Midcos, *Diebold Foundation*, And Transferee Liability

By Robert W. Wood


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Midco transactions were marketed to eliminate or reduce double tax on business sales. Most IRS attacks have come in the form of transferee liability cases that are often difficult for the government to win. Wood looks at transferee liability in light of the Second Circuit's decision in *Diebold Foundation*, which could be a game changer.

In two previous articles,[1] I reported on midco transactions wending their way through the courts. By definition, a transferee liability case involves the IRS pursuing one person for someone else's taxes. These cases are frustrating for taxpayers and for the government, which frequently loses because there are several hurdles to collecting money from a third party.

Although transferee liability issues can arise in many different circumstances, transferee liability cases involving midco transactions are arguably distinct. These are simple mergers and acquisitions deals that have turned into tax shelters. Midco transactions were long ago listed, but the large number of deals consummated in their heyday has left lingering tax liabilities.

Midco in the Middle

Shareholders owning stock in a C corporation with appreciated property have a dilemma. If the company sells appreciated property, it triggers a tax on the built-in gain. In a stock sale, the corporation continues to own the appreciated assets, so the corporate tax is not triggered. Of course, buyers prefer to purchase assets, while sellers typically do not want to sell them because of the built-in tax liability.

Midco transactions begin with shareholders selling appreciated C corporation stock to an intermediary entity. The intermediary sells the assets to the buyer, who gets a purchase price basis in the assets. The intermediary professes to have tax losses or credits to absorb the inherent tax liabilities, so the intermediary pays more to the shareholder than a tax-neutral party. In effect, the shareholders and intermediaries share a tax arbitrage.

The IRS challenged this type of transaction in Notice 2001-16[2] and has pursued promoters and participants relentlessly. On December 19, 2002, the IRS classified midco transactions as a coordinated issue and instructed auditors to use the economic substance and step transaction doctrines to disallow losses claimed to offset gains.[3] The directive said IRS auditors should focus on which party was responsible for involving the intermediary and paying its fees.[4]

But it soon became apparent that intermediaries would provide insufficient sources for collection. Therefore, the IRS directed auditors to focus on the potential liability of other parties involved in the transactions,[5] such as selling shareholders or buyers subject to transferee liability under section 6901.[6]

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[1]Robert W. Wood, ''The Boomerang Tax Problems of Midco Acquisitions — Part 1,'' *Tax Notes*, Oct. 8, 2012, p. 211; Wood, ''The Boomerang Tax Problems of Midco Acquisitions — Part 2,'' *Tax Notes*, Oct. 22, 2012, p. 443.

[2]2001-1 C.B. 730.

[3]IRS, ''Coordinated Issue All Industries: Intermediary Transaction Tax Shelters'' (Dec. 19, 2002).

[4]*Id.*

[5]*See* IRS, ''Examination of Multiple Parties in Intermediary Transaction Tax Shelters as Described in Notice 2001-16'' (Jan. 12, 2006).

[6]*Id.*

In Notice 2008-111,[7] the IRS described its position regarding when a person participating in an intermediary transaction under a plan may be subject to transferee liability for the target's unpaid corporate tax. A person engages in an intermediary transaction if the person knows or has reason to know that the transaction is structured to effectuate the plan. That might seem to be an easy test to satisfy, particularly when a closely held C corporation is being sold and is trying to avoid taxes.

However, the IRS must ascertain the transferor's liability and amount due. Because the liability is derivative, this determination is necessary before the IRS can shift its collection efforts to the transferee. Moreover, the burden of proof is on the IRS to establish the technical requirements for transferee liability under section 6901.

Bad Actors?

Frequently, the party the government and taxpayers want to pursue is the intermediary. Yet that may be a dead end. In *D.R. Diebold v. Commissioner*,[8] as in many other cases, the Tax Court held that the IRS failed to make its transferee liability case.

The most logical party to pursue is the original seller of the stock, who received a higher price and more net cash than he should have were it not for the intermediary. It sounds simple. Nonetheless, turning to state law or to the Fair Federal Debt Collection Practices Act,[9] the IRS has generally fared poorly.[10]

In California, for example, the Uniform Fraudulent Transfer Act[11] sets a high bar for what constitutes a fraudulent transfer. The law describes it as a transfer or obligation undertaken with an actual intent to hinder, delay, or defraud any creditor of the debtor, in which reasonable equivalent value is not received in exchange for the transfer or obligation, if the debtor either:

1. 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;[12] or

2. believed or reasonably should have believed that he would incur debts beyond his ability to pay as they became due.[13]

[7]2008-2 C.B. 1299.
[8]T.C. Memo. 2010-238, *vacated and remanded by Diebold Foundation Inc. v. Commissioner*, 736 F.3d 172 (2d Cir. 2013).
[9]P.L. 95-109, codified as 15 U.S.C. section 1692-1692p.
[10]*See Vendig v. Commissioner*, 229 F.2d 93 (2d Cir. 1956).
[11]Cal. Civ. Code section 3439.
[12]*See* Cal. Civ. Code section 3439.04(2)(A).
[13]*See* Cal. Civ. Code section 3439.04(2)(B).

Transferee Liability Then and Now

In *Diebold*, the IRS issued a notice of transferee liability against Mrs. Diebold as a transferee of Double D Ranch Inc. (Double D) even though she did not own the stock. The stock was owned by a New York 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.

Nevertheless, to support its transferee liability claim, the IRS argued that Mrs. Diebold was either a direct transferee from the corporation or a transferee of a transferee via the trust. The Tax Court refused to disregard the trust, noting that the transferee liability question was governed by state law. The court had to evaluate the IRS claims under the law of New York, where marital trusts are independent legal entities.

Thus, the Tax Court had to respect the trust's separate legal existence. It found no case in New York or elsewhere that imposed transferee liability merely because the trust was a grantor trust. In any event, Mrs. Diebold's marital trust was *not* a grantor trust.

The IRS even contended that Mrs. Diebold was the beneficial owner of trust assets because she exercised full control. But the Tax Court found that Mrs. Diebold did not exercise sole authority over the trust or its assets. Her co-trustees were notified of her reasonable disbursal requests in writing. The IRS also claimed that the trust should be disregarded because it participated in a fraudulent transfer. The IRS said a de facto liquidation plan made the transfer fraudulent.

However, the IRS failed to prove that Mrs. Diebold had engaged in a fraudulent conveyance of the stock. It also did not show that the distributions caused the trust to become insolvent and that the distributions were fraudulent under New York law. Accordingly, the Tax Court held that Mrs. Diebold was not a transferee.

Second Circuit Makeover

The Second Circuit in *Diebold* enunciated what it said are the two independent tests for transferee liability under section 6901. The IRS can collect against a transferee only if the party is a transferee and is subject to liability at law or in equity. Under the first prong of the statute, federal tax law is used to determine whether the party in question is a transferee. The second prong is whether the party is liable at law or in equity.

Under New York law, a transferee can be held liable if the transferor makes a conveyance without fair consideration that renders the transferor insolvent. The IRS claimed that the two prongs of section 6901 are not independent, while Mrs. Diebold said they were. The Service urged the court to invoke the substance over form doctrine to recharacterize the transaction. At that point, the IRS argued, the determination of state law liability must be made based on the recharacterized transaction.

Mrs. Diebold contended that the court must separately consider the second prong and state law. If a court determined that one of the two prongs does not apply, she asserted, it need not consider the other prong of section 6901. After all, the First and Fourth circuits both held that the two prongs of the statute are independent.[14] The Second Circuit recognized that the independence of the two prongs could make a pivotal difference, yet it could not agree with the IRS. Section 6901 is purely a procedural statute, the court said.

What Is Fraud?

Turning to the second prong of the statute, the Second Circuit examined New York law, concluding that Mrs. Diebold was a transferee after all. If the company had sold its assets and made liquidating distributions without holding back enough to pay taxes, the transaction would be fraudulent under New York law. However, in *Diebold*, a midco entity was interposed, so the company did not *directly* make a conveyance to the shareholders.

Nevertheless, the Second Circuit thought this series of transfers could fairly be collapsed. The court cited *Orr v. Kinderhill Corp.*,[15] 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, and with an intention to defraud creditors. Second, the transferee must have actual or constructive knowledge of the entire scheme that renders the exchange with the debtor fraudulent.

In *Diebold*, there was no question that one transferee received Double D's property, leaving Double D with nothing. But did the shareholders have actual or constructive knowledge of the entire scheme? 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.

On these facts, not much intuition was necessary to connect the dots. The Second Circuit said the shareholders knew they had a large C corporation tax problem. Not only that, but they specifically sought help to avoid that tax liability. They even interviewed three professional firms that offered to help avoid the tax.

Moreover, these were extremely sophisticated people, deploying a veritable stable of tax attorneys from two different firms. The goal for all was to limit their tax liabilities. Therefore, the Second Circuit was willing to draw reasonable inferences. Collapsing the transactions, the court found that Double D sold its assets and made a liquidating distribution, which left Double D insolvent.

Plainly, Double D received nothing from the shareholders in exchange. Thus, the New York definition of a fraudulent transfer was satisfied. The Second Circuit then remanded several issues to the Tax Court, including whether the second prong of section 6901 was met.

Future Cases

The Second Circuit in *Diebold* also addressed the appropriate standard of review. The question whether the shareholders had actual or constructive knowledge of the entire scheme was a mixed question of law and fact. The court said the standard of review should be: (1) *de novo* to the extent the alleged error is in the misunderstanding of a legal standard; and (2) clear error to the extent the alleged error is in a factual determination.

It is hard to read any of the midco transferee liability cases without considering the planning that could have prevented the transaction from being alluring. A timely S election could usually have avoided the underlying fact pattern. It is hardly innovative to suggest that appreciated assets in a closely held C corporation are a cause for worry.

Plainly, the shareholders may want or need to sell. Sometimes a transaction may be necessary because of health or economic circumstances. Scrambling for a quick fix can perhaps be understood, but it is never comfortable. Nor, it must be emphasized, is being a transferee.

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 Service and a little more distressing for taxpayers. And because transferee liability cases can arise in many different fact patterns, the government's win may help it outside the midco context as well as in it.

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[14] *See Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013); *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012).

[15] 991 F.2d 31 (2d Cir. 1993).