferee liability cases, some taxpayers in this position may give up. For example, in *MDC Credit Corp. v. Commissioner*,[8] Midcoast Investments Inc. stipulated to a liability of $672,000 plus interest. With penalties and additional interest, the total tax was $2.1 million.

The alleged transferees ended up with approximately $1.1 million in cash, thus saving approximately half the tax liability. This transferee liability case did not go to trial and was settled. Because it was decided by stipulation, *MDC Credit* does not reveal whether the selling shareholders knew of Midcoast's plan to avoid paying tax.

In *Starnes v. Commissioner*,[9] Tarcon Corp. had $3.1 million in cash and about $880,000 in liabilities. The big liability was the expected corporate tax on the company's gain from selling its warehouse. That gave it a net worth of approximately $2.2 million.

In a typical midco transaction, Midcoast paid Albert Starnes and three other shareholders $2.6 million for their stock. The shareholders made no

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[3]No. 08-20261 (5th Cir. 2009).

[4]P.L. 95-109, codified as 15 U.S.C. section 1692-1692p.

[5]Uniform Fraudulent Transfer Act, Cal. Civ. Code section 3439.

[6]Cal. Civ. Code section 3439.04(a)(2)(A) and (B).

[7]T.C. Memo. 2010-238, *vacated and remanded sub nom. Diebold Foundation Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013). For detailed discussion of *Diebold*, see Wood, "Midcos, *Diebold Foundation*, and Transferee Liability," *supra* note 1.

[8]No. 26922-08 (T.C. 2010) (stipulated decision).

[9]680 F.3d 417 (4th Cir. 2012).



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inquiries and seemed happy to close the deal. One shareholder even testified that he didn't *want* to understand!

Midcoast could do as it desired, it seemed, as long as it was on the hook for the taxes. Yet, when taxes were unpaid, the IRS pursued the shareholders under a transferee liability theory. However, the shareholders did not appear to have actual knowledge about Midcoast's post-closing plans.

As a result, both the trial and appellate courts let them off the hook. The IRS's frustration over these cases is palpable, as is its anxiety over having to move mountains to carry its burden of proof.

The Ninth Circuit Court of Appeals has joined the First, Second, and Fourth circuits in rejecting IRS arguments about the two-pronged test for transferee liability.[10] The Ninth Circuit ruled that the two requirements of section 6901 are independent. Thus, a failure to satisfy either requirement means there cannot be transferee liability.

### Other Theories

Given the difficulties the IRS has with transferee liability cases, it should not be surprising that the cases reveal some IRS experimentation with legal arguments. In *Diebold*, the IRS pursued the initial seller, although the Tax Court ultimately held that Diebold was not the seller.

In *LR Development Co. LLC v. Commissioner*,[11] the IRS took a different tack. It attacked the transaction from the perspective of the purchaser who ultimately bought the seller's assets. Interestingly, the buyer apparently had knowledge of the intermediary's plan to avoid paying the taxes. Therefore, the buyer negotiated a lower purchase price, expanding the tax arbitrage to three parties. Nevertheless, the IRS failed to collect.

### Due Diligence

The transferee liability cases necessarily must consider who knew what and who had a reason to know. Those are gritty factual issues and can be difficult to present. Sometimes, one has the sense there are winks and nods, and that the parties to the transaction do not want to know all the details. Conversely, sometimes the facts are rife with details that suggest taxpayer caution.

That was the situation in *Griffin v. Commissioner*.[12] The petitioner, Douglas Griffin, owned HydroTemp Manufacturing Co. Its largest customer, Pentair Corp., wanted HydroTemp's assets and bought them for $8.3 million. HydroTemp's expected tax bill from the sale was $2.6 million. Griffin conducted extensive 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 that the IRS was pursuing him. Griffin reported his gain from the sale of his HydroTemp stock and paid the tax shown on his return. HydroTemp's return showed no tax liability because of a $7 million short-term capital loss that the IRS later disallowed.

The IRS was unable to collect from HydroTemp, so it asserted transferee liability against Griffin. Fortunately, Griffin had strong contracts. Midcoast had committed to cause HydroTemp to pay its tax liability and agreed to indemnify HydroTemp for the $2.4 million of accrued taxes. Thus, Griffin sued Midcoast in 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. The IRS said the entire plan was entered into by Griffin solely to reduce his tax liability. It argued that the court should collapse the two transactions based on substance over form.

Nonetheless, the Tax Court rejected the IRS's arguments. It found that the asset sale and the 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 concluded that neither transaction was a fraudulent conveyance under Florida law. The Tax Court did not even think this was a close case.

In fact, the Tax Court considered the IRS's position in pursuing Griffin (despite his lack of knowledge of Midcoast's tax avoidance scheme) weak — so weak that Griffin was awarded $183,019 in litigation costs.

### Pressure Points

The IRS has occasionally succeeded in its quest to collect in the aftermath of a midco deal. For example, in *CHC Industries v. Commissioner*,[13] the IRS asserted transferee liability not against the buyer or seller but against the promoter that introduced the buyer to the midco. The allegedly fraudulent transfer was the payment of a finder's fee of approximately $275,000 to the finder, CHC Industries.

The Tax Court treated CHC as having constructive knowledge of the tax avoidance scheme. The constructive knowledge was attributed to CHC

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[10]*See Salus Mundi Foundation v. Commissioner*, 776 F.3d 1010 (9th Cir. 2014), *reversing and remanding* T.C. Memo. 2012-61.

[11]T.C. Memo. 2010-203.

[12]T.C. Memo. 2011-61.

[13]T.C. Memo. 2011-33.



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because of the source of the payment and CHC's close relationship with the midco entity. That made the finder's fee fair game for the IRS.

In *Frank Sawyer Trust of May 1992 v. Commissioner*,[14] the IRS used arguments similar to those in *Diebold* to assert that a trust was liable for more than $24 million in unpaid taxes and penalties owed by its former portfolio companies. It hoped to collapse various intermediary transactions; however, under the Uniform Fraudulent Transfer Act, the burden was on the IRS to prove that the trustee knew that the schemes were illegitimate. The IRS lost in Tax Court but got a reversal in the First Circuit.

On remand, the Tax Court held that the trust was indeed a transferee and subject to liability. However, it found that the trust was a good-faith transferee. Accordingly, the trust was not liable to the full extent stated in the notices of liability. The trust as transferee was liable only to the extent it received more than fair value. The IRS thus wound up with half a loaf.

## New Day

The latest in the litany of midco cases shows a new turn. One of the taxpayers in *Jacoby v. Commissioner*[15] worked in accounting and thereafter went to law school. He took a basic income tax course and worked for a law firm but was not exactly a tax lawyer.

He later worked at a wealth management firm and then at Twenty-First Securities Corp., where he was a licensed securities broker. His main job was to close deals involving tax-advantaged investments developed by Twenty-First and outside firms.

Jacoby eventually left Twenty-First to form his own business, SMD Capital Corp., in which he played the same kind of deal-maker role. He began working closely with Diversified Group Inc. (DGI) and its president, James Haber.

DGI was one of the firms that developed strategies for Twenty-First. As far as Jacoby knew, all transactions entered into by his clients were vetted and approved by DGI, DGI's outside counsel, and the client's counsel. One of the strategies used by DGI was the midco transaction.

Jacoby saw these tax arbitrage deals go swimmingly. He witnessed some transactions involving sales of companies that held only ordinary assets. He also saw at least one deal that involved the sale of an S corporation. Jacoby did not witness any transactions involving the sale of a company whose only asset was accounts receivable.

That was significant, because at the time, SMD's only significant asset was its accounts receivable due from DGI. Moreover, DGI was having trouble paying SMD. In that context, Jacoby asked Haber whether he could set up a midco transaction for Jacoby's company.

## Capital Gain for Receivables?

Haber put the usual midco wheels in motion, and a deal was struck. Instead of paying off receivables, DGI bought SMD for a price that was less than the receivables. Jacoby was supposed to recognize capital gain rather than the ordinary income he would have recognized had SMD collected the receivables.

Haber set up this deal, Jacoby had his attorney review it, and the transaction was closed without incident. Jacoby received monies from the transaction in 1999 and 2000. He reported all the details of the transaction to his accountants.

Jacoby also entered into a foreign currency transaction brought to DGI by KPMG LLP. It was expressly represented as something that would secure tax deductions beyond the economic value of the options. The entity used for the transaction was JPF III LLC. During 1999 Jacoby paid $40,000 to the attorney who was handling the JPF III transaction.

In December 1999 Jacoby signed an agreement providing that JPF III was his agent regarding the JPF III transaction. It was effective November 15, 1999. However, another JPF III document, the contribution agreement, stated that there was no agency between Jacoby and JPF III.

When Jacoby submitted information about the JPF III transaction to his accountants, he included a tax opinion that he believed was written by Steve Acosta, an employee of the law firm handling the transaction. The first page of the opinion said it was prepared by Acosta, but a later section said that the opinion had come from KPMG.

## Civil Fraud Attack

The IRS disallowed the results of the SMD and JPF III transactions on the Jacobys' 1999 and 2000 tax returns. The IRS resorted to the civil fraud attack in part because of the statute of limitations. The normal statute of limitations was already closed.

The civil fraud statute is relatively rarely invoked by the IRS. This is probably because it has historically been hard for the IRS to prove civil fraud. But at 75 percent, the civil fraud penalty is expensive.

Section 6663(a) imposes the penalty if any part of any underpayment of tax required to be shown on a return is attributable to fraud. The IRS bears the burden of proving fraud by clear and convincing evidence.[16] To satisfy its burden, the IRS must show

[14]T.C. Memo. 2011-298, *rev'd and remanded to* 712 F.3d 597 (1st Cir. 2013), *on remand*, T.C. Memo. 2014-59, *modified*, T.C. Memo. 2014-128.

[15]T.C. Memo. 2015-67.

[16]Section 7454(a).

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that an underpayment of tax exists and that the taxpayer intended to evade taxes known to be owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes.

The courts have developed a nonexclusive list of factors that demonstrate fraudulent intent.[17] These so-called badges of fraud include:

- understated income;
- inadequate records;
- implausible or inconsistent explanations of behavior;
- concealment of income or assets;
- failure to cooperate with tax authorities;
- participation in illegal activities;
- intent to mislead, which may be inferred from a pattern of conduct;
- noncredible taxpayer testimony;
- the filing of false documents;
- failure to file tax returns;
- failure to make estimated tax payments; and
- dealing in cash.[18]

No single factor is necessarily sufficient to establish fraud, but a combination of factors can constitute persuasive evidence of fraud.

The court in *Jacoby* found that an underpayment of tax existed, and it thought that the understatement was clear. But there was not enough evidence to say there was civil fraud. To show that the underpayment was obvious, the court cited *Seward v. Commissioner*.[19]

The IRS claimed that six of the badges of fraud were present. Jacoby argued that none of those indicators were present. The court addressed each of the asserted badges of fraud.

**Understatement of Income**

The relevance of an understatement of income may seem small, because in almost every case, this will be present. Yet, part of the relevance is a pattern of conduct. Indeed, the court in *Jacoby* noted that a "mere understatement of income does not constitute proof of fraud."

In contrast, a "consistent and substantial understatement of income is by itself strong evidence of fraud."[20] The court in *Jacoby* found that there were understatements of income for the years at issue. Nevertheless, it concluded that the IRS did not prove, nor even suggest, that Jacoby had understated his income for any other year. The court determined that the IRS had failed to prove the existence of consistent and substantial understatements of income.

**Implausible, Inconsistent Behavior Explained**

This factor is hard to articulate, but it amounts to things not adding up. In *Jacoby*, the court saw the IRS's argument on this factor as coming down to three points: (1) The SMD stock sale and the JPF III transaction were different from any of the strategies Jacoby had previously marketed; (2) Jacoby didn't seek tax advice from anyone else regarding the transactions; and (3) Jacoby was well versed in tax.

SMD was not your usual midco deal. In fact, it involved the sale of an S corporation whose only asset was accounts receivable. The court found that the record showed that Jacoby had previously witnessed clients engaging in transactions involving S corporations. He had also seen transactions that involved entities that held only ordinary income assets. Jacoby had seen these transactions approved by various firms, making them seem legitimate at the time.

The Tax Court agreed that there was nothing in Jacoby's history to reflect the occurrence of transactions involving entities whose only assets were accounts receivable. But the court found it to be plausible that Jacoby believed that the SMD transaction was sufficiently similar to prior transactions to not be problematic.

Another bone of contention was the IRS's view that Jacoby, "on his own and without any outside advice, designed the nominal sale of SMD stock." However, the court said Jacoby came up with the idea for the SMD stock sale after witnessing earlier DGI transactions. Then, Jacoby spoke with Haber regarding the legitimacy of the sale before initiating the transaction.

That was hardly the same as coming up with the idea on his own. Moreover, the court was persuaded that Jacoby had fully disclosed the details of the transaction to his accountants. He had provided them all the documents he had concerning the transaction. The court concluded that Jacoby had the expectation that his accountants would report the transaction appropriately on his joint tax returns.

The IRS was also bothered by Jacoby's alleged tax expertise. The court noted that Jacoby held an accounting degree as well as a law degree. Moreover, he had worked at an accounting firm, a law firm, and several financial services firms. But the court found that on closer examination, Jacoby's tax credentials were not as strong as they first appeared. True, Jacoby had been hired by a prestigious accounting firm, but he had no involvement with the tax side of the firm.

In law school, Jacoby did not specialize in tax law, and he did not have an LLM in taxation. When he marketed investment strategies, it was other

[17]*See Parks v. Commissioner*, 94 T.C. 654 (1990).
[18]*See Niedringhaus v. Commissioner*, 99 T.C. 202 (1992).
[19]T.C. Memo. 1961-114.
[20]*See Korecky v. Commissioner*, 781 F.2d 1566 (11th Cir. 1986).

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persons, such as Haber, who handled the development of the strategies. One can sell tax-advantaged transactions, it seems, without having a great deal of tax expertise.

In fact, the court concluded that the IRS did not show by clear and convincing evidence that Jacoby was anything more than a marketer who relied on tax specialists to devise and vet the strategies he was selling. That did not prove fraud.

**Concealment of Income or Assets**

Another typical badge of fraud is the concealment of income or assets. The IRS argued that Jacoby never invested money in the JPF III transaction, that he was never a partner in JPF III, and that JPF III never acted as his agent. The IRS also argued that even if JPF III had been acting as Jacoby's agent in the JPF III transaction, the Jacobys' 1999 and 2000 tax returns concealed income by hiding the existence of the principal-agent relationship.

The court said that it was unclear from the record whether a principal-agent relationship existed between Jacoby and JPF III. Nevertheless, the evidence showed that the Jacobys transferred $40,000 to an account controlled by the JPF III transaction counsel. This led the court to believe that the Jacobys did invest some amount of money in the JPF III transaction.

In any case, the court was persuaded that Jacoby believed he had a principal-agent relationship with JPF III. The court also thought it significant that Jacoby provided his accountants all the documents relevant to the transaction. Still, the IRS argued that the Jacobys were required to disclose any principal-agent relationships on their tax returns.

The court disagreed, noting that the IRS cited no authority in support of its contention. In short, the court said that it could not conclude that the Jacobys concealed this information.

**Filing False Documents**

Filing false documents is another obvious badge of fraudulent conduct. The IRS had some ammunition here, but it hardly amounted to a smoking gun. The IRS claimed that the Jacobys' 1999 and 2000 tax returns qualified as false, as did the backdated agency agreement with JPF III.

The IRS also found fault that there were different versions of the tax opinion. However, the court drew an important distinction about the date on the documents, which is a frequent source of confusion. Regarding the agency agreement, was the document backdated?

The court said it was not. After all, there is a key difference between an effective date provision that seeks to memorialize a prior oral agreement, and an attempt to backdate an agreement in order to retroactively obtain an unwarranted tax benefit. In the Jacobys' case, the agency agreement merely stated that it was ''made effective'' as of November 15, 1999.

The court agreed that the contribution agreement stated that JPF III was not acting as an agent raised serious concerns about the legitimacy of the agency agreement. At the same time, the court was not prepared to assume there was foul play. It found no indication that Jacoby was aware of the contribution agreement or the discrepancy between it and the agency agreement. Thus, the court concluded that the IRS had failed to show by clear and convincing evidence that Jacoby knew that the agency agreement was false or that he had submitted it with an intent to mislead.

The court's reading of the glitch with the genesis of the tax opinion was similar. That is, the court noted that Acosta did not draft the tax opinion was a concern. However, the court found no indication that Jacoby was aware of the discrepancy in authorship. It concluded that these questions regarding authorship certainly did not render the tax opinion fraudulent.

**Failure to Cooperate, Intent to Mislead**

A general failure to cooperate or a pattern and a practice showing an intent to mislead are two of the more amorphous factors generally discussed in civil fraud cases. The IRS argued that these two badges of fraud existed. Once again, the court disagreed.

Finding that there were no badges of fraud, the court held that the civil fraud penalty did not apply to the Jacobys. True, they entered into a midco transaction trying to convert ordinary income into capital gain. True, they took deductions based on a questionable tax-favored investment product. They even significantly understated their tax liability.

But the IRS did not prove that any of the badges of civil fraud were present.

**S Election, Anyone?**

It is hard to read most midco cases without thinking about subchapter S elections. *Jacoby* does not involve this element, because SMD was already an S corporation. Jacoby's midco transaction was a botched attempt to convert receivable income into capital gain. And he also had a KPMG option shelter, which certainly didn't help matters.

A timely S election could have obviated the midco transaction in most cases. As the remaining transferee liability cases wend their way through the courts, perhaps *Jacoby* will signal that the IRS may try for civil fraud when all else fails.



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