Transferee Liability for Shareholders, Even Innocent Ones? (Part 2)

By Donald P. Board • Wood LLP

Part 1 of this article appeared in The M&A Tax Report, Vol. 25, No. 4 (Nov. 2016), p. 4. Part 1 reviewed the principles courts have applied to decide whether to recast "midco" transactions in a form that would allow the IRS to recover unpaid corporate taxes from shareholders as transferees under Code Sec. 6901. Relying on precedents dealing with fraudulent-conveyance challenges to LBOs, the courts have generally permitted a recast only when shareholders knew or had reason to know that they were participating in a tax-avoidance scheme. Part 2 discusses the recent approach of the Seventh Circuit, which has held that state-law equitable principles permit a recast even when shareholders neither knew nor had reason to know that they were involved in an illicit transaction.

Equity Follows Tax

In 2005, Woodside filed a federal income tax return claiming losses that wiped out its gain from the asset sale. The IRS disallowed the phony losses and sent Woodside a notice of deficiency. Woodside couldn't pay, so the IRS assessed transferee liability against the selling shareholders.

The shareholders took their case to the Tax Court, which ruled in favor of the IRS. The shareholders then appealed to the Seventh Circuit. As usual, the IRS tried to blunt the second prong of *Stern.*

The IRS said Code Sec. 6901 was a trump card, establishing that it was a transferee for purposes of state fraudulent conveyance law (Wisconsin's version of the UFTA). The Seventh Circuit, like all the others, rejected the IRS's contention.

Hence, it was necessary to determine whether the Wisconsin courts would recast the stock sale as a liquidation for purposes of applying the UFTA. The Wisconsin courts were known to re-characterize transactions from time to time, especially for Wisconsin tax purposes. But the case law in Wisconsin, like that of many states, had not spelled out the conditions in which it is appropriate to recast a corporate transaction for fraudulent-conveyance purposes.

Faced with this gap in Wisconsin law, the Seventh Circuit might easily have reached for the leveraged buyout (LBO) precedents. That would have been the end of the line for the IRS. The parties had stipulated in the Tax Court that the shareholders neither knew nor had reason to know that Woodside's tax losses would be disallowed.

Fortunately for the IRS, the Seventh Circuit did not even *mention* the LBO cases. Instead, it filled the gap by holding that the Wisconsin courts *would* recast the midco transaction using generic versions of several familiar federal tax doctrines, including substance over form, business purpose and economic substance. These doctrines can apply even if the purported transferee lacked actual or constructive knowledge that the transaction involved illicit tax avoidance.

This analysis may come as a bit of a surprise. After all, the courts—including the Seventh Circuit in *Feldman*—have consistently held that the two prongs of the *Stern* test are independent. Federal tax principles determine whether a person is a transferee for purposes of Code Sec. 6901(a)(1). State law determines whether the IRS has substantive rights against that person.

But there is no contradiction here. Under *Stern*, it is clear that Wisconsin has the last word on the scope of its fraudulent conveyance law. The IRS cannot insist on being treated as a transferee for purposes of the Wisconsin UFTA simply because it is considered a transferee for federal tax purposes.

But if Wisconsin *wants* to recast transactions using federal tax principles, it is perfectly free to do so. The Seventh Circuit tried to divine how a Wisconsin court would deal with a midco transaction. It observed that the Wisconsin courts have used equitable doctrines to re-characterize transactions in a variety of contexts, including not only tax but also usury and the treatment of loans to corporate insiders.

The Seventh Circuit did not identify any Wisconsin cases involving the UFTA. Nevertheless, the court confidently asserted that "state fraudulent-transfer law is itself flexible, and looks to equitable principles like 'substance over form,' *just like the federal tax doctrines*." [*R. Feldman*, *supra*, 779 F3d at 459 (emphasis supplied).] So the IRS could get its recast under Wisconsin law using the same arguments that established that the shareholders were transferees for purposes of Code Sec. 6901(a)(1).

Arguments Beside the Point

The shareholders in *Feldman* argued that their stock sales could not be recast unless the IRS proved that they knew or should have known that MidCoast's tax scheme was illegitimate. At this point, one would have expected the Seventh Circuit to explain why it disagreed with decisions in the First, Second, Fourth and Ninth Circuits adopting the knowledge requirement from the LBO cases.

But the Seventh Circuit did not discuss the competing case law. Instead, it responded to the shareholders with a pair of unconvincing arguments. The first was based on the fact that the relevant provisions of the UFTA do not impose a knowledge requirement.

If a debtor has transferred property for less than reasonably equivalent value while insolvent, that's a fraudulent conveyance no matter what the transferee did or did not know. According to the Seventh Circuit, this demonstrates that "the shareholders' extensive emphasis on their due diligence and lack of knowledge of illegality is simply beside the point." However, the shareholders in *Feldman* were not pleading their diligence and lack of knowledge as a defense under the UFTA.

They were trying to prevent the IRS from recasting their stock sale as a liquidation in the first place. That's a different issue—and not one governed by the UFTA. The whole point of re-characterizing the transaction was to create a set of facts to which the UFTA *would* apply. Hence, the irrelevance of knowledge and diligence under the UFTA hardly establishes that knowledge and diligence are irrelevant to the question of whether to recast a transaction based on Wisconsin equitable principles.

The Seventh Circuit's second argument pointed to the fact that the transaction was built on the idea that MidCoast would offset the $750,000 tax liability triggered by the corporate asset sale. Hence, the transaction "was premised on the assumption that the taxes would *not* be paid." [*R. Feldman*, *supra*, 779 F3d at 460 (emphasis in original).]

Perhaps the Seventh Circuit believed this was enough to satisfy the knowledge requirement in the LBO cases that it failed to discuss. But knowing that a corporation expects to incur losses that will offset a gain is obviously not the same thing as knowing that the corporation intends not to pay a tax liability that is actually due. Under the LBO standard, it's only the second kind of knowledge that counts.

Sham Tips the Scale

The further one steps back from the details of a midco deal, the easier it is to see why the IRS insists it is really an asset sale followed by a liquidating distribution. The same goes for the role of the midco. Pull back and it looks like the midco is just taking a slice of the avoided taxes as a transaction fee.

In principle, the IRS could use this kind of high-altitude analysis to justify a recast. When litigating, however, the IRS does not put much faith in the big-picture approach. On the contrary, it tends to concentrate on small but damning details of the transaction.

In *Feldman*, the IRS focused attention on how the midco financed its purported purchase of the shareholders' stock. The promoters understood that it would look bad if the midco paid for the shares directly from the proceeds of the corporation's asset sale. Somebody might actually get the impression that the midco was just a conduit for the distribution of liquidation proceeds to the shareholders!

The corporation's remaining cash had been transferred to an escrow account controlled by MidCoast's lawyers. There was more than enough to pay the selling shareholders the $1.35 million they were owed for their stock. Nevertheless, the promoter wired in an *additional* $1.4 million, purportedly as a loan to MidCoast. Two hours later, $1.35 million was wired to the selling shareholders as payment for their stock.

The promoter's injection of $1.4 million into the escrow made it at least *possible* to claim that the shareholders were not being paid out of the asset-sale proceeds. However, just 60 seconds after the shareholders got their money, the promoter took her $1.4 million back.

This was a gift to the IRS. The promoter's putative loan was already dubious. It was undocumented and did not bear interest. Now it turned out that the "loan" was outstanding for a grand total of 122 minutes.

The Tax Court easily concluded that the supposed extension of credit was not what it purported to be. Or, as the Tax Court put it, the so-called loan was "a ruse, a recycling, a sham." Once some element of a transaction has been labeled a "sham" (*i.e.*, as something intended to mislead), all bets are off.

There is almost always room to debate the big-picture characterization of a transaction. What is form and what is substance is often in the eye of the beholder. But getting caught in a sham is the transactional equivalent of getting caught in a *lie*. A lie is something everybody understands.

Once a sham is identified, judicial sympathy for the responsible party evaporates. The court can disregard the transaction with a clear conscience. If any factual ambiguities remain in the larger transaction, these will generally be resolved against the shamster.

In *Feldman*, disregarding the promoter's sham loan left a transaction in which the selling shareholders transferred their stock to the midco. They were paid from the escrow with cash derived from Woodside's asset sale. Standing alone, that probably would not have established that the stock sale was "really" a corporate distribution.

But because the promoter had tried to obfuscate the source of the funds, the Tax Court did not hesitate to find that the shareholders had been paid off in a *de facto* liquidation that had left their corporation insolvent.

Following *Feldman*

The first case to follow the *Feldman* analysis was *S.K. Shockley* [109 TCM 1579, Dec. 60,329(M), TC Memo. 2015-113]. Once again, the IRS was trying to use Wisconsin law to recover unpaid corporate taxes in the wake of a midco transaction. The case was appealable to the Eleventh Circuit, but there was no Eleventh Circuit authority on recasts under Wisconsin law.

The Tax Court followed *Feldman*, holding that the Wisconsin courts would re-characterize the stock sale as a liquidation based on the actual substance of the transaction. Like the Seventh Circuit, the Tax Court in *Shockley* had nothing to say about the case law in other circuits adopting the knowledge requirement from the LBO cases.

The second case was *T.L. Weintraut* [112 TCM 122, Dec. 60,659(M), TC Memo. 2016-142]. This time, the focus was on Indiana's version of the UFTA. The case was appealable to the Seventh Circuit. The Tax Court followed the *Feldman* analysis, invoking state-law principles to uphold the IRS's recasting of the midco transaction as a liquidation.

As in *Feldman*, the court in *Weintraut* emphasized that a purported loan by one of the promoters was "mere window dressing" to disguise the fact that shareholders were selling their shares for the proceeds of the corporation's asset sale. Unlike *Feldman* and *Shockley*, however, the decision in *Weintraut* acknowledged that "certain courts" had refused to recast midco transactions unless the selling shareholders knew or should have known that the corporation's taxes would be left unpaid. The Tax Court did not think it necessary to discuss those cases in any detail, however, because they had not involved the Indiana UFTA.

Instead, it relied on a bankruptcy case in which the Seventh Circuit had applied Indiana fraudulent conveyance law to an LBO without regard to the knowledge of the participants. [*See Boyer v. Crown Stock Distrib., Inc.*, CA-7, 587 F3d 787 (2009).] But the Tax Court didn't take any chances. It was possible the Seventh Circuit might decide that Indiana, unlike Wisconsin, would *not* recast unless the shareholders had actual or constructive knowledge of the illicit tax scheme.

So the Tax Court reviewed in detail the many "red flags" the shareholders had ignored or actively avoided finding out about. Based on that dismal record, the court found that the shareholders had the kind of constructive knowledge that would have justified a recast in other circuits.

Conclusion

It is not clear whether the Seventh Circuit understood how far it was stepping out of line when it held that selling shareholders' diligence and lack of knowledge are "beside the point"—at least in Wisconsin. The fact that *Feldman* did not even mention the competing precedents in the other circuits certainly makes one wonder. The decision in *Weintraut*, on the other hand, suggests that the Tax Court is now aware that there is a "split in the circuits."

Perhaps that means it is just a matter of time until we have a case in which the two approaches to shareholder knowledge battle it out in public. That assumes, of course, that the pipeline of midco cases isn't about to run dry—perish the thought!

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