Recent developments in transferee liability for intermediary transactions (02/16/2012)

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Recent developments in transferee liability for intermediary transactions

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The Tax Court has decided four meaningful cases within the last year which are cause for reexamining the necessary elements for establishing transferee liability in intermediary transactions. One such case has been appealed by the IRS and the main issue being contested is whether the Tax Court erred in failing to apply the substance over form doctrine to hold taxpayers liable as transferees.

The IRS has assessed liability against numerous taxpayers in recent years for engaging in transactions with a common fact pattern:

Shareholders seeking capital gains treatment cause C corporations to sell all of their operating assets and subsequently sell their stock to alleged tax shelter intermediaries when the corporation's only material asset is cash, and the stock is burdened by corporate tax liability from the asset sale. The intermediary pays a premium for the stock, allowing the shareholders to net more after-tax dollars than would have been realized in an asset sale followed by liquidating distributions. All parties supposedly benefit as the intermediary purports to have either legitimate means of offsetting the tax liability or business ventures to invest in with the corporation's cash. Problems for selling shareholders arise when the intermediary attempts to offset the corporate tax liability with illegitimate deductions (often pursuant to prearranged plans unbeknownst to the shareholders) and proceeds to drain the corporation's assets, leaving the company incapable of paying its taxes once the deductions are disallowed.

The IRS has classified these and similar transactions as "intermediary transactions" described in **Notice 2001-16, CB 730** and **Notice 2008-111, 2008-51 IRB 1299** .

> **Observation:** It is important to note that **Notice 2008-111** , which clarifies **Notice 2001-16** , supposedly does "not affect the legal determination of whether a person's treatment of the transaction is proper or whether such person is liable, at law or in equity, as a transferee of

property in respect of the unpaid tax obligation...." (**Notice 2008-111, 2008-51 IRB 1299**)

The IRS asserts liability against the selling shareholders pursuant to **Code Sec. 6901** , arguing that the shareholders are transferees of the corporation's assets and liable for the corporate tax because they either 1) received corporate assets via actual or constructive distributions that left the corporation unable to pay its taxes; or 2) engaged in fraudulent transactions whereby they received consideration and the corporation was rendered insolvent. The Supreme Court's seminal decision in *Commissioner v. Stern* clarified that **Code Sec. 6901** merely provides the procedure for the IRS to seek recovery of unpaid taxes from transferees of taxpayer assets (Comm'r v. Stern, **1 AFTR 2d 1899** , 357 U.S. 39, 45 (1958)). The Court ruled that the substantive law of the state where the transfers occurred (as opposed to federal law) determines the existence and extent of transferee liability.

Recent Decisions

In Enbridge Energy Co. v. U.S., **101 AFTR 2d 2008-1733** , 553 F. Supp. 2d 716 (S.D. Tex. 2008), aff'd 354 Fed. Appx. 15 (5th Cir. 2009), the IRS resoundingly prevailed on summary judgment in the first published decision addressing intermediary transactions. Interestingly, the legal basis for the court's decision was not **Code Sec. 6901** transferee liability. Rather, the court relied solely upon the federal substance over form doctrine; transferee liability was neither addressed nor considered. In *Enbridge,* the seller of a business desired to consummate the transaction as a stock sale for capital gains treatment, and the purchaser sought an asset sale to receive a stepped-up asset basis. To accommodate both parties, the purchaser's tax counsel introduced the idea of an intermediary who would acquire the target company's stock, immediately sell the target company's assets to the purchaser, and offset the asset sale gain with built-in-loss assets subsequently contributed to the intermediary by its parent company.

The IRS triumphed in *Enbridge* against the asset purchaser by successfully arguing the conduit theory of the substance over form doctrine whereby the intermediary's involvement in the transaction was disregarded and the purchaser was treated as having directly acquired the target company's stock. The substance over form doctrine applied because the intermediary's involvement served no purpose other than tax avoidance, the intermediary was a shell company created solely for this deal, and the purchaser indemnified the intermediary against almost all the risks associated with the transaction.

In Starnes v. Comm'r, **T.C. Memo 2011-63** , Griffin, **T.C. Memo 2011-61** , and Frank Sawyer Trust of May 1992 v. Comm'r, **T.C. Memo 2011-298** , three recent decisions involving both intermediary transactions and **Code Sec. 6901** , the Tax Court ruled the IRS failed to establish transferee liability where shareholders sold their stock shortly after corporate asset sales, and the stock purchasers subsequently rendered the corporations insolvent, leaving tax obligations outstanding. Unlike in *Enbridge* where the taxpayer was intimately involved in plotting with the intermediary to avoid tax obligations, the taxpayers in *Starnes, Griffin* and *Frank Sawyer Trust* lacked actual knowledge of the intermediary's post-closing intentions.

Constructive knowledge could not be imputed because the taxpayers conducted reasonable due

diligence into the intermediaries' business credentials and financial capabilities to satisfy the tax. The opinions in these three cases indicate that the intermediaries did superb jobs selling the taxpayers on the transactions' legitimacy by representing that the corporations would be continued as going-concerns and by contractually assuming full responsibility for the corporate tax liabilities. Because the IRS was unable to prove that the shareholders possessed any actual or constructive knowledge of the intermediaries' "entire scheme" to leave the corporations insolvent and not pay the tax, the intermediaries' post-closing actions and the stock sales could not be collapsed into single integrated transactions in which the shareholders would be treated as having received liquidating distributions directly from the corporations.

The Tax Court's opinion in Feldman v. Comm'r, **T.C. Memo 2011-297** , broke the trend of taxpayer victories in intermediary transaction cases and held the shareholders liable as transferees for the corporation's unpaid taxes. Arguably, the most significant factual variation in *Feldman* was shareholder awareness of the intermediary's intention to not pay the taxes (the case record contained several fault-finding facts). For instance, prior to undertaking the transaction, the shareholders and intermediary's representatives held a meeting where they discussed concerns about potential transferee liability. Additionally, and unlike in *Starnes, Griffin* and *Frank Sawyer Trust*, the intermediary expressly informed the shareholders it would be offsetting the corporation's taxable gain by acquiring bad debts from other companies, and the intermediary termed the transaction a "no-cost liquidation."

The distinguishing facts in *Feldman* were summarized in the *Frank Sawyer Trust* opinion as follows:

> . . . (1) It was "absolutely clear" that the taxpayer was aware the stock purchaser had no intention of ever paying the tax liabilities; (2) the taxpayer did not conduct thorough due diligence of the stock purchaser; and (3) the "loan" used to purchase the stock was a sham because it was made by a shareholder of the purchaser and was not evidenced by a promissory note....

Although the facts in *Feldman* were less taxpayer favorable, the transactions in *Feldman, Frank Sawyer Trust* and *Starnes* had significant similarities. In all three cases, the transactions were promoted by the same intermediary and stock sales were consummated when the corporations held exclusively cash with large tax liabilities. The record in *Starnes* indicates the shareholders did not conduct any extensive due diligence. And, the opinion in *Frank Sawyer Trust* tends to establish the taxpayer likely knew the taxes would not be paid as it was "assumed [the intermediary] must have had some method of offsetting the taxable gains within the corporations." The *Feldman* opinion did not meaningfully distinguish its facts from the other recent decisions and merely stated "Starnes and Frank Sawyer Trust were decided largely on the basis of insufficiency of and burden of proof" and "the facts as found did not establish that the taxpayers knew [the intermediary] intended not to pay the taxes." Going forward, perhaps the lesson to be gleaned from these decisions is that determining transferee liability is a facts and circumstances test under which too much knowledge of the intermediary's post-closing intent is grounds for imposing liability pursuant to **Code Sec. 6901** .

Applying Federal or State Law in Collapsing Transactions

The Tax Court has never meaningful analyzed whether in assessing transferee liability, the federal substance over form doctrine, its state law counterparts, or both may be used in collapsing and recasting transactions. Given the Supreme Court's holding in *Stern* that "the existence and extent of [transferee] liability should be determined by state law," failing to definitively address this issue presents an unresolved legal question. Since collapsing transactions under state law arguably involves more burdensome standards than recasting transactions for federal tax purposes, resolution of this issue is imperative.

The Tax Court in *Feldman* wholeheartedly applied the federal substance over form doctrine, ruling that the stock sale was a sham, and in actuality, the shareholders had received liquidating distributions from the corporation and thus were liable as transferees under Wisconsin law. In contrast, the Tax Court in *Starnes* applied state law principles in determining whether the stock sale could be collapsed with the intermediary's post-closing acts and did not analyze the federal substance over form doctrine even though the IRS argued for its application. In *Frank Sawyer Trust,* the Tax Court extensively analyzed the applicability of state law standards for collapsing transactions, ruled such were inapplicable, and then stated "(w)hile we affirm that the existence and extent of transferee liability should be determined by State law if substance over form and its related doctrines are applicable, we find that the form of the stock sales should be respected in this case." In *Griffin,* the court analyzed the federal substance over form doctrine in assessing collapsibility and ruled the form should be respected without considering whether state law provided an independent basis for recasting the transactions.

While the *Starnes* decision's failing to consider the federal substance over form doctrine may not amount to a quasi-circuit split, resolution of whether state or federal law applies in collapsing transactions is needed as many pending transferee liability cases exist around the country whose outcomes could very well depend upon whether state or federal law is controlling. This uncertainty will hopefully be resolved in the near future as the IRS has appealed the *Starnes* decision to the Fourth Circuit Court of Appeals, arguing that the Tax Court manifestly erred by failing to apply the federal substance over form doctrine and such resulted in the erroneous determination that the shareholders were not liable as transferees under state law.

What the Future Holds

Counsels for the IRS and the shareholders in *Starnes* have filed their appellate briefs with the Fourth Circuit Court of Appeals, and oral arguments have been scheduled for March 22, 2012. The issue being vehemently contested is the correct procedural sequence by which courts should determine transferee liability and whether state or federal law should initially be applied to determine the actualities and substance of transactions. The IRS contends the first step in determining whether transferee liability exists in intermediary transactions is to apply the federal substance over form doctrine to establish whether transactions should be recasted as asset sales followed by liquidating distributions. The second analytical step is for courts to apply state fraudulent transfer law to the recasted transaction (a corporate liquidation) and determine if the shareholders are liable as transferees.

Contrarily, the shareholders' counsel asserts that per the Supreme Court's decision in *Stern,* state law, including state law collapsible transaction principles, is the determinative and substantive law controlling whether transferee liability exists. Therefore, courts must first look to state law to determine if the shareholders engaged in fraudulent transactions, and if so, only then does it become necessary to determine if the shareholders are transferees under **Code Sec. 6901** .

> **Observation:** In *Stern,* the Supreme Court addressed the question of "whether the substantive liability enforced under § 311 (Code Section 6901's predecessor) is to be determined by state or federal law," and the Court ruled state law was controlling. The lower court in *Stern* had determined both that the taxpayer was "(1) not a 'transferee' under Sec. 311 and (2) in any case, applicable State law (Kentucky) prevented liability on the facts. The Supreme Court found it unnecessary to pass on the Sixth Circuit's first holding and rested its decision on a consideration of the second." (Comm'r v. Stern, **1 AFTR 2d 1899** , HN 1, 357 U.S. 39, (1958)) The shareholders' appellate brief in *Starnes* argues that by implication, *Stern* stands for the proposition that in ascertaining whether transferee liability exists, a court must first determine whether under state law the taxpayer made a fraudulent transfer and only after determining such in the affirmative does the determination of whether one is a "transferee" become necessary or applicable.

In the alternate, the shareholders' counsel argues that meeting the definition of a "transferee" under **Code Sec. 6901** , which includes "distributees" per **Code Sec. 6901(c)** and "the shareholder of a dissolved corporation" per **Reg. § 301.6901-1(b)** , simply gives the IRS the ability to pursue state law collection remedies. The determination of whether a shareholder is subject to transferee liability, however, is wholly dependent on state law and necessitates the finding of fraudulent transfers.

In *Starnes,* the Tax Court applying state law concluded a fraudulent transfer did not exist because the corporation received "reasonably equivalent value" from the transaction in the form of over $2 million dollars that the intermediary transferred to a corporate account. To prevail on appeal, the IRS needs to have the federal substance over form doctrine applied prior to the state law analysis, because if successful, the intermediary's participation and its over $2 million of funding would likely be disregarded. The fraudulent transfer determination would then involve analyzing a transaction where the shareholders simply caused the corporation to sell its assets and make liquidating distributions without leaving reserves for tax liability.

Under such circumstances, the finding of fraud would be a foregone conclusion as the shareholders would be deemed to have undertaken a transaction for their financial benefit to the known detriment of the IRS, and the corporation would not have received any value from the transaction, much less reasonably equivalent value. However, this hypothetical transaction is not what actually transpired under state law as there was a stock sale and immediately after closing the corporation possessed the resources to satisfy the tax obligations. Insolvency only resulted due to the stock purchaser's post-closing act of stripping the corporate assets.

The shareholders' counsel has a strong argument that using federal law to recast transactions before applying state law contravenes the Supreme Court's ruling in *Stern* and erroneously imputes actual and constructive fraud when it does not otherwise exist. The IRS's own appellate brief in *Starnes* directly cites support for the legal principle that the IRS is on equal footing with private creditors in determining transferee liability: "(t)he Government's substantive rights against the transferee are **precisely** those which other defrauded creditors would have under the law of the state in which the transfers were made." (Appellant's Opening Brief at 33, Starnes v. Comm'r, **T.C. Memo. 2011-63** (Nos. 11-1636 (L), 11-1706, 11-712, 11-714); Johnson Ownbey Co. v. Commissioner **47 AFTR 2d 81-1243** , 645 F.3d 540, 543 (6th Cir. 1981), emphasis added)

Private creditors are not afforded the luxury of using the legal voodoo that is the substance over form doctrine whereby unpaid liabilities could be collected from alleged debtors based upon fictitious happenings. Rather, creditors are required to prove debtor fraud based upon what actually occurred. Accordingly, in pursuing transferee liability, the IRS should be limited to utilizing remedies generally available to creditors, without any extraordinary powers to prove fraud when there is not an independent basis under state law for establishing such. The Fourth Circuit's decision in *Starnes* and its ruling on whether state or federal law applies in collapsing transactions will likely have far reaching implications in determining whether taxpayers who allegedly engaged in intermediary transactions will be subject to transferee liability.

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