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Shareholders Liable for Buyer's Taxes in Midco Transaction

By Robert W. Wood • Wood LLP

The Tax Court has handed down a new decision in a midco transaction, *M.A. Tricarichi* [110 TCM 370, Dec. 60,427(M),TC Memo. 2015-201]. It has been well over a decade since the era of the midco transaction. Yet the aftermath of these transactions continues to percolate through the courts. [*See* Robert W. Wood, *Midco Litigation Morphs from Transferee Liability to Fraud*, M&A Tax Report, May 2015, at 1.] The factual setting is uniform.

Midco transactions were promoted to shareholders of closely held C corporations with large built-in gains. These shareholders faced the prospect of paying corporate-level taxes on the gain, followed by a shareholder-level tax when funds were distributed to them. Nobody is happy about that *General Utilities* gaffe.

Plainly, the problem could not be avoided by selling the shares. Sure, you can sell the shares, but buyers would surely insist on a discount. And the discount would be equal to the built-in tax liability, since the buyers would end up with it. That is where a buyer with a magic tax wand would come in.

Promoters of midco transactions said that their intermediary company would buy the shares. Don't worry, the intermediary company has losses—or will generate them somehow—to obviate the tax. The promoter and the target shareholders would split the taxes saved, and everyone would win.

Well, so it seemed. In most cases, of course, the midco losses were not real and would be disallowed. The midco would evaporate along with the promoters. The IRS would chase them to no avail. Then, the IRS would seek payment from other parties involved in the transaction.

That typically meant the shareholders of the C corporation who benefited. As we have noted in these pages in the past, the IRS often loses transferee liability cases. Nevertheless, the IRS prevailed in *Tricarichi* despite lots of lawyering and expert witnesses on the side of the taxpayer.

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Who Knew?

Transferee liability cases necessarily must consider who knew what and who had reason to know. Those are gritty factual issues, and they 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. The latter was the situation in *D.R. Griffin* [101 TCM 1274, Dec. 58,571(M), TC Memo 2011-61]. *Griffin* is a stunning contrast to *Tricarichi.*

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.

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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 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 the Tax Court awarded Mr. Griffin $183,019.42 in litigation costs.

Transferee Liable

The IRS has occasionally succeeded in its quest to collect in the aftermath of a midco deal. For example, in *CHC Industries* [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* [102 TCM 623, Dec. 58,845(M), TC Memo 2011-298], 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. [*See Frank Sawyer Trust of May 1992*, 107 TCM 1621, Dec. 59,952(M), TC Memo 2014-128, *supplementing* 107 TCM 1316, Dec. 59,871(M), TC Memo. 2014-59, *on remand from* CA-1, 2013-1 USTC ¶50,253, 712 F3d 597, *rev'g and remanding* 102 TCM 623, Dec. 58,845(M), TC Memo. 2011-298.] In large part, therefore, the IRS wound up with half a loaf.

Tricarichi

Tricarichi involved a typical midco fact pattern. Not surprisingly, a key issue was whether the seller knew or should have known that the purported tax savings driving the richly priced deal were illusory. The taxpayer in *Tricarichi* claimed that he neither knew nor should have known.

But the Tax Court did not find the taxpayer's testimony credible. In fact, the court found that many deal points offered by the midco entity (Fortrend) raised red flags that demanded further inquiry. Fortrend offered to pay $11.2 million more than the net book value—a premium of 47 percent—while insisting that the assets be turned into cash.

The court said that Mr. Tricarichi was sophisticated enough to know that *no one* pays a 47-percent premium for cash—which cannot be worth more than its face value—unless something is very wrong. Besides, the court said that the ginned-up business purpose for the transaction made no sense. It was clear that the company would be gutted.

And with true arbitrage, the deal price was determined based solely on the selling company's tax liability, nothing else. For that reason, above all others, the court concluded that Mr. Tricarichi knew or should have known that Fortrend was not going to pay his company's tax liabilities. At a minimum, it was enough to put the taxpayer on inquiry knowledge.

It did not help the court's view of the taxpayer that he kept professing ignorance, even about the numbers. The Tax Court did not find this testimony credible. And it even went so far as to call his testimony evasive, noting that he was visibly uncomfortable.

There may have been good reason for that. Indeed, the court went on to describe the bidding war the taxpayer fomented between the dominant midco players, Midco and Fortrend. Playing off the two tax shelter competitors was so obviously a knowing and aggressive move that the Tax Court had little difficulty in finding this taxpayer to be anything but innocent.

Transferee Burdens

One reason that the IRS loses many transferee liability cases is the burden of proof. The IRS bears the burden of proving that a person is liable as a transferee. Moreover, the courts have struggled with different tests for imposing that liability. That is particularly true considering the impact and applicability of state law.

Knowledge of the liability is one key element, but there are different kinds of knowledge, including constructive knowledge. Some cases define constructive knowledge as the knowledge that ordinary diligence would have elicited. Other cases require more active avoidance of the truth.

Constructive knowledge includes inquiry knowledge. "Inquiry knowledge" exists where the transferee was aware of circumstances that should have led him or her to inquire further into the circumstances of the transaction. But in *Tricarichi*, the court found it so beyond the pale that it really didn't matter what standard it applied.

Even some of Mr. Tricarichi's experts had said that due diligence did require investigating. Mr. Tricarichi and his advisers were clearly suspicious about Fortrend's scheme. But instead of digging deeper, the Tax Court concluded that they engaged in willful blindness, actively avoiding learning the truth.

They knew it was probably a reportable or listed transaction with the IRS too. There was ample evidence that Mr. Tricarichi and his lawyers and accountants were looking at the IRS notices, researching sham transactions and the like. Mr. Tricarichi even fenced with his accountants at PwC over whether the transaction was reportable.

Everyone, it seemed, knew what it was. PwC advised that it appeared to be "a very aggressive tax-motivated strategy" that was "subject to IRS challenge." PwC specifically declined to give a "more likely than not" assurance on this point.

The Tax Court noted that Mr. Tricarichi turned his back on this red flag. In Tax Court, he testified that Fortrend's tax-elimination strategy was of no concern to him because "that was their business."

S Election, Anyone?

It is hard to read most midco cases without thinking about S elections. Midco transactions came along in response to the 1986 tax reforms, or perhaps more accurately, in response to the people who *failed to respond* to the 1986 tax reforms. Up until 1986, when the assets of a corporation were sold in connection with the corporation's liquidation, the tax picture was rosy.

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 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 did not get the memo about the key 1986 tax changes. Over the following decades, many C corporation sellers found themselves facing big double-tax bills. That was where one of several facilitators of the midco deal came in.

As the remaining transferee liability cases wend their way through the courts, it is worth remembering that sometimes, there are simple solutions, provided that you pay attention and plan ahead.