The M&A Tax Report

SEPTEMBER 2017 VOLUME 26, NUMBER 2

The Monthly Review of Taxes, Trends & Techniques

The Midco Saga: Is the End Finally in Sight?

By Donald P. Board • Wood LLP

On July 11, 2017, the Tax Court handed down the first substantive ruling in a "Midco" case since November 2016. In *D.J. Buckrey* [114 TCM 45, Dec. 60,965(M), TC Memo. 2017-138], the IRS was seeking—for the umpteenth time—to collect unpaid corporate tax from shareholders who sold shares to a Midco promoter following an asset sale. As usual, the IRS's weapon of choice was the transferee-liability provisions of Code Sec. 6901.

After a deep dive into state debtor-creditor law, the Tax Court concluded that Minnesota law would *not* permit the IRS to recharacterize the stock sale as a corporate distribution for purposes of Minnesota's version of the Uniform Fraudulent Transfer Act ("UFTA"). This was bad news for the IRS. After all, it generally needs a recast if it hopes to collect from shareholders in a Midco transaction.

Although interesting as part of the continuing Midco saga, the specific holding of *Buckrey* may be less significant than its timing. For more than a decade, the federal courts were, by their own admission, "plagued by Midco cases" [*J.M. Alterman Trust*, 110 TCM 507, Dec. 60,460(M), TC Memo. 2015-231]. For years, they churned out Midco decisions with almost metronomic regularity.

But the most recent Midco decision dates from eight months before *Buckrey* [*see W.S. Stuart*, CA-8, 2016-2 USTC ¶50,468, 841 F3d 777]. What should we make of the time gap between the two decisions? Just a lull in the action? Or is it possible—fingers crossed—that the pipeline of Midco cases is finally starting to run dry?

Either way, the rise and fall of the Midco shelter has been a remarkable episode. In fiscal terms, these transactions were a fiasco for the Treasury Department. The IRS's efforts to collect from shareholders have been vigorous but often unsuccessful—*Buckrey* being the latest example.

If there is an upside to the Midco saga, it may lie in the fact that the years of litigation have illuminated two important questions. First, what are the roles of state and federal law in determining whether a transaction can be rechartacterized under Code Sec. 6901? Second, whose law governs the transferee's liability for interest?

ALSO IN THIS ISSUE

Criminal Minds

Midco deals first appeared on the IRS's radar screen in the late 1990s. In the most blatant form of the transaction, the Midco promoter would purchase the stock of a C corporation that had recently sold its assets and incurred a large taxable gain. The promoter would pay the shareholders a price equal to (1) the net asset value of the corporation *plus* (2) a "premium" equal to a negotiated percentage of the corporation's tax liability.

Following the sale, the new owner would stuff the corporation with counterfeit losses. This would (temporarily) eliminate the company's tax liability for the year of the asset sale. Some promoters even filed for—and routinely received—*refunds* of corporate taxes paid in prior years.

Several years later, the IRS would disallow the fictional losses and send the corporation a Notice of Deficiency. The unpaid tax on the asset sale, along with penalties, might total tens of millions of dollars. And that's *before* interest.

But the IRS's efforts to collect these impressive sums went nowhere. The promoter would have long since drained the asset sale proceeds and everything else of value out of the corporation. The cash would have been stashed in dozens of disguised bank accounts in the Cook Islands and other choice destinations.

In Notice 2001-16, the IRS designated Midco deals as "listed transactions" under Code Sec. 6011. But promoters still found plenty of shareholders eager to play ball. Selling to some guys in suits who said they had a group of companies with big losses that could offset the corporation's gain was, well, alluring.

In 2013, a mere 12 years after the issuance of the Notice, the Department of Justice swung into action. It filed criminal charges against the principals of MidCoast Financial, a leading Midco promoter. According to the indictment, MidCoast defrauded the U.S. Treasury of more than $200 million in corporate income taxes between 2003 and 2011 [*see Veera*, DC-PA, No. 12-444 (Oct. 1, 2013)].

Several MidCoast operatives—including at least one lawyer—ended up in federal prison. So far, however, the owners of the firm have been unavailable to stand trial. They are on extended vacations outside the United States, perhaps even including a stop in the Cook Islands.

Walk on the Civil Side

Criminal prosecutions may get the headlines, but the number of indictments is tiny. For more than a decade, the real action has been the IRS's efforts to collect its civil judgments from shareholders using Code Sec. 6901.

The Code provides summary procedures for collecting taxes from the taxpayers who actually incur them. Code Sec. 6901 authorizes the IRS to use these procedures to collect unpaid taxes from certain *third parties*. Our focus will be Code Sec. 6901(a)(1)(A), which applies to third parties who are both (1) "transferees" of the taxpayer's property and (2) liable, "at law or in equity," to the IRS for the unpaid tax.

Two-Pronged Analysis Under Stern

In *M.J. Stern* [SCt, 347 US 39 (1958)], the IRS contended that a third party's liability as a transferee is a matter of federal common

The M&A Tax Report
The Monthly Review of Taxes, Trends & Techniques

EDITOR-IN-CHIEF
Robert W. Wood

MANAGING EDITOR
Michael Henaghan

COORDINATING EDITOR
Raghavendra Kaup

THE M&A TAX REPORT (ISSN 1085-3693) is published monthly by Wolters Kluwer, 2700 Lake Cook Road, Riverwoods, Illinois 60015. Subscription inquiries should be directed to 2700 Lake Cook Road, Riverwoods, IL 60015. Telephone: (800) 449-8114. Fax: (773) 866-3895. Email: cust_serv@cch.com.

law, period. After reviewing the history of the predecessor of Code Sec. 6901(a)(1)(A), however, the Supreme Court adopted a two-pronged analysis that takes account of *both* federal and state law.

The first prong of the *Stern* analysis relates to the statutory requirement that the third party be a transferee of the taxpayer's property. "Transferee" is defined, in general terms, in Code Sec. 6901(h). The application of the definition is plainly a matter of federal concern, and *Stern* endorses the development of uniform federal common law to decide who qualifies.

The second prong considers whether the third party is liable to the IRS "at law or in equity." Although there is an obvious federal interest in collecting unpaid taxes, *Stern* concluded that Congress did *not* intend to impose federal uniformity in this area. To collect under Code Sec. 6901(a)(1)(A), the IRS must have a right to recover from the third party under *state* law.

Recasting Midco Transactions

The first prong of *Stern* requires the stockholder to be a statutory transferee. But Midco transactions are structured so that the corporation does not transfer anything to its stockholders. They just sell their shares to the promoter and go home.

The IRS needs to recharacterize the sale as a corporate distribution. Under *Stern*, this "federal" recast depends on federal common law. This opens the door to a troupe of familiar federal tax principles, *e.g.*, the priority of substance over form, which can facilitate the recast.

The second prong requires liability to the IRS under state law. That means state fraudulent conveyance law, usually the local version of the UFTA. But fraudulent conveyance law also requires a transferee. So, the IRS also needs a "state" recast if it wants to collect from selling shareholders.

Whose law decides whether a stock sale should be recharacterized as a distribution for purposes of state fraudulent conveyance law? Under the logic of *Stern*, it seems clear that state law controls. Code Sec. 6901 provides the IRS with a streamlined procedure for *asserting* its rights under state law, but it is not supposed to change them.

However, it is often easier to get a recast using federal principles, so the IRS has repeatedly sought to circumvent *Stern* in Midco cases. The IRS concedes that state law determines substantive liability, but it argues that federal common law still determines the *facts* to which state law is applied. Hence, the "federal" recast governs *both* prongs of the analysis.

Nice try, but the First, Second, Fourth, Seventh, Eighth and Ninth Circuits have all rejected the IRS's argument as fundamentally inconsistent with *Stern*. Whether to recast a transaction before applying a state fraudulent conveyance statute is as much a matter of state substantive law as the terms of the statute itself. The bottom line is that the IRS is stuck with state law.

Pre-Notice Interest

The second focus of contention has been the appropriate roles of state and federal law when it is time to compute interest recoverable under Code Sec. 6901(a)(1)(A). Interest may not seem like a big deal, especially when rates are low. But, as the Tax Court's decision in *M.A. Tricarichi* [112 TCM 33, Dec. 60,648(M), TC Memo. 2016-132] shows, the interest stakes in Midco cases can be huge.

West Side Story

In 2003, West Side Cellular, a C corporation doing business in Ohio, settled some major litigation on favorable terms. After winding up its affairs, West Side found itself holding $40.6 million in cash and owing an expected $16.9 million to the IRS.

If West Side had simply paid the tax and liquidated, it could have distributed $23.7 million to its sole shareholder, Michael Tricarichi. Not a bad payday, but Mr. Tricarichi thought he could do better. A few months later, he sold his stock to a Midco promoter for $35.2 million. That was $11.2 million *more* than West Side's net asset value.

The promoter then claimed $42.5 million in fake losses, which allowed West Side to report zero tax liability on its 2003 tax return. After paying back the Dutch bank that had financed the stock purchase, the promoter netted over $5 million in cash from the deal.

In 2009, the IRS disallowed the losses and notified West Side that it owed $21.2 million in tax and penalties. West Side did not even try to defend the reported losses. The company didn't have a dime to its name, so why bother?

Transferee Liability

The IRS sent Mr. Tricarichi a notice of transferee liability on June 25, 2012 (the "Transferee Notice Date"). According to the IRS, he was liable for the original $21.2 million in tax and penalties, plus *$13.9 million in interest*. Mr. Tricarichi's total liability ($35.1 million) was just shy of the $35.2 million he had paid for his shares back in 2003.

Unlike West Side, Mr. Tricarichi mounted a vigorous defense. Focusing on the second prong of the *Stern* analysis, he argued that Ohio would not recast his stock sale as a distribution. The Tax Court, however, disagreed and held Mr. Tricarichi liable under Code Sec. 6901(a)(1)(A) [*see* Robert W. Wood, *Shareholders Liable for Buyer's Taxes in Midco Transaction*, THE M&A TAX REPORT (Dec. 2015)].

Calculations of Interest

The Tax Court then asked the parties to submit calculations of the *amount* of Mr. Tricarichi's liability. There was no dispute about the basic tax and penalties, but the parties differed sharply regarding his liability for interest during the period that started on March 15, 2004, when West Side's 2003 tax payment was due, and ended immediately before the Transferee Notice Date in 2012 (the "Pre-Notice Period").

According to the IRS, Mr. Tricarichi was responsible for $13.9 million in federal interest that accrued under Code Sec. 6601 during the Pre-Notice Period. Mr. Tricarichi invoked *Stern* to argue that the accrual of interest was governed by *state* law. He claimed that Ohio would not have started the interest clock until the Transferee Notice Date, so his interest liability for the Pre-Notice Period was *zero*.

The Tax Court held Mr. Tricarichi liable for the $13.9 million. When the value of the transferred property *exceeds* the transferor's liability to the IRS, *federal* interest continues to accrue under Code Sec. 6601 until the federal claim has consumed the full value of the transferred property [*see L.L. Lowy*, 35 TC 12 (1960)].

That was what skewered Mr. Tricarichi. He received $35.2 million, but West Side owed the IRS "only" $21.2 million. That left a $14 million value cushion to support the accrual of $13.9 million in federal interest.

What result if a transferee receives corporate property worth *less* than the transferor's tax liability? Although no federal interest can accrue, *Stern* lets the IRS assert any right to prejudgment interest it may have under state law. The transferee's liability for prejudgment interest (when it exists) is personal, so it is not limited by the value of the transferred property [*see S. Stein Est.*, 37 TC 945, Dec. 25,360 (1962)].

It is quite possible that Ohio would *not* have awarded the IRS interest for the Pre-Notice Period. Unfortunately for Mr. Tricarichi, that was irrelevant. The IRS was seeking to collect $13.9 million in *federal* interest out of the value of the transferred property.

Mr. Tricarichi has appealed to the Ninth Circuit, and the government may decide to seek review in *Buckrey*. So, we have not yet heard the last word on the Midco shelter. But the end could be nigh.