

TRANSFeree LIABILITY

Thompson & Knight



Impact

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TRANSFeree LIABILITY

- **The basics of transferee liability**
- **Recent developments – cases involving midco transactions**
- **Key issues/questions**



THE BASICS OF TRANSFEREE LIABILITY

SOURCE OF LAW

- **Internal Revenue Code supplies procedural rules, §§ 6901 – 6905**
 - **Dates back to Section 280 of the Revenue Act of 1926**
- **Substantive liability is generally based on state law**

IRC § 6901(a)

- **The “liability, at law or in equity, of a transferee of property” for income taxes, estate taxes, and gift taxes shall “be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as in the case of the taxes with respect to which the liabilities were incurred.”**

IRC § 6901(a), cont'd

- **N/A to employment taxes, excise taxes, etc.**
- **Does not itself create or define the substantive transferee liability**
 - **“At law” generally refers to liabilities established by contract**
 - **“At equity” generally refers to liability under state fraudulent transfer laws, or the “trust fund” doctrine**

STATUTE OF LIMITATIONS

- **Normal limitations period, § 6901(c):**
 - For an initial transferee, one year beyond the limitations period for assessment against transferor
 - For subsequent transferees, one year beyond the limitations period for assessment against preceding transferee
 - Cumulative extension limited to 3 years
- **Can extend by agreement, § 6901(d)**
- **Mailing of a notice of liability suspends, § 6901(f)**

BURDEN OF PROOF

- **In Tax Court, § 6902(a)**
 - **Transferor's liability for tax: Petitioner's burden to disprove**
 - **Whether the petitioner is a "transferee" under appropriate legal standard: Respondent's burden to prove**
- **In refund suits, some courts have held that the plaintiff must prove the absence of transferee liability**
 - ***Madonia*, 57 A.F.T.R.2d 570 (W.D.N.Y. 1985); *Van Benschoten*, 47 A.F.T.R.2d 5707 (S.D. Cal. 1959)**

EXHAUSTION OF REMEDIES

- The Tax Court requires that the IRS first exhaust all reasonable remedies against the transferor before proceeding against the transferee - *Gumm*, 93 T.C. 475, 480 (1989); *Kuckenber*, 35 T.C. 473, 480 (1960); *Miller*, 42 T.C. 593, 599 (1964)
- In *Gumm*, the 9th Cir. suggested that the IRS can proceed administratively against the transferee rather than undergo protracted litigation against the transferor

ACCESS TO INFORMATION

- **IRS won't share information about the transferor's tax liability until it issues the transferee notice of deficiency – IRC § 6103**
- **After transferee files a petition in Tax Court, he can request the court to order production of relevant records of the transferor – IRC § 6902(b)**

SUBSTANTIVE LIABILITY

- **Model act, Uniform Fraudulent Transfer Act (“UFTA”), established in 1984**
- **Texas version is the Texas Uniform Fraudulent Transfer Act (“TUFTA”), Tex. Bus. & Com. Code §§ 24.001-24.012**

TUFTA KEY CONCEPTS

- **“Reasonably equivalent value” (REV), defined as “within the range of values for which the transferor would have sold the assets in an arm’s length transaction” TUFTA § 24.004(d)**
- **Insolvency – when the sum of the debtor’s debts is greater than all of its assets at a fair valuation, § 24.003(a)**
 - **Presumed insolvent if it does not generally pay its debts as they become due, § 24.003(b)**

TUFTA KEY CONCEPTS, cont'd

- **“Claim” means “a right to payment or property, whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured,” § 24.002(3)**
- **“Debt” means “a liability on a claim,” § 24.002(5)**

FOUR TYPES OF “FRAUDULENT TRANSFER”

- **Applicable to existing claims, or future claims arising within a reasonable time after the transfer**
 - **Actual fraud, TUFTA § 24.005(a)(1)**
 - **Risk of insolvency, § 24.005(a)(2)**
- **Applicable to existing claims only**
 - **Constructive fraud, or actual insolvency, § 24.006(a)**
 - **Insider fraud, § 24.006(b)**

ACTUAL FRAUD

- **Transfer “with actual intent to hinder, delay, or defraud any creditor”**
- **Badges of fraud, TUFTA § 24.005(b)**
 - **Transfer to an insider**
 - **Debtor retained possession or control**
 - **Transfer was concealed**
 - **Transfer after debtor threatened with suit**
 - **Transfer of substantially all of debtor’s assets**

ACTUAL FRAUD, cont'd

- **Badges of fraud, continued**
 - Debtor absconds
 - Debtor removed or concealed assets
 - Did not receive REV for property transferred
 - Debtor was insolvent or became insolvent shortly thereafter
 - Transfer shortly before or after substantial debt was incurred
 - Transfer of essential assets of the business to a lienor who transferred them to an insider

RISK OF INSOLVENCY

- Debtor didn't receive REV for the transfer, and
- Debtor either
 - Was engaged in a business or transaction for which remaining assets were unreasonably small, or
 - Intended to incur (or transferee believed or reasonably should have believed the debtor would incur) debts beyond its ability to pay

CONSTRUCTIVE FRAUD

- Debtor didn't receive REV for the property
- Debtor was already insolvent or became insolvent as a result of the transfer

INSIDER FRAUD

- **Transfers to insiders, e.g., director, officer, or “person in control” of a corporation, if**
 - **Transfer was made to pay an existing debt to the insider,**
 - **Debtor was insolvent at the time, and**
 - **Insider had reasonable cause to know of the insolvency**
- **In effect, this prevents insiders from putting their claims before other creditors when the company is insolvent**

DEFENSES

- **Transferee is not liable for the debtor's debts if he took the property in good faith and paid REV; TUFTA § 24.009(a)**
- **Insider fraud does not apply if, § 24.009(b)**
 - **Transfer was made in the ordinary course of business between the debtor and the insider,**
 - **Debtor obtained "new value" from the insider after transfer, or**
 - **Transfer was part of a good-faith effort to rehabilitate the debtor and the transfer secured additional value**

IRS REMEDIES

- **Collect directly by filing suit to recover the transferred property, TUFTA § 24.008 or Federal Debt Collection Procedures Act 28 U.S.C. § 3301, *et seq.***
- **If transfer was after assessment, levy/seize the property, as the federal tax lien attaches, IRC § 6323(a), (h)(6)**
- **Assert transferee liability administratively under IRC §§ 6901 – 6905**
 - **Can reach any property owned by the transferee**



RECENT DEVELOPMENTS

“Bad facts make bad law”?

RECENT DEVELOPMENTS

- **Several high-profile cases involving midco transactions**
- **The taxpayers have won the majority of the cases, but not all**
- **In the process, there have been some clarifications of the law – both positive and negative for taxpayers**
- **Still developing, as several cases are currently on appeal**

BAD FACTS

- **Abusive “midco transaction” tax shelters made their first appearance in the late 1990s and became widely known around 2001**
- **IRS first identified these as a “listed transaction” in 2001, and shortly thereafter identified transferee liability as a way to combat them**
- **An internal directive in 2006 focused IRS efforts on collecting from parties other than the midco, by transferee liability**

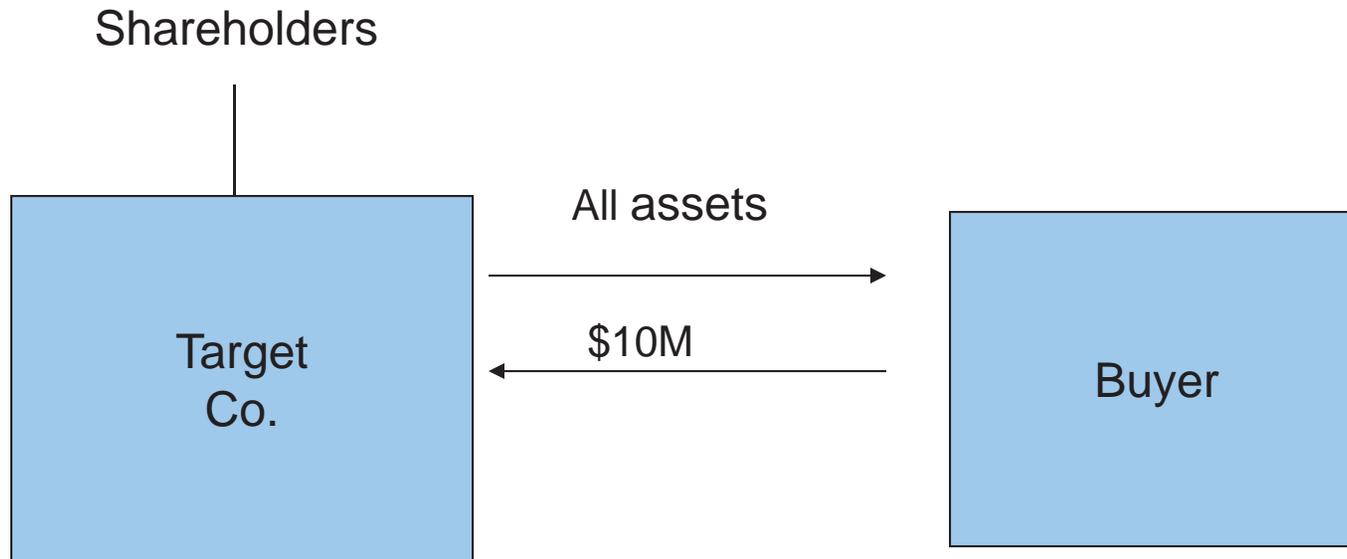
LISTED TRANSACTION

- **Current definition, Notice 2008-111**
 - **Target corporation owns (directly or indirectly) assets with built-in gain and insufficient tax benefits to completely eliminate the gain**
 - **At least 80%, vote or value, of the stock is disposed of within a 12-month period**
 - **At least 65% of the target corporations assets are sold within a year before or year after the stock sale**
 - **At least half of the “built-in tax” of the target “is purportedly offset or avoided or not paid”**

AS A PRACTICAL MATTER

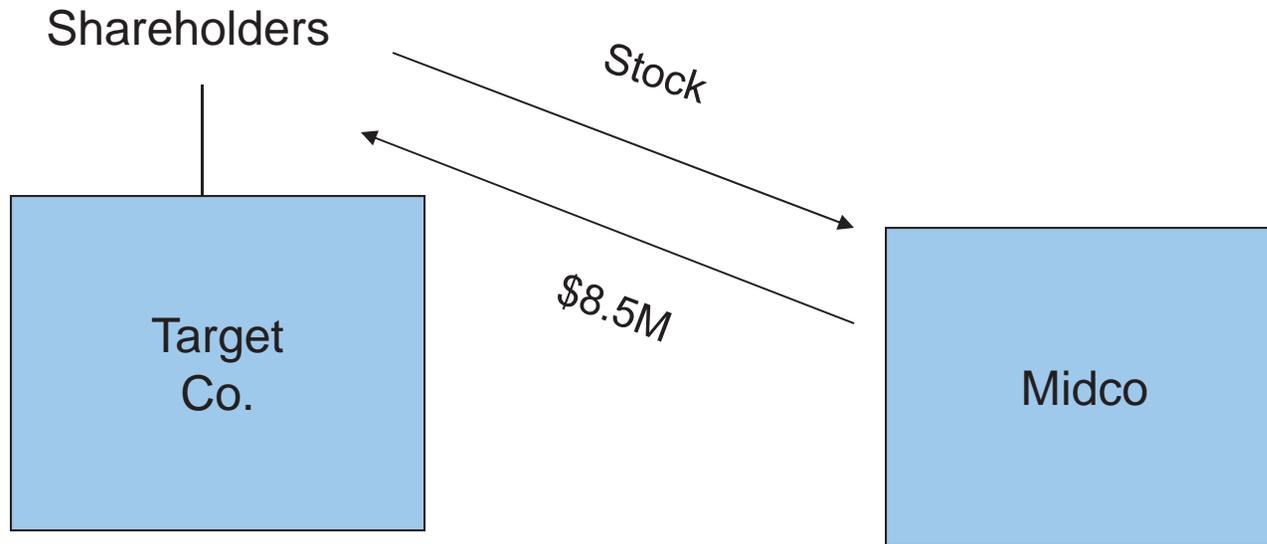
- **The IRS doesn't pursue transferee liability in all cases meeting the standards of Notice 2008-111, and may pursue even if the case doesn't meet those standards**
- **Most often, it is asserted for midco transactions involving**
 - **Promoted transactions, with the sale of all stock and all assets**
 - **Tax avoidance by improper means**
- **Typical fact pattern for the recent cases:**

MIDCO TRANSACTION STEP 1



Net assets -- basis of \$2M, FMV of \$10M

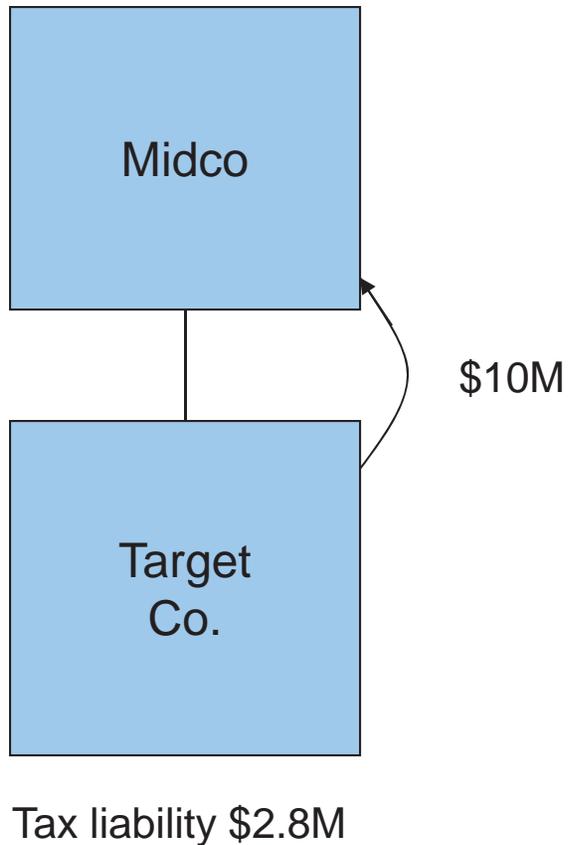
MIDCO TRANSACTION STEP 2



Cash \$10M
Tax liability \$2.8M
Net worth \$7.2M

Sales price usually defined
as cash balance less certain
percentage of the tax liability
– here, 55%

MIDCO TRANSACTION STEP 3



The transaction only makes sense if the \$2.8M tax liability can be eliminated

There may be legitimate ways in which the tax liability could be reduced, but the promoter typically uses Son-of-BOSS, distressed asset/debt, or other tax shelters

MIDCO TRANSACTION FINAL RESULTS

	<u>Before</u>	<u>After</u>
Midco		
Share of tax savings		\$ 1.5M
Shareholders		
Net worth of Target	\$ 7.2M	7.2M
Share of tax savings		1.3M
IRS	2.8M	0.0M
Total	\$10.0M	\$10.0M

WHY TRANSFEREE LIABILITY?

- **The midco/promoter has made itself judgment proof**
- **Only source of payment for the tax liability is the selling shareholders or the buyer**
- **But transferee liability only applies if there is a transfer of money or property from the target company, to the shareholders or the buyer, for less than REV**

GOVERNMENT WINS

- ***CHC Industries, Inc.*, T.C. Memo 2011-33 (2/2/11)**
- ***Feldman*, T.C. Memo 2011-297 (12/27/11)**

TAXPAYER WINS

- ***LR Development Co.*, T.C. Memo 2010-203 (9/16/10)**
- ***Griffin*, T.C. Memo 2011-61 (3/15/11)**
- ***Frank Sawyer Trust*, T.C. Memo 2011-298 (12/27/11)**
- ***Slone*, T.C. Memo 2012-57 (3/1/12)**
- ***Salus Mundi Foundation*, T.C. Memo 2012-61 (3/6/12)**
- ***Starnes*, T.C. Memo 2011-63 (3/15/11), *aff'd*, 680 F.3d 417 (4th Cir. 5/31/12)**

ON APPEAL

- ***Frank Sawyer Trust*, 1st Cir. No. 12-1586, docketed 5/11/12, argued 11/8/12**
- ***Slone*, 9th Cir. No. 12-72464, docketed 8/3/12, briefing complete**
- ***Salus Mundi Foundation*, 9th Cir. No. 12-72527, docketed 8/10/12, final brief due 3/25/13**
- ***Feldman*, 7th Cir. No. 12-3144, docketed 9/19/12, briefing started**



KEY ISSUES/QUESTIONS

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- **Did the target company transfer property to the purported transferee?**
- **Is the tax liability an existing claim at the time of the transfer, or is it a future claim?**
- **Whose knowledge or intent is relevant?**

WAS THERE A TRANSFER?

- **Buyer of assets – usually the transfer is for REV, so no transferee liability**
 - **But watch the details! *LR Development* and also *CHC Industries***
- **Selling shareholders – technically receive payment from the midco, not the corporation; no transfer unless the IRS is allowed to recast the transaction**

RECASTING THE TRANSACTION

- **Using federal tax law, substance-over-form or economic substance doctrines – government’s preference**
- **State law usually allows recasting the transaction if the shareholders had actual or constructive knowledge that the midco would likely not pay its legitimate debts**

SUBSTANCE OVER FORM

- **Some older transferee liability cases held that the sale of stock in a corporation holding only cash was, in substance, a liquidation**
 - **“when a corporation owns just cash . . . The corporation has already been effectively liquidated” *Owens*, 568 F.2d 1233 (6th Cir. 1977)**
- **Most (but not all) of the new transferee liability cases have declined to recast the transaction**

SUBSTANCE OVER FORM, cont'd

- ***Starnes*** – substance over form doctrine is not applicable, because *Comm'r v. Stern*, 357 U.S. 39 (1958) said that determination of transferee liability is based solely on state law
- ***Frank Sawyer Trust* and *Slone*** – government can recast the transaction under substance over form, but only if there is a “preconceived plan to avoid taxation”; Respondent didn’t demonstrate such
- ***Starnes* (dissent) and *Feldman*** – recast the transaction; lacked business purpose and economic substance, and in substance was a liquidation

SUBSTANCE OVER FORM, cont'd

- This is likely to be a key issue in the appeals of *Frank Sawyer Trust*, *Feldman*, *Salus Mundi Foundation*, and *Slone*
- Chances of the government prevailing?

WHY THIS IS IMPORTANT

- **Government believes substance over form is a more objective determination and would not require the same degree of proof of the transferees' knowledge and intent**
- **For example, most courts have been reluctant to recast the transaction under state law, based on “actual or constructive knowledge of the scheme” standards**

CONSTRUCTIVE KNOWLEDGE

- ***Frank Sawyer Trust*** – “Further inquiry was likely warranted considering Fortrend agreed to pay the trust more than the net book value of the company when the only assets were cash and the only liabilities were income tax liabilities”; the extent of inquiry was not clear; but Respondent didn’t meet the burden of proof
- ***Salus Mundi Foundation*** – no inquiry made, but none required under the circumstances

CONSTRUCTIVE KNOWLEDGE, cont'd

- ***Starnes*** – the Tax Court reasonably found “that no reasonably diligent inquiry . . . would have disclosed Midcoast’s intent to fail to pay its taxes”; “even though [they] might have conducted further inquiry, such a hypothetical effort would not likely have revealed” the plan
- These conclusions frequently rely on the hypothetical possibility that the taxes could have been avoided legitimately

LEGITIMATE TAX AVOIDANCE

- ***Frank Sawyer Trust*** – “there are legitimate tax planning strategies to defer or avoid paying taxes”
- ***Salus Mundi Foundation*** – “There are legitimate transactions that [the promoter] could have contemplated to offset or defer [the target’s] built-in gains, and respondent has failed to show why” the shareholders should have known the promoter “planning on using a fraudulent tax strategy”

LEGITIMATE TAX AVOIDANCE, cont'd

- Legitimate tax avoidance in these transactions may not be as easy as the courts suggest
 - *Feldman* – the “asset recovery” story is “preposterous”
- But Respondent has the burden of proof, and it's difficult to prove a negative

CONSEQUENCES OF APPEALS RESOLUTION?

- A reaffirmation of *Stern* and *Starnes*, that federal law is not applicable to the determination of transferee liability, would be helpful to selling shareholders in midco transactions, by reducing the likelihood of being found to be “transferees”
- But it could have unanticipated effects in other areas; we could not rely on federal tax law with respect to other aspects of transferee liability

KEY ISSUES/QUESTIONS

- Did the target company transfer property to the purported transferee?
- Is the tax liability an existing claim at the time of the transfer, or is it a future claim?
- Whose knowledge or intent is relevant?

EXISTING CLAIM OR FUTURE CLAIM?

- **If the tax liability is a future claim, only the “actual fraud” and “risk of insolvency” categories are available; both involve subjective determinations of the transferee’s knowledge or intent, difficult to prove**
- **If the tax liability is an existing claim, the “constructive fraud” category is available, which requires showing only a transfer for less than REV and resulting insolvency, both objective determinations**
- **The law is unclear, but evolving in an unfavorable direction**

HISTORICALLY

- **Most transferee liability cases involved transfers after the tax return was filed but before an audit and assessment**
 - **“The United States is considered a creditor ‘from the date when the obligation to pay income taxes accrues,’ essentially on April 15 of the year following the tax year in question” – *United States v. Green*, 201 F.3d 251 (3d Cir. 2000)**
 - **Government was a creditor on 4/15/78 for income tax liability for the 1977 tax year – *Roland v. United States*, 838 F.2d 1400 (5th Cir. 1988)**

MIDCO CASES ARE CHANGING THAT

- ***LR Development***
 - Tax liability is a contingent claim as of the date the assets are sold, for purposes of determining insolvency
 - But assumed *arguendo*, in discussion of the badges of fraud, that the tax liability did not become a debt until March 15 of the year following the tax year
 - And FN 50, discussing risk of insolvency category, says “tax is considered as due and owing on the date on which the tax return in which the tax must be reported is required to be filed”

MIDCO CASES ARE CHANGING THAT, cont'd

- ***Feldman***
 - “Income tax liabilities arising from the sale of corporate assets are ‘claims’ existing at the time of the sale.”
- ***Starnes***
 - Government argued constructive fraud (applicable only to existing claims), but the court did not explicitly address the question of whether the income tax liability was an existing claim

EXISTING CLAIMS?

- **The government is beginning to argue, and courts are accepting, that the tax liability is an existing claim at the date of the transfer, before the end of the tax year**
- **This might be the right answer for midco transactions where the corporation had reduced its assets to cash, but the courts have not explained their reasoning or expressly limited their conclusion to that scenario**
- **Might this spill over into other transferee liability cases?**

KEY ISSUES/QUESTIONS

- **Did the target company transfer property to the purported transferee?**
- **Is the tax liability an existing claim at the time of the transfer, or is it a future claim?**
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KNOWLEDGE AND INTENT

- The transferee's actual or constructive knowledge is relevant to recasting the transaction under state law
- The debtor's knowledge or intent is relevant to the determination of transferee liability for the actual fraud or risk of insolvency categories
- Even if the transferee has no knowledge of actual fraud or risk of insolvency, he can be held liable based on the debtor's intent

KNOWLEDGE AND INTENT, cont'd

- In the midco transaction context, the debtor is a corporation; whose knowledge and intent are relevant?
 - Owner immediately before the transaction (the selling shareholders)?
 - Owner immediately after the transactions (the midco/promoter)?
- *LR Development* looked at the midco promoter!

CONCLUSION

- **The IRS considers the midco transactions abusive and will continue to pursue them aggressively**
- **The law of transferee liability is evolving as a result of these cases, in ways that may be unfavorable to taxpayers**
- **And those changes may apply to all transferee liability cases, rather than just midco transactions**



QUESTIONS?

[Updates on following page]

UPDATE TO TRANSFEREE LIABILITY PRESENTATION

After this presentation on March 4, 2013, to the Dallas Bar Association, there have been two interesting developments concerning transferee liability.

First, on March 29th, the First Circuit issued its decision in *Frank Sawyer Trust of May 1992 v. Commissioner*. A brief discussion of the implications of the case, along with a link to the court's opinion, is available at <http://taxlawyer.typepad.com/blog/2013/04/new-development-in-transferee-liability.html>

Second, on April 10th, the administration issued its budget for fiscal year 2014. The budget included a proposal to combat the midco tax shelters by imposing direct liability for the selling stockholders. This proposal implicitly recognizes that a different approach might be necessary because the government continues to lose these transferee liability cases. A brief discussion of the proposal, along with a link to the Treasury Department's "Greenbook," is available at <http://taxlawyer.typepad.com/blog/2013/04/a-proposed-legislative-fix-to-the-midco-tax-shelter.html>