The Metropolitan Corporate Counsel®

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Volume 18, No. 6 © 2010 The Metropolitan Corporate Counsel, Inc. June 2010

# Pending Cases In The U.S. Tax Court To Test IRS Transferee Liability Position On "Midco" Transactions

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Beginning in the late 1990s, after a period in which it had focused on being more "customer oriented" while audit rates dropped radically, IRS woke up to the fact that major legal and accounting firms were marketing various tax savings strategies to taxpayers and earning substantial fees for their services. It also realized that substantial tax revenues were being lost due to taxpayers' use of these strategies.

Over the next decade the IRS vigorously attacked these schemes and those who promoted and marketed them on numerous fronts and, by using the judicially created economic substance and step-transaction doctrines,[1] IRS has won most of these battles. Most taxpayers have thrown in the towel and repaid all or most of the tax savings they attempted to obtain together with interest and substantial penalties.

One of the last battles in the tax shelter wars is still being fought in the U.S. Tax Court and IRS victory is still in doubt. The issue to be decided is whether the IRS can assert transferee liability as a tax collection tool against corporate shareholders who utilized so-called Midco or middle-company transactions to facilitate the sale of their businesses to buyers who, although interested in the underlying assets, for a variety of business and tax reasons did not want to buy the corporate entity (or its stock).

While this business problem is not a new or uncommon one, the "Midco" transaction represented a seemingly easy solution. An intermediary company (M), functioning in some ways like a "1031 exchange company" used frequently to facilitate tax-deferred "like-kind" exchange real estate transactions, buys the target corporation's (T) stock from the selling shareholders (X) and then turns around and sells the corporation's assets to a buyer (Y) who often already had discussions with the stock seller previously. Y then claims a tax basis in the assets equal to the price paid.

What aroused IRS's ire in the Midco transactions that developed in the late 1990s and were marketed by firms such as Fortrend, ICA and MidCoast Financial was that after the asset sale closed, the tax due on the sale of the T's assets was frequently offset by one or more of the other creative tax strategies IRS has also determined to be abusive and never paid.

On February 26, 2001 the IRS issued Notice 2001-16[2] in which it alerted taxpayers and their representatives that it had become aware of certain transactions involving the use of middle or intermediary companies that were being marketed to taxpayers "for tax avoidance purposes" and declared those transactions and any "substantially similar" transactions to be "listed transactions" under IRC § 6011, subjecting participating taxpayers and those involved in promoting the transaction to expanded disclosure registration and recordkeeping rules on pain of substantial monetary penalties. The IRS warned taxpayers and their representatives of its intention to challenge the reported tax results of Midco transactions by recharacterizing the transaction as either a sale of T's stock to Y by the selling shareholders(s) (X) or a sale of T's stock to Y depending on the facts involved and that it could assert an array of penalties against the participants and/or their advisors.

On December 19, 2002 IRS internally classified Midco transactions as a "coordinated issue" and instructed its auditors to use the economic substance and steps transaction doctrines to disallow any of the offsetting losses claimed and to recast the transaction to be consistent with what IRS viewed as economic reality.

In its "Intermediary Transaction Tax Shelter Coordinated Issue Paper,"[3] IRS told its examiners to evaluate all of the facts and circumstances of the case to determine whether the proper characterization of the transaction should be as a stock sale or an asset sale. To make this determination, IRS listed a number of factors to consider but, for the most part, the factors listed focused on which party (buyer or seller) had brought the intermediary company into the transaction and paid its fees.

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Unlike other cases where the tax shelter transaction was reported on the return of either an individual taxpayer or an on-going business entity, in Midco transactions, the entity selling its assets will often file a "final" return for the year of the transaction and disappear, leaving IRS with a Pyrrhic victory by having disallowed any claimed offsetting losses and recast the Midco transaction.

In light of this, in a memorandum dated January 12, 2006 entitled "Examination of Multiple Parties in Intermediary Transaction Tax Shelters as described in Notice 2001-16," IRS examiners were told that IRS has made a "management decision" to refocus attention "on the potential liability of parties other than just the intermediary entities which will almost certainly be inadequate sources for collection."[4]

Examiners were urged to develop cases of potential transferee liability against the selling shareholders or even the buyer under IRC § 6901 as the only way to collect the tax that IRS feels should have been paid at the outset of the transaction.

In a typical scenario, IRS might recast a Midco transaction and claim it is essentially a sale of the corporate assets of T by that entity followed by a distribution of the proceeds of that sale to X (T's shareholders) as a liquidating dividend without leaving T sufficient assets for the payment of T's resulting tax liability.

In such a recast scenario, IRS would then rely on IRC § 6901(h) and Treas. Reg. § 301.6901-1(b) which provide that a corporate shareholder who received liquidating distributions that left the corporation with insufficient funds to satisfy its tax debts may be held liable as a transferee for the unpaid corporate tax, interest and penalties to the extent of the amount received by the shareholder as a liquidating distribution. I.R.M. 5.17.14.5.11(8).

In a typical Midco case however, the selling shareholder(s) may have long ago retired to warmer climates and have no idea of what the intermediary company (M) did with their formerly owned entity (T) after their transaction with the buyer (Y) closed. The selling shareholders might not ever have seen the "final return" filed for T by M or ever known it claimed improper loss/deduction transactions to offset the tax due on T's ultimate asset sale to Y. Indeed, the selling shareholders may not have ever known that IRS was auditing T or that it had proposed substantial tax and penalty assessments against T until they receive a notice from their local Post Office that a piece of certified mail from the IRS has arrived for them. Only then do they learn that IRS is seeking to recover from them as transferees of T.

The shareholders' reaction might well be "I got paid by M before M sold the assets of T so how can they say I got a distribution from T's asset sale" or "how can they now come after me, I didn't have anything to do with filing T's return and claiming any bogus deductions on it?" or "I was only a minority shareholder in T and had nothing to do with hiring M" or even, "I assumed M had some legitimate way of offsetting the tax due on the sale and had no idea what they were planning to do."

While these may sound like reasonable responses, the IRS in Notice 2008-111[5] dismisses all of them as irrelevant. In Section 4 of Notice 2008-111, IRS stated that a person (e.g. X, a selling shareholder of T) is part of the Plan for tax avoidance and potentially liable as a transferee for the unpaid corporate level tax of T if:

"…the person knows or has reason to know the transaction is structured to effectuate the Plan. Additionally, any X that is at least a 5 percent shareholder of T (by vote or value) *or* any X that is an officer or director of T engages in the transaction pursuant to the Plan if any of the following knows or has reason to know the transaction is structured to effectuate the Plan:

(i) *any* officer or director of T,

(ii) *any* of T's advisors engaged by T to advise T or X with respect to the transaction, or

(iii) *any* advisor of *that X* engaged by that X to advise it with respect to the Transaction.

IRS makes a limited concession in this regard by holding that where there are more than five officers of T, the term "officer" is limited to the CEO and the next four most highly paid officers.

IRS goes on, in Section 4 of Notice 2008-111 to state that, in its view, "[a] person can engage in the Transaction pursuant to the Plan even if it does not understand the mechanics of how the liability purportedly might be offset or avoided or the specific financial arrangements or relationships of the other parties or of T *after* the Stock Disposition."

While IRS reliance on the economic substance and step transaction doctrines may well enable it to unravel a Midco transaction and assess T with the tax (and interest and penalties) that should have been paid on the transaction if M had not been used, the strict technical requirements of establishing transferee liability (an issue on which IRS, not X, bears the burden of proof)[6] seem to cast doubt on the soundness of the IRS's position in Notice 2008-111. *See,* I.R.M. 5.17.14.5.1 et. seq.

For example, absent proof of actual fraud, in most "transferee-in-equity" cases, the existence of a transfer for inadequate consideration from the transferor to the transferee is a requirement for transferee liability as is the fact that the underlying tax liability of the transferor must have existed at the time the transaction between the transferee and transferor occurred. Similarly, IRS must establish that it exhausted all reasonable efforts to collect from the transferor prior to seeking to assert liability on the alleged transferee. Finally, the IRS must have brought its transferee claim within one year from the expiration of the period assessing against the transferor.

All of these issues are now before the U.S. Tax Court in several cases which have been tried and are pending decision.[7] In each of these cases, the seller and buyer could not agree on either an asset or stock sale and an intermediary (ICA in *Shockley* and Fortrend in *LR Development*) was engaged to create a Midco transaction at the end of which the buyer and seller achieve what each desired. However, as a result of steps taken by the intermediary after the buyer/seller transaction was accomplished, the tax liability that would have otherwise been due was either eliminated or offset. In *Shockley* (where the sellers were introduced to ICA by an accounting firm), the IRS has asserted transferee liability against the sellers for the taxes that would have been due from SCA on an asset sale. In *LR Development*, where the buyer's accountants introduced Fortrend, IRS asserted transferee liability against the buyer. A detailed discussion of the facts of these cases will be the subject of a follow-up article.

The outcome of these cases will undoubtedly provide taxpayers and their advisors with a better understanding of how far IRS is allowed to go in pursuing collection of unpaid taxes from other participants in transactions that IRS has been able to recharacterize under the economic substance or step transaction doctrines.

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[1] Gregory v. Helvering, *293 U.S. 465 (1935),* Commissioner v. Court Holding Co., *324 U.S. 331 (1945).*

[2] *Notice 2001-16, 2001-9 I.R.B. 730 (2/26/01).*

[3] *Coordinated Issue: All Industries: Intermediary Transaction Tax Shelters (eff. 12/19/02).*

[4] *http://www.irs.gov/businesses/article/o,,id=153182,oo.html.*

[5] *Notice 2008-111, 2008-51 I.R.B. (12/22/08).*

[6] *IRC § 6902(a).*

[7] Sandra K. Shockley, Transferee, et. al. v. Commissioner, *Docket Nos. 28207-08, et. al. (tried in January 2010) and* LR Development Company LLC, Transferee v. Commissioner, *Docket No. 8836-06 (tried in May 2008).*