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Midco Litigation Morphs from Transferee Liability to Fraud

By Robert W. Wood • Wood LLP

M&A Tax Report readers know that tax considerations are almost always important in documenting a transaction that combines or disposes of a business. For those who do not remember Midcoast deals, they are worth revisiting, for they touch on a number of tax issues of continuing interest. Up until 1986, when the assets of a corporation were sold in connection with the corporation's liquidation, the tax landscape was different.

If the deal was properly planned, no corporate-level gain would be recognized. In 1986, the rules changed dramatically, making C corporations far less desirable. Of course, the basics mechanics of buying and selling businesses remained unchanged.

When shareholders of a C corporation with appreciated property want to sell, they can sell assets or stock. In an asset sale, the C corporation sells the appreciated property (triggering a tax on the built-in gain) 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 did not get 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 sale. That was where Midcoast came in, one of several facilitators of the midco deal.

Midcoast Middleman

Midco transactions involved shareholders selling their C corporation stock to an intermediary. The midco entity then sold the assets of the C corporation to the buyer, who took a purchase-price basis in the assets.

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 to the IRS for the sale. The net to distribute to shareholders would be $600,000.

However, a midco might come on the scene and pay $800,000 or so for the corporate shell, complete with latent tax liability. On these numbers, the seller might happily accept it, assuming that the midco entity has some kind of tax-exempt status or tax attributes, such as losses, that allow 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 closed this down. [See Notice 2001-16, 2001-1 CB 730.]

Shelter Profiling

In Notice 2008-20 [IRB 2008-6, 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 vs. 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 not being taxed).

These four components plus a "plan" made the transaction suspect. The "plan" requirement is broad. In fact, it is arguably present virtually any time a target is selling built-in gain assets where the sale of assets is related to a sale of stock designed to avoid tax.

Nonetheless, a critical element of Notice 2008-111 [2008-51 IRB 1299] is that a person must know or have reason to know that a transaction is structured to effectuate the plan. Although the IRS made its position on midco transactions clear with the issuance of Notice 2001-16 [2001-1 CB 730] and later guidance, it has also litigated cases.

The first big success the IRS had was in *Enbridge Energy Co.* [CA-5, 2009-2 USTC ¶50,737, 354 FedAppx 15], when the Fifth Circuit affirmed the district court's grant of summary judgment for the IRS.

Transferee Liability Cases

A major difficulty the IRS has had with midco transactions is who 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 or she should have.

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

As the liability is derivative, the IRS must first figure the tax to the taxpayer. Only then can the IRS turn its collection efforts to the transferee. Plus, the burden of proof is on the IRS rather than the taxpayer to establish the technical requirements under Code Sec. 6901 for transferee liability.

And state law or federal law that is unfamiliar territory to most tax advisers also comes into play. For the determination of transferee liability, the IRS must resort to state law or the Federal Debt Collection Act. In California, the California Uniform Fraudulent Transfer Act sets forth the elements of a fraudulent transfer.

It is a transfer or obligation undertaken with an actual intent to hinder, delay or defraud any creditor of the debtor, and where reasonable

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equivalent value is not received in exchange for the transfer or obligation, if the debtor either:

- was engaged or was about to engage in a business or transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or
- intended to incur, believed or reasonably should have believed he would incur debts beyond his ability to pay as they became due. [See Cal. Civ. Code § 3439.04(a).]

Diebold Issue

In *D.R. Diebold* [100 TCM 370, Dec. 58,374(M), TC Memo 2010-238, *vac'd and rem'd*, CA-2, 2013-2 USTC ¶50,590, 736 F3d 172], the IRS issued a notice of transferee liability to Mrs. Diebold. The facts involved a typical midco transaction. Moreover, Mrs. Diebold clearly seemed to have benefited financially by the tax arbitrage the Midco deal was designed to capture.

Nonetheless, Mrs. 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. This nuance turned out to be critical.

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

Other Transferees

Despite the difficulty the IRS has with transferee liability cases, some taxpayers in this position may give up. For example, in *MDC Credit Corp., f.k.a Midcoast Credit Corp., Midcoast Mortgage Corp., Transferee* [U.S. Tax Court, Docket No. 26922-08], Midcoast stipulated to a liability of $672,000 plus interest. With penalties and interest, the total tax was $2.1 million.

The alleged transferees ended up with approximately $1.1 million in cash, thus saving approximately half of the tax liability. This transferee liability case did not go to trial and settled. Because this case was decided by stipulation ($672,000 plus interest), it does not reveal whether the selling shareholders knew of Midcoast's plan to avoid paying tax.

In *A.J. Starnes* [CA-4, 2012-1 USTC ¶50,380, 680 F3d 417], Tarcon Corporation 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 deal, Midcoast paid Albert Starnes and three other shareholders $2.6 million for their stock. The shareholders made no inquiries and seemed happy to get the deal closed. One shareholder even testified he did not 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 court let them off the hook. The IRS frustration at these cases is palpable, as is its anxiety over having to move mountains to carry its burden of proof.

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 ruled that Mrs. Diebold was not the seller.

In *LR Development Co., LLC* [100 TCM 231, Dec. 58,334(M), TC Memo 2010-203], 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 still 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 that there are winks and nods and that the parties do not want to ask questions.

Conversely, sometimes the facts are rife with details that suggest taxpayer caution. That was the situation in *D.R. Griffin* [TC Memo 2011-61, Dec. 58,571(M), 101 TCM 1274]. In this case, Douglas Griffin owned HydroTemp Manufacturing Company.

Pentair Corporation, 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. Mr. 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, Mr. Griffin had no further involvement with HydroTemp until he found that the IRS was pursuing him. Mr. 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, which the IRS later disallowed.

The IRS was unable to collect from HydroTemp, so it asserted transferee liability against Mr. Griffin. Fortunately, Mr. 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, Mr. 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 Mr. Griffin solely to reduce his tax liability.

The IRS argued that the court should collapse the two transactions based on substance over form. Nonetheless, the Tax Court rejected the IRS's arguments. The court found that the asset sale and the stock sale had independent legal significance and were not part of a preconceived plan.

Mr. 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. The Tax Court did not even think this was a close case.

In fact, the Tax Court considered the IRS's position in pursuing Mr. Griffin (despite his lack of knowledge of Midcoast's tax-avoidance scheme) was weak. The IRS's position was so weak that Mr. Griffin deserved an award of litigation costs. The Tax Court granted Mr. Griffin's motion, awarding him $183,019.42 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 Inc.* [101 TCM 1148, Dec. 58,537(M), TC Memo 2011-33], 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 because of the source of the payment and its close relationship with the midco entity. That made the finder's fee fair game for the IRS.

In *Frank Sawyer Trust of May 1992* [TC Memo 2011-298, Dec. 58,845(M), 102 TCM 623, *rev'd and rem'd*, CA-1, 2013-1 USTC ¶50,253, 712 F3d 597, *modified*, 107 TCM 1621, Dec. 59,952(M), TC Memo 2014-128], the IRS tried to pursue distributions with arguments similar to those in *Diebold*, hoping to collapse everything together. But 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 Frank Sawyer Trust of May 1992 was indeed a transferee, and was subject to liability.

However, the court held 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 only liable to the extent it received more than fair value. In large part, therefore, the IRS wound up with half a loaf.

New Day

The latest in the litany of midco cases shows a new turn. The taxpayers in *S.F. Jacoby* [TC Memo 2015-67] were Mr. and Mrs. Jacoby. Mr. Jacoby 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. Thereafter, he worked at a wealth management firm, and then at Twenty-First, where he was a licensed securities broker. His main job was to close deals involving tax-advantaged investments developed by Twenty-First and by outside firms.

Mr. Jacoby eventually left Twenty-First to form his own business, SMD, in which he played the same kind of dealmaker role. He began working closely with Diversified Group, Inc. (DGI) and its president, Mr. Haber. DGI was one of the firms that developed strategies for Twenty-First.

As far as Mr. 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 employed by DGI was the midco transaction. Mr. Jacoby saw these tax arbitrage deals go swimmingly.

Mr. Jacoby 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. He did not witness any transactions involving the sale of a company whose only asset was accounts receivable.

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

Capital Gain for Receivables?

Mr. 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. Mr. Jacoby was supposed to recognize capital gain rather than the ordinary income he would have recognized had SMD collected the receivables.

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

Mr. Jacoby also entered into another transaction that had been conceived by DGI. It was a foreign currency transaction involving options. It was expressly represented as something that would secure tax deductions beyond the economic value of the options.

That opinion transaction was conceived by KPMG. The entity used for that transaction was JPF III. During 1999, Mr. Jacoby paid $40,000 to the attorney who was handling the JPF III transaction.

In December 1999, Mr. Jacoby signed an agreement that provided that JPF III was his agent with respect to 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 Mr. Jacoby and JPF III.

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

Civil Fraud Attack

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 pursued by the IRS. In large part, this is probably because it has historically been hard for the IRS to prove it. At 75 percent, it is an expensive penalty.

Code Sec. 6663(a) imposes the civil fraud 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. [Code Sec. 7454(a).] To satisfy its burden, the IRS must show 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, or badges of fraud, that demonstrate fraudulent intent. [See *R.B. Parks*, 94 TC 654, Dec. 46,545 (1990).] These badges of fraud include:

- understating income;
- maintaining inadequate records;
- implausible or inconsistent explanations of behavior;
- concealment of income or assets;
- failing to cooperate with tax authorities;
- engaging in illegal activities;
- an intent to mislead, which may be inferred from a pattern of conduct;
- lack of credibility of the taxpayer's testimony;
- filing false documents;
- failing to file tax returns;
- failing to make estimated payments; and
- dealing in cash. [See *P.E. Niedringhaus*, 99 TC 202, Dec. 48,411 (1992).]

The cases make clear that no single factor is necessarily sufficient to establish fraud. However, a combination of a number of factors can constitute persuasive evidence of fraud. With respect to Mr. and Mrs. Jacoby, the court found that the civil fraud penalty did not apply.

The court did find that an underpayment of tax existed, and the court even thought that the understatement was a fairly clear one. But there was just not enough evidence to say there was civil fraud. To show that the underpayment was obvious, the court cited *T.F. Seward* [20 TCM 561, Dec. 24,795(M), TC Memo. 1961-114].

That case stands for the proposition that accounts receivable "cannot be turned into capital gain items by means of a sale." The court concluded that the IRS had shown by clear and convincing evidence that, as a result of the SMD stock sale, the Jacobys had underpaid their taxes for the two years at issue.

But was there any intent to evade taxes? The IRS claimed that six of the badges of fraud were present. In contrast, the Jacobys 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, since 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." [See *C.M. Korecky*, CA-11, 86-1 USTC ¶9232, 781 F2d 1566.] The court in *Jacoby* found that there were understatements of income for the years at issue. Nevertheless, the court concluded that the IRS did not prove, nor even suggest, that the Jacobys had understated their income for any other year. The court concluded that IRS had failed to prove the existence of consistent and substantial understatements of income.

Implausible or Inconsistent Explanations of Behavior

This factor is hard to articulate, but amounts to things not adding up. In *Jacoby*, the court saw the IRS's argument on this factor as coming down to these points. The SMD stock sale was different from any of the strategies Mr. Jacoby had previously marketed. It 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 Mr. 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. Mr. 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 Mr. Jacoby's history to reflect the occurrence of transactions involving entities whose only asset was accounts receivable. But the court found it to be plausible that Mr. Jacoby believed that the SMD transaction was sufficiently similar to prior transactions so as not to raise any concerns.

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

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 by the fact that Mr. Jacoby had fully disclosed the details of the transaction to his accountants. He had provided all the documents he had relating to the transactions to them. The court concluded that Mr. Jacoby had the expectation that his accountants would report the transaction appropriately on the Jacobys' tax returns.

The IRS was also bothered by Mr. Jacoby's alleged tax expertise. The court noted that Mr. Jacoby held an accounting as well as a law degree. Moreover, he had worked at an accounting firm, a law firm and at several financial services firms.

But the court found that on closer examination, Mr. Jacoby's tax credentials were not as strong as they first appeared. True, Mr. Jacoby had been hired by a prestigious accounting firm. But he had no involvement with the tax side of the firm.

In law school, he did not specialize in tax law, and he did not have an LL.M. in taxation. When he marketed investment strategies, it was other persons, such as Mr. 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 IRS did not show, by clear and convincing evidence, that Mr. Jacoby was anything more than a marketer who relied on tax specialists to devise and vet the strategies he was selling. That did not evidence fraud.

Concealment of Income or Assets

Another typical badge of fraud is the concealment of income or assets. The IRS argued that Mr. Jacoby never invested money in the JPF III transaction, was never a partner in JPF III and that JPF III never acted as his agent. IRS also argued that even if JPF III had been acting as Mr. 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 Mr. 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 Mr. Jacoby believed there was a principal-agent relationship between Mr. Jacoby and JPF III. The court also thought it significant that Mr. Jacoby provided his accountants with 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 did not cite any authority in support of this 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 was hardly a smoking gun. The IRS argued that there were false documents filed with IRS. The IRS claimed that the Jacobys' 1999 and 2000 tax returns qualified as false, and so did the backdated agency agreement with JPF III.

The IRS also found fault with the fact that there were different versions of the tax opinion. However, the court drew an important distinction about the date on documents that was a frequent source of confusion. Regarding the agency agreement, was this 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 fact that the contribution agreement stated that JPF III was not acting as an agent raised serious concerns as to the legitimacy of the agency agreement. At the same time, the court was not prepared to assume there was foul play here. The court found no indication that Mr. Jacoby was aware of the contribution agreement or the discrepancy between it and the agency agreement.

Thus, the court ruled that the IRS had failed to show, by clear and convincing evidence, that Mr. Jacoby knew that the agency agreement was false or that he 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 the fact that Mr. Acosta did not draft it was a concern. However, the court found no indication that Mr. Jacoby was aware of the discrepancy in authorship. The court concluded that these questions regarding the authorship of the tax opinion certainly did not render the tax opinion fraudulent.

Failure to Cooperate, Intent to Mislead

A general failure to cooperate or 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 ruled 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 midco cases without periodically scratching your head. The *Jacoby* case does not involve this element, since his company was an S corporation. His midco transaction was a botched attempt to convert receivable income into capital gain. And he also had a KPMG option shelter, which certainly did not help matters.

In most midco transactions, of course, a timely S election could have avoided the underlying fact patterns. That means the S election could also have avoided the midco transaction. As the remaining transferee liability cases wend their way through the courts, perhaps the *Jacoby* case will signal that the IRS may try for civil fraud when all else fails.

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