which define material participation and which were written in 1986.

As a corollary, Stuart Hurwitz stated that the issue is what is “arbitrary and capricious” in terms of the regulations the Service has issued.

HOT TOPICS

Members discussed the following topics:

Steve Walker discussed a case he is presently litigating, a CDP Appeal which the Tax Court has advised the parties will be decided using the judicial guidelines set forth in *Mayo.* The taxpayer is arguing that the court should set aside the decision by the Appeals Officer as it was reached in an arbitrary and capricious manner.

Lavar Taylor discussed a recent case which settled before trial where the IRS assessed a trust fund recovery penalty per IRC Section 6672 while a protest was pending. The government conceded two days before trial that this was incorrectly done. Lavar asked that anybody with this issue please feel free to give him a call.

Lavar also discussed the pending case of *Wilson v. Commissioner,* an IRC 6015 “record rule” case in which the taxpayer is arguing that she should be able to introduce evidence in Tax Court which was not submitted previously. In this case, the wife had an abusive husband and was unable to introduce evidence regarding this at the administrative level.

James Counts stated that EDD is going to start focusing even more so on construction taxpayers who may be evading their employment tax obligations.

Dennis Brager discussed California statute SB 459 which provides penalties for the willful misclassification of employees as independent contractors. It was signed by Governor Brown recently and is found Labor Code § 226.8. As the law originated from the California Labor Commissioner it has not gotten quite the same attention as if it had been issued by a taxing authority, but Dennis pointed out that it applies to anyone giving advice to someone that they do not need to classify an employee as an employee (although specifically exempting attorneys). He felt that the statute may have a wide ranging effect.

The Chair asked for ideas for upcoming meetings. See the Chair’s Message for confirmed details of the February 17, 2012 meeting.

The Chair also asked for ideas for the next annual meeting.

The Chair urged anyone wanting to write a paper for the Washington trip or who has a suggestion for an upcoming meeting or the November, 2012 tax conference to please let him know.

ARTICLES:

TRANSFEREE LIABILITY AND INTERMEDIARY TRANSACTIONS: RECENT CASES

Bryant W. H. Smith, Esq.

The IRS has many tools to collect taxes when a taxpayer does not voluntarily pay the tax it owes. One of these tools is collecting the taxpayer’s tax from a third party. Most tax practitioners are aware of collection from responsible persons, but what about collecting from a third party that had no control over the taxpayer's failure to pay? That is where the IRS can assert transferee liability.[1] While the determination of transferee liability depends upon state law, 26 U.S.C. § 6901 makes it simple for the IRS to collect from transferees when there is a fraudulent conveyance, or, potentially even when there is a legitimate conveyance. *See Commissioner v. Stern*, 357 U.S. 39, 42, 45 (1958).

In California, the California Uniform Fraudulent Transfer Act sets forth the elements of a fraudulent transfer: A transfer or incurring of an obligation 1) "[w]ith actual intent to hinder, delay, or defraud any creditor of the debtor," and 2) "without receiving a reasonably equivalent value in exchange for the transfer or obligation, and the debtor either: (A) [w]as engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction," or "(B) [i]ntended to incur, or believed or reasonably should have believed that he or she would incur, debts beyond his or her ability to pay as they became due." Cal. Civ. Code § 3439.04(a).

One area where the IRS asserts transferee liability is in a so-called "intermediary transaction" or "Midco transaction" as defined in IRS Notices 2001-16 and 2008-111. An intermediary tax shelter transaction typically involves a closely-held corporation that: (1) has recognized significant taxable gain from a sale of its assets; (2) has insufficient tax benefits to offset or avoid the resulting tax liability; (3) has no other liabilities; and (4) holds only cash. A promoter, usually after entering into discussions with the shareholders, purchases the stock at a price between the corporation's net, after-tax value and its pre-tax value. The promoter then removes the cash and does not pay the corporate tax. The IRS cannot collect the unpaid tax from the corporation, because it has no assets, or from the promoter, because the promoter usually does not receive any direct transfers and uses foreign entities and bank accounts. Although the promoter arranges for the tax liability to be eliminated, avoidance of the corporate tax ultimately is achieved by rendering the corporation judgment-proof by the time the IRS learns of the transaction.

To see how this plays out in reality, consider this hypothetical: A taxpayer owns all of the stock of a corporation that has appreciated assets and wants to end his relationship with the corporation. The corporation's assets have a fair market value of $10 million, but the selling of the assets would trigger a $5 million tax for the corporation. If he liquidated and paid the tax, he would end up with a net of $5 million. What price can the taxpayer receive for his stock in the corporation? It depends on the buyer, does it not? A buyer who wants to continue the corporation's business without triggering the tax may value the stock well above $5 million because she can defer the $5 million of tax indefinitely. A buyer who can effectuate a legitimate merger of the corporation with a second corporation that has built-in losses may be able to legally shelter the $5 million of tax. Does the answer change if the tax is triggered before the stock sale? Does the answer change if the buyer is a corporate raider who misrepresents its intentions to the seller? What if the buyer is merely an intermediary between the taxpayer the ultimate buyer?

From the perspective of the IRS, the same transaction may appear to be very different: A taxpayer owns all of the stock of a corporation that has appreciated assets for which $5 million of tax will be due when the tax is

[1] A full discussion of the history and breadth of transferee liability is outside the scope of this article. This article analyzes key recent cases.

triggered. The tax is triggered, and the owner of the corporation walks away with more than the value of the assets less the $5 million in tax. If the tax is not paid by the corporation, then the taxpayer should be liable.

With that backdrop, consider some recent "Midco" or "intermediary transaction" cases. The IRS had early victories by stipulation against a promoter and the sellers in one transaction, but has not fared as well in cases that have been litigated.[2] Each of the decisions has been fact-driven, and the Tax Court has seemed reluctant to find transferee liability where the alleged transferee acted in good faith.

***MDC Credit Corp., f.k.a Midcoast Credit Corp., Midcoast Mortgage Corporation, Transferee v. Commissioner of Internal Revenue*, U.S. Tax Court, Docket No. 26922-08**

In this case, in September 2010, MidCoast stipulated to a liability of $672,000.00 plus interest as a transferor of SBP Michigan, Inc., a corporation it raided. However, the parties also stipulated, below Chief Judge Colvin's signature, that MidCoast would be relieved from the liability if full payment of the $2,100,504.36 liability is made by any of the sellers of the corporation's stock.[3] Why would the Service create by stipulation a priority with the promoter effectively placed at the lowest priority?

Prior to the sale of SBP Michigan, the alleged transferees owned a company with a value of approximately $1.8 million and a potential tax liability of approximately $1.1 million plus penalties and interest for a total of $2.1 million. After the sale of SBP Michigan, the alleged transferees ended up with approximately $1.1 million in cash—saving approximately one-half of the tax liability. In the context of the earlier hypothetical, this kind of saving may not be inappropriate, unless the selling shareholders were knowing participants in MidCoast's scheme. Because this case was decided by stipulation, it is unclear whether the selling shareholders knew of or participated in MidCoast's plan to avoid paying the tax. As seen in the cases discussed below, absent some actual or constructive knowledge, the selling shareholders may very well have done better by going to trial.

***LR Development v. Commissioner*, T.C. Memo 2010-203**

In *LR Development v. Commissioner*, T.C. Memo 2010-203, the IRS asserted transferee liability against the buyer of the target corporation's assets. After the sole shareholder of a company died, his estate wanted to sell its stock in the company. The ultimate buyer, LR Development Company, introduced an intermediary into the negotiations. This intermediary, Fortrend, offered to purchase the company's stock and sell the company's assets to the buyer. In the stock sale agreement, Fortrend agreed to pay the taxes resulting from the asset sale, which

[2] It is unknown how many other cases were settled by stipulation.

[3] In February 2011, the following stipulated decisions were entered: In Docket Number 26881-08, Gelman Family Limited Partnership, and Charles Gelman, General Partner, stipulated to a liability of $105,537.00 plus interest as a transferee of SBP Michigan, Inc. In Docket Number 26882-08, the Charles Gelman Revocable Trust, Charles Gelman, Trustee, stipulated to a liability of $750,484.00 plus interest as a transferee of SBP Michigan, Inc. In Docket Number 26885-08, George E. & Joan M. Quist stipulated to a liability of $82,084.00 plus interest as a transferee of SBP Michigan, Inc. In Docket Number 26887-08, the Rita Gelman Revocable Trust, Rita Gelman, Trustee, stipulated to a liability of $140,716.00 plus interest as a transferee of SBP Michigan, Inc. In Docket Number 26888-08, Palladium Associates, Inc., stipulated to a liability of $35,179.00 plus interest as a transferee of SBP Michigan, Inc. These other transferees, therefore, stipulated to liabilities totaling $1,114,000 as transferees of SBP Michigan, Inc.

obligation was assumed by the buyer in a separate agreement. Fortrend represented that it had methods to minimize the tax liabilities from the asset sale. The buyer made an escrow payment into an account controlled by Fortrend and those funds were applied against a loan Fortrend received to buy the target company's stock. The target company reported no tax liability for the year of the sales because the gains from the asset sale were offset by a $17.2 million loss from currency arbitrage, which the IRS later disallowed.

The Tax Court found that the buyer was not a transferee because Illinois law has a strong presumption against finding third party beneficiaries (including the IRS) to agreements and because there was no contemplation of insolvency. The court found that the contemplation of insolvency required the target company to believe or to have reason to believe that it would incur debts, including tax liability, beyond its ability to pay. The court then found that the IRS did not meet its burden of proof on this issue because it did not present *any* evidence that the target company should have believed the gains from the asset sale would not be sheltered by the claimed losses.[4] The court's analysis suggests that the IRS could have prevailed had it presented evidence related to the promoter's intent or belief regarding the disallowed losses.

In this case, the buyer had knowledge of the intermediary's plan to avoid paying the taxes and negotiated a lower purchase price because of that knowledge, so it is somewhat surprising that the buyer was not found to be a transferee. On the other hand, Fortrend was the real bad actor, so perhaps that explains the court's ruling.

CHC Industries, Inc. v. Commissioner, T.C. Memo 2011-33

In *CHC Industries v. Commissioner*, T.C. Memo 2011-33, the IRS asserted transferee liability, not against the buyer or the seller, but the entity that introduced the buyer to MidCoast, the promoter. The allegedly fraudulent transfer was the payment of a finder's fee of approximately $275,800. CHC Industries introduced Fortrend International, LLC to MidCoast. Through MidCoast, Fortrend acquired the stock of the Town and Checker taxi company, which, in turn acquired a holding company, St. Augustine, holding only cash ($5,255,258) following the redemption of its interest in another venture. The cash from St. Augustine was distributed to various entities, including to CHC, leaving St. Augustine insolvent and unable to pay its tax liabilities. The parties stipulated that the finder's fee was fair consideration for CHC Industries' services, but because CHC was paid by St. Augustine, instead of MidCoast or Fortrend, the Tax Court determined that the payment to CHC was a fraudulent transfer.

Here, CHC had at least constructive knowledge of the tax-avoidance scheme because of the source of its payment and its close relationship with Fortrend. Because of this constructive knowledge, CHC differs from the taxpayer in our initial hypothetical who was acting in good faith.

Griffin v. Commissioner, T.C. Memo 2011-61

In *Griffin v. Commissioner*, T.C. Memo. 2011-61, petitioner Douglas Griffin was the sole shareholder of HydroTemp. For a legitimate business purpose, HydroTemp sold most of its assets to Pentair, its largest customer. The tax liability from the sale was approximately $2.4 million. HydroTemp loaned $5 million of the proceeds of the sale to Griffin because it was

[4] The court also rejected the IRS's arguments of actual fraud and trust fund liability for the same reasons.

unable to place the funds in an interest-bearing account for approximately 6 months because of the naming rights included in the sale to Pentair. Griffin placed the funds in an interest-bearing account.

Subsequent to the loan to Griffin, Griffin decided to sell his interests in HydroTemp to MidCoast. Griffin conducted extensive due diligence, including visiting the offices of MidCoast and examining their books, and ultimately completed sale only after the advice of counsel. After the sale to MidCoast, Griffin had no ownership interest in, or involvement with, HydroTemp. MidCoast committed to causing HydroTemp to pay its tax liability and agreed to indemnify HydroTemp for the $2.4 million of accrued taxes. MidCoast caused HydroTemp to extinguish Griffin's liability for the $5 million note as part of the purchase of Griffin's stock. Griffin reported the gain from the sale of his HydroTemp stock on his individual income tax return and paid the tax shown on the return.

Following Griffin's sale of his HydroTemp stock to MidCoast, HydroTemp's balance sheet reflected total assets of approximately $2.6 million, including a loan receivable from MidCoast[5] and the accrued tax liability of approximately $2.4 million. When HydroTemp filed its tax return, the return showed no tax liability because of a $7 million short-term capital loss from the sale of binary options that offset the gains from the Pentair asset sale. The IRS audited HydroTemp's return and disallowed the $7 million loss. The IRS was unable to collect the tax, penalty, and interest from HydroTemp, so it asserted transferee liability against Griffin.

The assertion of transferee liability by the IRS was the first indication Griffin received that there were problems with the sale of his HydroTemp stock to MidCoast. Griffin sued MidCoast in Florida District Court, obtaining a judgment that MidCoast was liable for HydroTemp's tax liability.

The IRS argued that the asset sale to Pentair and the subsequent stock sale to MidCoast, were part of an integrated plan known as an "intermediary transaction" entered into by Griffin solely to reduce his tax liability. The IRS argued that the court should collapse the two transactions using the substance over form doctrine.

The Tax Court emphasized that Griffin had no knowledge of MidCoast's plan to avoid paying HydroTemp's tax liability and did not, himself, demonstrate any intent to avoid payment of the tax. Accordingly, it rejected the IRS's arguments and found that both the asset sale and the stock sale had independent legal significance and were not part of a preconceived plan. The court also found that neither transaction was a fraudulent conveyance under Florida law, because HydroTemp was not insolvent after either sale and because reasonably equivalent value was transferred for the corporate assets.

Again, the alleged transferee's lack of knowledge regarding the scheme to avoid payment of the tax liabilities appears to undergird the court's decision. In fact, the IRS's pursuit of this case despite Griffin's lack of knowledge of the tax-avoidance scheme so was egregious that, following the Tax Court's decision, Griffin made a motion for litigation costs. The Tax Court granted the motion and awarded Griffin $183,019.42 in litigation costs.

The case has been appealed to the U.S. Court of Appeals for the Eleventh Circuit, but a briefing schedule has not yet been set.

---

[5] MidCoast removed HydroTemp's remaining cash through this loan.

***Starnes v. Commissioner*, T.C. Memo 2011-63**

Decided the same day as *Griffin*, *Starnes v. Commissioner*, T.C. Memo 2011-63, is similar in many ways to *Griffin.* The facts in *Starnes* are more typical of a "midco" or "intermediary transaction" case, but again include an alleged transferee that was acting in good faith. Tarcon had been a freight consolidation business, but deregulation of the trucking industry transformed the company into a warehouse-leasing business. The shareholders of Tarcon investigated selling Tarcon's real estate and were met with multiple offers for both the real estate and stock in Tarcon. One of the prospective buyers of Tarcon's stock was MidCoast. Tarcon first negotiated the sale of its real estate to ProLogis, leaving Tarcon with cash of approximately $3.1 million. The resulting tax for Tarcon would be approximately $880,000. Then Tarcon's shareholders decided to sell their stock to MidCoast. The purchase price of approximately $2.6 million for the Tarcon stock was negotiated based on a formula that applied a percentage of the tax liability. MidCoast committed to continuing Tarcon as a going concern and assured the shareholders that Tarcon's tax liabilities would be paid. After they sold their Tarcon stock to MidCoast, the shareholders had no further communications with MidCoast or knowledge with respect to Tarcon's funds. Each of the Tarcon shareholders reported the gain from the sale of the Tarcon stock on their individual income tax returns.

Tarcon's corporate tax return for the year of the sale to ProLogis showed no tax liability because of losses that offset the gain from the ProLogis sale. The IRS audited Tarcon's return and disallowed the claimed losses. The IRS was unable to collect from Tarcon, and asserted transferee liability against Tarcon's former shareholders.

The Tax Court found that there was no transferee liability for the selling shareholders. The IRS argued that the stock sale to MidCoast was in substance a distribution from the corporation in liquidation, but the court followed the money and determined that Tarcon received reasonably equivalent value in the asset sale. The IRS's counterargument that the subsequent transfer of the funds by Tarcon three weeks after the asset sale should be collapsed as a single integrated cash transfer under the Uniform Fraudulent Transfer Act which had the net effect of putting the money out of reach of creditors did not persuade the court. The Court found that the asset sale and the stock sale were not linked and that the Tarcon shareholders did not have actual or constructive knowledge of the entire scheme. The IRS did not meet its burden of proof by merely contending that the shareholders "could not have believed MidCoast planned to generate a profit with Tarcon in that manner" following the closing of the Tarcon stock sale. Thus the Court did not collapse the transactions, determined that Tarcon had received reasonably equivalent value, and found that there was no fraudulent conveyance. Accordingly, the selling shareholders of Tarcon were found not to be liable as transferees or under the trust-fund doctrine.

The IRS appealed the Tax Court's decision in *Starnes* to the U.S. Court of Appeals for the 4th Circuit. The case has been fully briefed at the Court of Appeals, but oral argument has not yet been scheduled.

<u>The IRS's Opening Appellate Brief</u>

The IRS makes two basic arguments in its opening brief.

Its first argument is that, as a matter of federal tax law, the selling shareholders are transferees of Tarcon and, therefore, the substance over form doctrine applies to recast the asset and stock sales as one transaction—a distribution from the corporation in liquidation. In substance, the IRS argues, Tarcon was a company holding cash, so selling the stock for cash was merely an exchange of cash for cash—with the shareholders receiving more cash than Tarcon was worth because they received more than the amount of Tarcon's cash less its tax liabilities—and the shareholders' lack of knowledge of the entire scheme is irrelevant. The IRS also argues that the shareholders had constructive knowledge because they were willfully blind to MidCoast's scheme: "A reasonable person would know that the only way MidCoast could profit from the transaction was by not paying the entire tax liability." (p. 32)

The IRS's second argument is that the shareholders are liable for Tarcon's tax liabilities under North Carolina's fraudulent conveyance laws and trust-fund doctrine. The IRS argues that Tarcon received nothing in exchange for transferring its cash to the shareholders, rendering it insolvent. Further, the IRS argues, the transfer is void because it was made with the intent to hinder, delay, or defraud the IRS. Finally, the IRS argues that as trustees of corporate property, the shareholders had to hold the liquidating distributions in trust for Tarcon's creditor, the IRS.

In essence, the IRS argues that the Tax Court should have first found the shareholders to be transferees under federal law and recast the transactions under the substance-over-form doctrine, then, using the recasted transactions, the Tax Court should have found transferee liability as a matter of North Carolina law.

<u>The Taxpayers' Answering Appellate Brief</u>

In Answer to the IRS's opening brief, the Taxpayers (the shareholders) argue that the Tax Court correctly analyzed the question of transferee liability under North Carolina law and that it would have been improper for the Tax Court to first recast the transactions under federal law before applying North Carolina law. Further, the shareholders argue that they received cash from MidCoast, not Tarcon, so they cannot be transferees under North Carolina law. In addition, the shareholders argue that they lacked constructive knowledge that Tarcon would not pay its tax liabilities—they were not put on inquiry notice that Tarcon would not pay its tax liabilities, but made reasonable inquiries nonetheless.

In sum, the shareholders argue that the Tax Court correctly analyzed the transactions under North Carolina law and found that they were not transferees and there was no fraudulent transfer.

<u>The IRS's Reply Appellate Brief</u>

In reply, the IRS reiterates its belief that there is a threshold question of whether the shareholders are transferees under federal law. The IRS then argues that once it is determined that they are transferees, the court should have applied the substance-over-form doctrine, to recast the transactions as a liquidation, which recasting the shareholders did not challenge in their answering brief. Then, the IRS argues, as transferees, the shareholders are liable under North Carolina law for Tarcon's unpaid tax liability. Finally, the IRS argues that the shareholders lack of knowledge regarding the entire scheme is irrelevant because they were on inquiry notice that Tarcon would not pay its tax liabilities and failed to make adequate inquiry.

Conclusion

Let's go back to the hypothetical at the outset of the article. As seen in recent cases, there are certainly scenarios in which a taxpayer can sell his stock for a price greater than the net of assets less tax liabilities without exposing himself to transferee liability. On the other hand, if a few facts change, the IRS can solidly assert transferee liability. Transferee liability cases are fact-driven. The recent cases discussed herein have favored the taxpayers thus far because of good facts, but taxpayers need to be careful who they deal with or they could end up footing someone else's tax bill. However, the IRS seems to be asserting transferee liability without regard to the facts of the case, so if you have a client that entered an intermediary-type transaction without knowledge of a plan to avoid a tax liability, you should be able to prevail in the Tax Court.

Bryant W.H. Smith, Esq.
Bryant@taxwarrior.com

Martin A. Schainbaum, P.L.C.
351 California Street, Suite 800
San Francisco, CA 94104-2406
www.taxwarrior.com
(415)-777-1040