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The New Application of Transferee Liability

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THE NEW APPLICATION OF TRANSFEREE LIABILITY

The IRS has a wide variety of tools to collect taxes due, including liens, levies, and the seizure and sale of tangible property. Yet, as with other creditors, the IRS's collection tools are useless if the debtor has insufficient assets. This means, as with other creditors, that the IRS must also be concerned about debtors/taxpayers who move their property beyond the creditors' reach by transferring it to a third party. One part of the solution, for the IRS as well as other creditors, is to collect from the person who received property from the debtor/taxpayer.

The IRS has used transferee liability for decades to recover taxes that cannot be collected from the actual taxpayer. In recent years, transferee liability has become the weapon of choice in response to a particular transaction: the intermediary, or "midco," transaction. This article starts with an overview of transferee liability, both administrative procedures in the Internal Revenue Code (the "Code") and substantive law creating such liability; continues with the history of the IRS response to the intermediary transaction tax shelters; and then reviews recent case law.

I. TRANSFEREE LIABILITY FOR TAXES

Congress gave the IRS authority to pursue collection from transferees more than 80 years ago.[1] Section 6901(a) of the Code provides that the "liability, *at law or in equity*, of a transferee of property" (emphasis added) for:

- The taxpayer, with respect to income taxes
- The decedent, with respect to estate taxes
- The donor, with respect to 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." There is no Code provision for transferee liability for other types of tax, such as employment taxes and excise taxes. Sections 6901 to 6905 primarily deal with procedural aspects of transferee liability.

For example, the limitations period for assessment of transferee liability extends: (a) for an initial transferee, one year beyond the limitations period for assessment against the transferor; and (b) for subsequent transferees, one year beyond the limitations period for assessment against the preceding transferee; but (c) the cumulative extension for a chain of transferees does not extend beyond three years after the limitations period for assessment against the initial transferor.[2] There are also the usual provisions for

[1] Transferee liability for taxes dates back to section 280 of the Revenue Act of 1926, the predecessor of Section 6901.

[2] I.R.C. § 6901(c).

extending the limitations period by agreement or suspending the limitations period by the mailing of a notice of deficiency.[3] After the IRS issues a notice of transferee liability and the transferee files a petition in the Tax court, the transferee can request the court to order production of relevant records of the transferor.[4] The burden of proof in Tax Court is divided: the IRS has the burden of proof on the issue of whether the petitioner was a "transferee" under the appropriate legal standards but not on the issue of the transferor's liability for tax.[5] Some courts have inferred a requirement that the IRS have exhausted all reasonable remedies against the transferor before proceeding against the transferee, unless such attempts would be futile.[6] Accordingly, the IRS makes a reasonable search for additional assets to satisfy the debts from the original taxpayer before asserting transferee liability.[7]

The Code establishes procedural requirements for collecting a tax liability from a transferee, but it does not itself create or define that substantive transferee liability. The only reference in the Code to the legal standards for transferee liability is the phrase italicized in the provision cited above: "at law or in equity." The existence and extent of transferee liability are determined by state or federal law.[8] Liability "at law" generally refers to liabilities established by contract; liability "in equity" generally refers to liability under federal or state fraudulent transfer laws.[9] The government also sometimes asserts liability in equity based on the so-called "trust fund doctrine."

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[3] I.R.C. § 6901(d), (f).

[4] I.R.C. § 6902(b). Returns and "return information" are confidential and the IRS cannot release them to other parties, with carefully limited exceptions. I.R.C. § 6103. Thus, during a transferee liability audit, the potential transferee often does not have information concerning the tax liability for which it may be liable.

[5] I.R.C. § 6902(a). Thus, the petitioner could defend against transferee liability by disputing the underlying transferor's liability but would have the burden of proof. Although the IRS has the burden of proof with respect to transferee liability in Tax Court, some courts have held that in refund suits the plaintiff must prove the absence of transferee liability. *Madonia v. United States*, 57 A.F.T.R.2d (RIA) 570 (W.D.N.Y. 1985); *Van Benschoten v. United States*, 4 A.F.T.R.2d (RIA) 5707 (S.D. Cal. 1959).

[6] *See, e.g.*, *Gumm v. Comm'r*, 93 T.C. 475, 480 (1989) (requiring "that all reasonable efforts to collect from the transferor were made and that further collection efforts would be futile"), *aff'd*, 1991 U.S. App. LEXIS 11372 (9th Cir. 1991) (limiting the requirement; "The Commissioner may legitimately use the summary procedure provided by section 6901 to collect taxes from the transferee rather than involving the government in protracted litigation as a condition precedent to recovering the federal tax deficiency."); *Kuckenberg v. Comm'r*, 35 T.C. 473, 482 (1960) ("Petitioners, in their brief, argue that a transferee liability in equity is secondary and that because of that fact the Commissioner must first proceed against the corporation. That is undoubtedly true as a principle of equity. . . . Equity does not require a futile thing and if a corporation has been dissolved and left without any assets equity does not require a proceeding against the corporation before the creditor can proceed against the transferee."), *nonacq.*, 1961-2 C.B. 6 (1961), *aff'd*, 309 F.2d 202 (9th Cir. 1962); *Miller v. Comm'r*, 42 T.C. 593, 599 (1964) ("Respondent must establish either that he attempted to collect the tax liabilities due from the transferor, or that such attempts would have been meaningless and futile.").

[7] I.R.M. 5.17.14.4.3.3.

[8] *Comm'r v. Stern*, 357 U.S. 39, 42, 45 (1958) (discussing the predecessor of Section 6901).

[9] Bittker, McMahon & Zelenak, *Federal Income Taxation of Individuals*, ¶ 48.07.

Fraudulent transfer laws are described in Section II below. The trust fund doctrine arises from principles of equity and has been described differently based on the circumstances. The doctrine can be applied against purchasers. For example, if the purchaser pays consideration to someone other than the seller for the purpose of avoiding the seller's debts, a court may hold the purchaser liable for those debts.[10] The trust fund doctrine can also be applied against sellers. For example, stockholders who receive liquidating distributions from a corporation that dissolves without satisfying its liabilities may be held liable as transferees.[11]

II. FRAUDULENT TRANSFER LAWS

Most states have enacted a version of the Uniform Fraudulent Transfer Act ("UFTA").[12] Federal fraudulent conveyance law is set forth in the Federal Debt Collection Procedures Act ("FDCPA").[13] However, the FDCPA and the UFTA are nearly identical. Although practitioners should always compare the FDCPA with the relevant state law, normally there is no significant distinction. The Texas version of the UFTA is the Texas Uniform Fraudulent Transfer Act ("TUFTA").[14]

The government can recover from transferees not only the underlying tax but also penalties and interest.[15] TUFTA provides, however, that the amount a creditor can recover from a transferee is the lessor of the value of the asset transferred or the amount necessary to satisfy the creditor's claim.[16]

TUFTA sets forth several different categories of situations in which a creditor can recover from a transferee. Some of these categories are far from what most people think of if you mention "fraudulent transfer." The transferee can be found liable for existing or *present* claims by creditors under all of these provisions. Under some of the provisions, the transferee can even be found liable for *future* claims by creditors, if they arise within a reasonable period of time after the transfer. This difference is particularly important with respect to tax liabilities, as discussed further below.

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10 *E.g.*, *LR Development Co. v. Comm'r*, 100 T.C.M. (CCH) 231 (2010).

11 *E.g.*, *Hunter v. Fort Worth Capital Corp.*, 620 S.W.2d 547, 549 (Tex. 1981). The trust fund doctrine has been codified in section 7.12 of the Texas Business Corporation Act.

12 The National Conference of Commissioners on Uniform State Laws, also known as the Uniform Law Commission ("ULC"), proposed the Uniform Fraudulent Conveyance Act ("UFCA") in 1918; it was adopted by 26 states. The ULC revised and renamed (as the UFTA) this model act in 1984. It has been adopted by over 40 states as well as the District of Columbia. The UFTA, with prefatory note and comments, is available at http://www.law.upenn.edu/bll/archives/ulc/fnact99/1980s/ufta84.pdf.

13 28 U.S.C. § 3301, *et seq.*

14 Tex. Bus. & Com. Code §§ 24.001 – 24.012.

15 *Coca-Cola Bottling Co. v. Comm'r*, 22 B.T.A. 686 (1931).

16 *Id*. § 24.008(b).

A. <u>Actual fraud – present or future claims by creditors</u>

Actual fraud occurs when the debtor transfers property "with actual intent to hinder, delay, or defraud any creditor."[17] Because this category depends on the debtor's intent, which rarely can be determined directly, TUFTA specifies nonexclusive factors or "badges of fraud" that may indicate the debtor's intent. These factors include whether: (1) the transfer was to an insider; (2) the debtor retained possession or control of the property transferred after the transfer; (3) the transfer was concealed; (4) before the transfer was made, the debtor had been sued or threatened with suit; (5) the transfer was of substantially all the debtor's assets; (6) the debtor absconded; (7) the debtor removed or concealed assets; (8) the value of the consideration received by the debtor was reasonably equivalent to the value of the asset transferred; (9) the debtor was insolvent or became insolvent shortly after the transfer was made or the obligation was incurred; (10) the transfer occurred shortly before or shortly after a substantial debt was incurred; and (11) the debtor transferred the essential assets of the business to a lienor who transferred the asset to an insider of the debtor.[18]

This category is not limited to creditors who already have a claim against the debtor when the transfer is made; it applies whether the liability to the creditor arises before or within a reasonable time after the property is transferred. This is also the only category of fraudulent transfers that requires actual fraudulent intent. It's probably the only scenario that many taxpayers would think of when they hear the term "fraudulent transfer."

The determination of whether a transfer is actually fraudulent depends on the debtor's intent and actions, not those of the transferee. A transferee who has no intent to defraud the creditor, or even knowledge that the debtor intends to defraud the creditor, may still be liable. However, there is a general defense described below that may protect the transferee from liability.

B. <u>Constructive fraud – present claims by creditors</u>

The transferee may be liable if: (a) the debtor transfers property *after* the creditor's claim arose; (b) the debtor didn't receive reasonably equivalent value for the property transferred; and (c) the debtor was already insolvent or became insolvent as a result of the transfer.[19]

This category applies two important concepts for fraudulent transfer law. First, present constructive fraud does not apply if the debtor received "reasonably equivalent value," defined as "within the range of values for which the transferor would have sold

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17 *Id.* § 24.005(a)(1). TUFTA generally applies both to transfers of property by and obligations incurred by the debtor. For simplicity, this discussion is limited to transfers of property.

18 *Id.* § 24.005(b).

19 *Id.* § 24.006(a).

the assets in an arm's length transaction."[20] Thus, those who purchase property from or sell property to the debtor at a fair price are not exposed to liability simply because the debtor may be insolvent. In those circumstances, the transfer itself did not substantially harm creditors and thus should not be discouraged.

Second, present constructive fraud only applies if the debtor was, or become as a result of the transfer, "insolvent." Generally, a debtor is insolvent when the sum of its debts (with some exclusions) is greater than all of its assets at a fair valuation.[21] A debtor is presumed insolvent if it is not generally pays its debts as they become due.[22] As a result, creditors may not collect from the transferee if the debtor has sufficient assets to pay the debt. However, as with the intent element of actual fraud, the transferee may not even be aware that the debtor is insolvent and may have to fall back on the defense to liability discussed below.

C. <u>Contemplation of insolvency – present or future claims by creditors</u>

The previous category was limited to debts that existed before the property was transferred. However, the transferee may be liable also for debts that arose within a reasonable time *after* the transfer of property. The requirements for this category, which also covers existing debts, are that:

- The debtor didn't receive reasonably equivalent value in exchange for the transfer; and
- The debtor either:
    - Was engaged in a business or transaction for which its remaining assets were unreasonably small, or
    - Intended to incur (or the transferee believed or reasonably should have believed the debtor would incur) debts beyond its ability to pay as they became due.[23]

Just as the previous category may impose liability on the transferee if the debtor is insolvent, this category may impose liability on the transferee if the debtor is *likely* to become insolvent. In both cases, the transferee may be found liable (if it receives property for less than reasonably equivalent value) based on facts of which it may not be aware. This category also, as with actual fraud, depends on the intent or belief of the debtor, not that of the transferee.

D. <u>Insider fraud – present claims by creditors</u>

The final category involves transfers of property to an "insider"; for a debtor corporation, for example, insiders generally include a director, officer, or "person in

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20 *Id*. § 24.004(d).
21 *Id*. § 24.003(a).
22 *Id*. § 24.003(b).
23 *Id*. § 24.005(a)(2).

control" of the corporation, or their relatives.[24] An insider to whom the debtor transfers property may be liable if: (a) the transfer was made to pay an existing debt to the insider; (b) the debtor was insolvent at the time; and (c) the insider had reasonable cause to know the debtor was insolvent.[25] This category also applies only to present creditors. The insider fraud category does not apply if the transfer was in the ordinary course of business between the debtor and the insider, or the debtor obtained "new value" from the insider after the transfer, or the insider was making a good-faith effort to rehabilitate the debtor and the transfer secured additional value for that purpose.[26] This prevents insiders from putting their claims before those of other creditors when the company is insolvent.

E. General defense to transferee liability

Although one or more of the above provisions may apply, the transferee will not be liable if it took the property in good faith and paid reasonably equivalent value.[27] Further, if a transferee meets this standard, subsequent transferees will not be liable either.

Because the absence of reasonably equivalent value received for the transfer is an element of constructive fraud and transfers in contemplation of insolvency, this defense apparently only applies against allegations of actual fraud and insider fraud. Even with respect to actual fraud, whether the debtor receives reasonably equivalent value is one of the factors to be considered and "good faith" may be a conclusion concerning the other factors. As a result, the practical effect of this defense is not entirely clear.

F. Remedies

Although the IRS can proceed under Section 6901, it also could collect directly under TUFTA if desired. The IRS could file suit to recover the transferred property from the transferee, in the same manner as any other creditor.[28] If the transferee occurred after the tax was assessed, the IRS also could proceed administratively with normal collection methods, as the federal tax lien attaches to the transferee's interest in the property.[29] Both of these remedies are limited to the specific property transferred. One significant advantage of a transferee liability proceeding is that the claim could then be collected from any property owned by the transferee. Filing suit directly under state law is also a cumbersome remedy compared to the familiar IRS administrative processes of assessment and collection.[30]

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[24] *Id*. § 24.002(7)(B).

[25] *Id*. § 24.006(b).

[26] *Id*. § 24.009(f).

[27] *Id*. § 24.009(a).

[28] *Id*. § 24.008.

[29] The transfer would not be a "purchaser," with the property not subject to the federal tax lien. I.R.C. § 6323(a), (h)(6).

[30] This is one reason that the predecessor of Section 6901 was enacted. *See Comm'r v. Stern*, 357 U.S. 39 (1958).

III. THE INTERMEDIARY, OR "MIDCO," TRANSACTION AND THE IRS RESPONSE

These tax shelters made their first appearance in the late 1990s and became widely known around 2001. In its most simplified form, an intermediary transaction typically involves four parties: (1) a closely-held C corporation that holds assets with a fair market value greater than the tax basis (the "target"); (2) the shareholders of the target (the "sellers"); (3) an intermediary company (the "midco"); and (4) a third party who wishes to buy the assets of the target (the "buyer").

The sellers desire to dispose of either the entire company or the vast majority of its assets. Even after finding a buyer, the sellers face a dilemma. If the targets sells its assets to the buyer and then distributes the cash to the shareholders in liquidation, the transaction is subject to two levels of tax (first at the corporate level and then at the shareholder level). On the other hand, if the shareholders sell their stock to the buyer, the buyer does not get a stepped-up basis in the assets and the resulting higher depreciation deductions. As a result, the buyer typically is not willing to pay as much for a stock sale as for an asset purchase. The intermediary transaction is an attempt to accommodate the tax objectives of both parties, so that the shareholders obtain most of the benefits of a stock sale while the buyer obtains the benefits of an asset purchase.

The shareholders sell their stock in the target to the midco and the target then sells the assets to the purchaser. By itself, that structure gives the buyer the benefits of an asset purchase but does not eliminate the second level of tax – the target still exists, often as part of the intermediary's affiliated group, and would be liable for the tax resulting from the asset sale. This becomes a tax shelter if the intermediary company plans to avoid paying the anticipated tax liability for the target corporation. This is usually accomplished by causing the target to engage in a separate transaction before the end of the tax year, to reduce the tax liability reported on the return, and then stripping the target of all of its assets.[31] The resulting tax savings may be shared by the intermediary company, the sellers, and/or the buyer. The sellers may receive a price for their stock higher than they would receive in a liquidation after paying the corporate tax liability, and the buyer may negotiate a lower price for the assets than would otherwise be paid for an asset sale. Even after the IRS identifies the shelter and assesses additional taxes, the target corporation is collection-proof; the intermediary company usually is collection-proof as well.

Unlike many other tax shelters, the seller and buyer often have no involvement with or even knowledge of the loss-generating transaction that shelters gain on the sale of

[31] If the target is part of the intermediary's affiliated group, another member of the group may execute the separate tax shelter transaction. The intermediary company could also simply strip the target of its assets while filing a tax return for the target corporation but not paying the liability shown. Because that would make it easier for the IRS to identify and begin collection efforts for the liability, though, the intermediary usually engages in a transaction that purportedly reduces the tax liability.

the target's assets. The promoter not only sets up and owns or controls the intermediary company but also takes a more active role in the transaction. As a result, the promoter often captures half or more of the savings from the shelter transaction. Because of the promoter's more active involvement, this article sometimes refers to the intermediary company, owned or controlled by the promoter, simply as "the promoter."

The IRS designated the intermediary transaction as a "listed" transaction in 2001 but has struggled with how to define it properly. The definition cannot be too narrow or it would allow the parties to engineer their way around the designation. For example, if defined in terms of a stock sale followed almost immediately by a sale of all of the assets, the intermediary transaction could be structured with an asset sale followed by a pre-arranged stock sale of a shell corporation containing nothing but cash and a tax obligation. (In fact, the promoters often specifically sought out companies that intended to sell all their assets and intentionally acquired the target's stock after the only remaining asset was cash.) Alternatively, the parties could delay the second step in the transaction until several months after the first step, or sell the assets of the target to multiple buyers, or retain some small amount of assets. At the same time, the definition cannot be too broad or it might encompass innocent transactions in which there was no intent to avoid tax liabilities. Because of the harsh penalties and other consequences applicable to listed transactions, an overly broad definition may be inappropriate as well. The balance between too narrow a definition and too broad a definition has proved difficult to achieve.

The IRS definition of the intermediary transaction has evolved over the past ten years, as has the IRS strategy for combating these tax shelters.

Notice 2001-16[32]

This was the IRS's initial response to the intermediary transaction shelters. The description was fairly simplistic: a stock sale to the intermediary, followed by an asset sale to the eventual buyer. In one version of the transaction, the target corporation is included in an affiliated group that files a consolidated return and the gain on the asset sale is offset by other losses or credits in the group. In another version of the transaction, the intermediary is an entity that is not subject to tax and simply liquidates the target corporation.

The Notice set forth several different possible grounds for challenging the tax consequences of the transaction:

- the midco is an agent for the sellers (and therefore the target sold assets while it was still owned by the sellers);
- the midco is an agent for the buyers (and therefore the buyer purchased stock rather than assets and receives no step-up in basis);

[32] 2001-1 C.B. 730 (Jan. 19, 2001).

- the transaction is recast as the shareholders selling the assets or the target selling the assets while the shareholders still owned the target; or
- the affiliated group including the intermediary cannot properly offset losses (or credits) against the gain (or tax) resulting from the sale of the assets.

With the benefit of hindsight, this first Notice has an obvious limitation. It focused on determining the proper tax consequences and didn't address the final problem of collection. If the transaction is recast as the target selling the assets while the shareholders till owned the target, or the IRS disallows losses used by the intermediary to eliminate the target's gain from the sale of assets, the target will owe additional taxes. If the target no longer has any assets, however, the determination that it owes additional taxes will not be enough. The Notice did not mention transferee liability.

Also, the definition of the abusive transaction was both too narrow and too broad. Taxpayers could argue that reversing the order of the sales – the asset sale taking place before the stock sale – or a significant delay between the two sales put the transaction outside the scope of the definition. At the same time, this definition could apply to non-abusive transactions, in which the gain is offset by legitimate operating losses.

Three months after the Notice, the IRS issued Chief Counsel Notice 2001-023. The CCN cited, as support for the IRS position on intermediary transactions, the Supreme Court decision in *Commissioner v. Court Holding*:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exists solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.[33]

The CCN provided Chief Counsel attorneys with more guidance on factors that support treating the midco as a conduit and how to determine whether the transaction should be characterized as an asset sale or a stock sale. The most significant factors in deciding how to characterize the transaction were probably how the transaction between buyer and seller was originally structured and whether the buyer or the seller introduced the promoter to the transaction. The CCN also identified the collection problem resulting from the target no longer having any assets and suggested transferee liability as an appropriate solution.

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33 324 U.S. 331, 334 (1945).

Internal Directive, 2006

On January 12, 2006, the Large and Mid-Size Division of the IRS ("LMSB") issued an internal directive[34] to reflect "a management decision to re-focus attention on the potential liability of parties other than just the intermediary entities, which will almost certainly be inadequate sources of collection." The directive emphasized to IRS auditors that they should examine not only the target corporation but also the original shareholders of the target, the promoters, the intermediaries, and the ultimate buyers of assets. It also added an important new element to the definition of an intermediary transaction tax shelter – that the individual parts of the transaction are "[p]ursuant to a pre-arranged plan."

Transferee liability was described as a secondary collection tool, not at the forefront of an examination, but a tool that should not be ignored, since "ultimately transferee liability may be the only way for the Service to recover a determined tax liability that is otherwise uncollectible." Transferee examinations should be deferred until the IRS had determined the proper tax treatment of a transaction and determined that one or more participants: (a) had a tax liability; and (b) had transferred assets. The CCN provided guidance on how to approach and evaluate these transactions and also referenced relevant portions of the Internal Revenue Manual.[35]

The directive also noted the importance of consistency. "[T]he Service's characterization of the facts and their significance for purposes of transferee liability should be consistent with and not contrary to the Service's position on the primary liability [by the transferor], especially if the position has been advanced in a notice of deficiency or in litigation. If the position changes or is rejected in litigation, then any transferee liability case may have to be changed accordingly (such as when the Service position shifts to an alternative theory) or even abandoned." As a practical matter, even if the IRS could make a case for transferee liability against both the buyer and the seller, it would rarely do so due to the potential negative effects of inconsistent arguments. Its choice of which to pursue is usually driven by the factors discussed in the directive and the CCN.

Notices 2008-20 and 2008-111

In Notice 2008-20,[36] in response to concerns that the previous definition could result in over-disclosure or under-disclosure, the IRS specified four necessary components of an intermediary transaction tax shelter. Certain sellers and buyers were

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[34] *Examination of Multiple Parties in Intermediary Transaction Tax Shelters as described in Notice 2001-16* (Jan. 12, 2006), *available at* http://www.irs.gov/businesses/article/0,,id=153182,00.html. The directive is often referred to as the "Barry Shott memo," after the Acting Industry Director who issued it.

[35] *See* I.R.M. 4.11.52, Transferee Liability Cases; I.R.M. 5.17.14, Fraudulent Conveyances and Transferee Liability.

[36] 2008-6 I.R.B. 406 (Jan. 17, 2008).

excluded from being treated as participants in a listed transactions. This definition did not include the "pre-arranged plan" component described in the 2006 directive.

In Notice 2008-111,[37] the IRS brought back that element, with frequent references to "Plan" and the statement that a "transaction that has all four components described in section 3 is only an Intermediary Transaction with respect to a person that engages in the transaction pursuant to the Plan. A person engages in the transaction pursuant to the Plan if the person knows or has reason to know the transaction is structured to effectuate the Plan." The new Notice retained the same basic framework of required elements of the transaction, with some refinements:

- The target corporation, either directly or indirectly, owns assets which, if sold, would result in taxable gain. As of the time of the stock sale, the target corporation has insufficient tax benefits to eliminate or offset that taxable gain in whole (in Notice 2008-20, "in whole or in part"). Tax benefits resulting from a listed transaction or built-in loss property acquired within a year before the stock sale cannot be considered in determined whether the target corporation would be able to eliminate or offset that taxable gain. Thus, the target corporation has a "built-in tax."
- At least 80% (in Notice 2008-20, 50%) by vote or value of the stock in the target corporation is disposed of in one or more related transactions within a 12 month period.
- At least 65% (in Notice 2008-20, "all or most") of the target corporation's assets are sold within the period from a year before the stock sale to a year after the stock sale, in one or more transactions in which gain is recognized.
- At least half (in Notice 2008-20, "all or most") of the "built-in tax" of the target corporation "is purportedly offset or avoided or not paid."

The new Notice also established some safe harbors:

- For any seller who did not hold 5% or more of the stock in the target corporation.
- For all participants, if the purchaser of the stock in the target corporation is an issuer (or consolidated for financial reporting purposes with an issuer) of stock or securities that are publicly traded on an established securities market.
- For any buyer who only acquires certain types of assets.

Notices 2001-16, 2008-20, and 2008-111, of course, are directly relevant only to disclosure requirements for listed transactions. As with any listed transaction, the Notices do not by themselves determine the proper tax consequences, which are still subject to judicial review. They do, however, provide insight into the circumstances in

[37] 2008-51 I.R.B. 1299 (Dec. 1, 2008).

which the IRS is most likely to assert transferee liability, just as the CCN and directive provide insight into the IRS litigation strategy.[38]

IV. THREE KEY ISSUES IN TRANSFEREE LIABILITY CASES ARISING FROM AN INTERMEDIARY TRANSACTION

Certain characteristics of federal tax liabilities, and the normal pattern of an intermediary transaction, have particular significance in determining three key aspects of the transferee liability determination.

Present claim versus future claim

Courts interpreting fraudulent transfer laws in Texas and other states have concluded that the government becomes a creditor of a taxpayer as of the date the obligation to pay income taxes accrue,[39] the 15th day of the third month following the close of the taxable year for corporate taxpayers.[40] This date is when the claim accrues even for additional tax, not shown on the return, that the IRS assesses at some later date.[41] Thus, there may have been no existing claim when the property was transferred but a subsequent assessment might retroactively create a claim that existed as the date of the transfer. Under these authorities, however, the tax liability would not be a present claim with respect to transfers before the filing date of the tax return. In abusive intermediary transactions, the transfer almost always takes place before the end of the tax year, so that the promoter can execute another transaction to generate losses and offset the gain from the asset sale.

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38 The government's initial litigation strategy for intermediary transactions did not focus on transferee liability. In *Enbridge Energy Company v. United States*, 553 F. Supp. 2d 716 (S.D. Tex. 2008), *aff'd*, 104 A.F.T.R.2d (RIA) 7289 (5th Cir. 2009), the buyer brought the promoter into the transaction. The IRS audited the buyer and adjusted its return to reflect the transaction as a stock sale to the buyer rather than an asset sale. As a result, the buyer had a carryover basis in the assets acquired and could not take the higher depreciation and amortization deductions. The court upheld the IRS determination.

39 *See United States v. Evans*, 99 A.F.T.R.2d (RIA) 1793 (W.D. Tex. 2007); *Stretch-O-Rama, Inc. v. Hart*, 79 F. Supp.2d 660, 667 n. 14 (E.D. Tex. 1999); *Short v. United States*, 395 F. Supp. 1151, 1154 (E.D. Tex. 1975). *See also United States v. Green*, 201 F.3d 251, 257 (3d Cir. 2000); *United States v. 58th Street Plaza Theatre, Inc.*, 287 F. Supp. 475 (S.D. N.Y. 1968); *Hatch v. Morosco Holding Co, Inc.*, 50 F.2d 138 (2d Cir. 1931).

40 *See Roland v. United States*, 888 F.2d 1400, 1403 (5th Cir. 1988) (government was creditor on tax due date); *United States v. Green*, 201 F.3d at 257 (discussing date when individual's obligation to pay income taxes accrues).

41 *See, e.g., Zahra Spiritual Trust v. United States*, 910 F.2d 240 (5th Cir. 1990) *United States v. Evans*, 99 A.F.T.R.2d (RIA) 1793 (W.D. Tex. 2007) In these cases, the United States was considered an existing creditor as to tax liabilities for previous tax years that were under investigation but were not assessed until after the transfers in issue. The Fifth Circuit did not address whether the government would have been an existing creditor if the taxpayers had been totally unaware of the potential claim. *See Zahra*, 910 F.2d at 248.

This is a critical issue. If the tax liability is not a present claim at the time of the transfer, the IRS must prove actual fraud or contemplation of insolvency. Both require evidence as to the debtor's intent and/or belief. That may be difficult to establish, particularly when the target corporation does not challenge the notice of deficiency issued to it disallowing the offsetting losses. Constructive fraud is usually easier to prove, as the IRS need only establish insolvency at the time of or as a result of the transfer. However, constructive fraud only applies to present claims, not future claims.

In two of the cases discussed below, the court applied the standard for contemplation of insolvency but not the standard for constructive fraud. That was critical for a taxpayer win in one of those cases. In two other cases discussed below, the court applied the standard for constructive fraud, either in addition to or in place of the standard for contemplation of insolvency. None of the opinions, however, explicitly addressed the issue of whether the tax liability was a present claim or a future claim.

<u>Insolvency</u>

As a general principle, a debtor's insolvency is determined at the time of conveyance.[42] Although the United States does not become a creditor until the tax liability accrues, the insolvency determination includes the tax liability for the year of transfer even if the tax liability has not accrued. In *Wyche v. Comm'r,*[43] the Board of Tax Appeals rejected the contention that the tax liability for the 1930 tax year should not be considered in assessing whether a distribution made on January 30, 1930, left the corporation insolvent because no tax liability had yet accrued. The Board of Tax Appeals stated that it was "well settled that transferee liability extends to after accruing taxes in the sense of retroactive liability for taxes in the year of transfer or prior years. In other words, the liability need not have been known when the transfer was made."[44] This result is supported by TUFTA's broad definition of the term "claim," defined as "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."[45] This is also consistent with the conclusions of the cases discussed below.

<u>Existence of a transfer from the debtor (target corporation)</u>

Transferee liability, by definition, requires a transfer of property from the target corporation to the transferee. Yet in the typical intermediary transaction, there often is no obvious transfer (for less than reasonably equivalent value) to either the buyer or the seller.

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42 *Jackson Law Office, P.C. v. Chappell*, 37 S.W.3d 15 (Tex. App.—Tyler, 2007, pet. denied).
43 36 B.T.A. 414 (1937).
44 *Id.* at 419.
45 Tex. Bus. & Com. Code § 24.002(3). *See Evans*, 99 A.F.T.R.2d (RIA) 179, *21.

While the buyer typically receives property directly from the target corporation, the buyer also typically pays reasonably equivalent value for the assets purchased, which would usually negate transferee liability. As explained in the discussion of *LR Development Co.* below, however, one common feature of intermediary transactions may open the door for a holding that the buyer did not pay reasonably equivalent value, or indeed any value, to the target corporation.

The selling shareholders typically receive payment for their shares from the intermediary company rather than the target corporation. On the surface, there doesn't appear to be a transfer from the debtor (the target corporation) to its shareholders. If the form of the transaction is respected, there is no transfer of property and therefore no transferee liability. Several earlier transferee liability cases, not involving intermediary transactions, have addressed the issue of whether the form of the transaction should be respected or whether the transaction should be recast as one in which the shareholders received property from the corporation whose stock they sold. For example, the shareholders in *Bates Motor Transport Lines v. United States*, [46] *Delpit v. Commissioner*, [47] *Owens v. Commissioner*, [48] and *Scott v. Commissioner* [49] were considered transferees of the corporation whose stock they sold, while the courts in *Vendig v. Commissioner* [50]

[46] 200 F.2d 20 (7th Cir. 1952), *aff'g* 17 T.C. 151 (1951). The petitioner was the president of and a major stockholder in both the target corporation ("Bates") and the acquiring corporation ("Standard"), and received shares of Standard in return for his shares in Bates. Bates then transferred all of its assets to Standard and liquidated. The shares of Standard were issued directly to the petitioner, but the court held that this was the same as if Standard had issued its shares directly to Bates, which then issued the shares of Standard to the petitioner as a liquidating distribution.

[47] T.C. Memo 1991-147. The shareholder had already adopted a plan of liquidation for the target corporation before selling it to a third party, and at the time of the sale the target's liabilities exceeded assets by $39 million. The shareholder also received an option to purchase the acquiring corporation at fair market value and continued to receive profits from the subsidiaries of the target, as adjustments to the purchase price, after the sale. The court concluded that the acquiring corporation was a mere conduit for the flow of the target's liquid assets into the shareholder's hands while avoiding liabilities.

[48] 64 T.C. 1 (1975), *aff'd in part, rev'd in part*, 568 F.2d 1233 (6th Cir. 1977). The target corporation was an S corporation. In the transaction: (1) the S corporation sold all of its assets; (2) the sole shareholder sold it to third parties, who had substantial net operating losses, for less than the cash that was the corporation's sole asset; (3) the third parties withdrew all of the cash; (4) the S corporation liquidated; and (5) the S corporation filed its final tax return, showing the taxable income as distributed to the purchasers. The court concluded that this was not a bona fide stock sale and instead should be treated as a distribution of cash by the S corporation to the former sole shareholder. The former shareholder was also liable as a transferee for a deficiency in an earlier year that the corporation was a C corporation. "When one purports to sell cash in corporate solution the burden is surely particularly severe on the seller to show that the only purpose served is not tax avoidance." *But see Gray v. Comm'r*, 561 F.2d 753 (9th Cir. 1977).

[49] T.C. Memo 1998-426, *aff'd*, 236 F.3d 1239 (10th Cir. 2001). The transaction was originally planned as an asset sale followed by a liquidating distribution, which the former shareholders would use to purchase stock in the company that bought the assets. The petitioner insisted on restructuring the transaction so that rather than a liquidating distribution from the target corporation he would receive stock directly from the purchasing corporation for a nominal cash amount. The parties stipulated that part of the property issued to the petitioner was actually an amount paid to the target corporation for its assets, and the court relied on that for its holding.

[50] 229 F.2d 93 (2d Cir. 1956), *rev'g* 22 T.C. 1127 (1954). The petitioner exchanged her preferred stock in the target company for preferred stock in the purchasing company, and the target then liquidated

and *Southern Arizona Bank & Trust Company v. United States* [51] declined to impose transferee liability. No consistent pattern has emerged from these cases, which seem to turn on the specific facts involved. In one of the cases below in which transferee liability was asserted against the seller, the court declined to recast the transaction.

V. TRANSFEREE LIABILITY + INTERMEDIARY TRANSACTION = ????

In recent years, the IRS has emphasized using transferee liability to combat intermediary transactions. The results to date have been mostly favorable to the taxpayers, reflecting the reality that transferee liability is a very fact-specific determination requiring proof of several different elements. Different facts, or a different approach by the litigators, may yield quite different results.

<u>The basics – procedural requirements</u>

The taxpayers have won two recent cases on procedural grounds rather than on the merits. Neither of these cases gave much insight into the application of the transferee liability theory to an intermediary transaction. In *Diebold v. Commissioner*,[52] the stock of the target corporation was held by a marital trust created on the death of the husband for the benefit of the wife. The marital trust and a related foundation sold the stock to an intermediary company, which soon thereafter sold most of the assets. The IRS issued a notice of transferee liability to the wife, rather than the marital trust, but the court held for the petitioner. The marital trust could not be disregarded; thus, the IRS had sued the wrong party.[53] In *Shockley v. Commissioner*,[54] the court held that the petitioners, former shareholders in the target corporation, were not liable as transferees because the statute of limitations had expired before the IRS issued the notice of transferee liability. The

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and transferred all assets and liabilities to the purchasing company. The purchasing company assumed the target's liabilities. In rejecting the government's transferee liability argument, the court noted that the petitioner did not remove cash or other property, so the target's creditors were not harmed by the transaction. There should be no transferee liability if the assets of the corporation have not been affected or diminished.

[51] 181 Ct. Cl. 426 (1967). The sole shareholder sold the target company to a new corporation to carry on the business of the old company; the target was then liquidated and its assets transferred to the new corporation. The former shareholder also agreed to indemnify the purchaser for any taxes owed by the target for periods prior to closing. The court concluded that liability for the taxes was contractual only and that the former shareholder was not a transferee because he did not receive any of the target's assets on its liquidation. However, the taxpayer was trying to establish transferee liability, to support a deduction for expenses incurred in contesting taxes imposed on the tax, and the government was arguing that he was not a transferee. Accordingly, this decision may be explained by the principle of holding taxpayers to the form of their own transactions.

[52] T.C. Memo 2010-238 (Oct. 26, 2010).

[53] The court suggested that the wife could be held liable as a transferee of a transferee, although this may have required the IRS first to have issued a notice of transferee liability against the marital trust. In any event, the IRS had not offered sufficient evidence that the wife was liable as a transferee from the marital trust, by showing that distributions by the marital trust to the wife qualified as fraudulent conveyances under state law.

[54] T.C. Memo 2011-96 (May 2, 2011).

statute of limitations was suspended by a notice of deficiency issued to the target corporation, but not by a notice of deficiency issued to the shareholders as a courtesy copy, even though the shareholders had filed a Tax Court petition to challenge the validity of the "notice" they received. As they no longer owned an interest in the target, they had no authority to contest a notice of deficiency against the target.

The promoter's intent and belief

LR Development Company v. Commissioner[55] is a rare example of transferee liability asserted against the buyer of the target corporation's assets. After the sole shareholder of the target company died, the estate sought to sell the company's stock. A potential buyer for the target's assets introduced to the negotiations an intermediary company, which eventually agreed to purchase the target's stock from the estate and then sell most of the assets to the buyer. The buyer also offered to the target's senior management an equity interest in a new entity to be formed to purchase the assets. Under the terms of the agreement, the purchaser of the assets (LR Development) was to make payment to an escrow account under the control of the promoter, rather than directly to the target company, and the funds were further required to be applied against a loan that the promoter took out to buy the stock. Under the terms of the stock sale agreement, the promoter was responsible for any tax attributable to the period after closing, including tax on the subsequent asset sale. Under the terms of a separate assumption agreement, the buyer (petitioner) assumed that obligation of the promoter. The target avoided tax on the sale of assets, apparently through a basis-boosting tax shelter that generated a substantial loss to offset the gain from the sale of the assets. The target sold Canadian currency with a fair market value of $44,156 and a carryover basis of $17,268,000.

The court rejected the government's argument that the petitioner was a transferee in law under the terms of the stock sale agreement and assumption agreement. Those terms were between the parties to the transaction and Illinois law has a strong presumption against finding third party beneficiaries of agreements; further, the assumption agreement included a statement specifically negating third party beneficiaries of that assumption.

The court rejected the government's argument for transferee liability based on contemplation of insolvency, although the court held for the government on a key point. Because the purchase price for the assets was deposited, under the terms of the agreements, into an account under the control of the promoter, the target did not receive reasonably equivalent value for the property it transferred to the buyer. This provision may have been required by the bank that loaned the promoter the funds for the purchase of the stock, but it created potential exposure for the buyer.

However, the contemplation of insolvency argument also required that the target believed or reasonably should have believed it would incur debts (such as the tax

55 T.C. Memo 2010-203.

liability) beyond its ability to pay. The government argued that the promoter "lacked any objective basis to believe" that its tax liability from the asset sale could be sheltered by the Canadian currency transaction. However, the government offered little in support of that assertion, other than pointing out that the basis claimed in the Canadian currency was almost 400 times fair market value. The government called no witnesses and presented no documentary evidence regarding that assertion. There was nothing in the record concerning how or under what circumstances the intermediary company had acquired the currency. Thus, the government did not meet its burden of proof and the transfer did not meet the standards for a transfer in contemplation of insolvency.

The court also rejected the government's argument for transferee liability based on actual fraud. The government pointed to seven different "badges of fraud," six of which were specified in the Illinois fraudulent transfer law. The court concluded that the government had met its burden of proof with respect to five of the seven factors, including that the debtor (target company) did not receive reasonably equivalent value and that the debtor was insolvent as a result of the transfer. For purposes of the insolvency factor, the court made two key determinations. First, the court included the tax liability as a contingent liability, even though the debtor might have engaged in additional transactions or activities before year end to reduce or eliminate the tax. This is consistent with the UFTA, which includes the tax liability in the insolvency determination even though it is not yet a "present claim." Second, the court rejected the petitioner's assertion that the target's assets included a receivable from the promoter received in return for the target's cash. The petitioner argued that there was such a loan/receivable but apparently did not present any evidence in support. Therefore, the court ignored it.[56]

The government met its burden of proof with respect to five of the badges of fraud. However, the court concluded that those badges of fraud raised only a suspicion of intent to hinder, delay, or defraud the government. Whether that was enough for a finding of actual fraud depended on the factor the court had considered under the contemplation of insolvency argument: whether the promoter believed or reasonably should have believed that the loss from the disposition of the Canadian currency would offset the gain from the sale of its other assets to the buyer. Because the government had not met is burden of proof as to that factor, the actual fraud argument failed as well.

Finally, the court rejected the government's argument under the trust fund doctrine. The court focused on the underlying rationale for this principle of equity, to protect creditors from fraudulent action by the debtor. Therefore, the government would have to show that the transfer was for a fraudulent purpose of avoiding liability. Because

[56] The government did not argue, and the court did not analyze, the constructive fraud standard. Because the court found that the target did not receive reasonably equivalent value for the property transferred to the buyer and that the target was insolvent as a result of the transfer, it seems likely that the court would have found the buyer liable under the constructive fraud standard, although the government did not prove the intent or belief necessary for a transfer in contemplation of insolvency. This demonstrates again the importance of the distinction between present claims and future claims.

the court had already concluded the government had not met its burden of proof to establish actual fraud, the court also concluded that the government had not met its burden of proof to establish that the trust fund doctrine should apply.

The petitioner was not found liable for the target's tax liability. However, the court did agree with the government that the transfer was not for reasonably equivalent value and resulted in insolvency and that several of the badges of fraud were present. With additional evidence as to the promoter's intent or belief, the government might well have won. *LR Development* illustrates the importance of approaching a transferee liability case in the same way as a fraud case, or for that matter, in the same way as the penalty issue in various tax shelter cases.

<u>A minor mistake allows the government an easy win</u>

CHC Industries, Inc. v. Commissioner [57] is the only case discussed here in which the IRS asserted transferee liability against someone other than the seller or buyer. The promoter and intermediary company generally insulate themselves effectively against recovery, but not everyone who works with them does. The transfer at issue was a finders fee paid to CHC when one company (Checker Taxi, Inc., later renamed CDGH, Inc.) entered into an intermediary transaction with the promoter. The parties stipulated that the finders fee presented fair consideration for the services that CHC provided to the promoter. Unfortunately for CHC, it was not paid by the promoter. It submitted an invoice for the finders fee both to CDGH and to another target company (St. Augustine) that entered into a separate intermediary transaction with the promoter. An employee of the promoter paid the petitioner from St. Augustine's bank account.

CHC was unaware of the source of the payment and properly reported the entire amount as income on its tax return. It also gave reasonably equivalent value for the amount it received. At trial, however, the government easily established that CHC received property from one target company (St. Augustine) while it provided services to the promoter in connection with another target company (CDGH). CHC argued that the payment should be treated as received from the promoter, applying substance over form. Although the government often argues substance over form for transferee liability cases, a taxpayer must present strong proof for the court to disregard the form in which the taxpayer cast a transaction. CHC did not present the strong proof necessary to overcome the form of the transaction. The court suggested that the substance over form doctrine would not have been applicable in any event. CHC not only facilitated the transaction, it likely would have been aware of the type of transaction the promoter intended. The payment to CHC had no apparent purpose other than for St. Augustine to claim a deduction to which it was not entitled. St. Augustine did not receive reasonably equivalent value and was insolvent as a result of that and other transfers. As a result, the transfer was fraudulent and CHC was liable.

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[57] T.C. Memo 2011-33.

The court properly applied the standard for a transfer in contemplation of insolvency. The petitioner did not dispute that St. Augustine should have reasonably believed it would incur debts beyond its ability to pay as they came due. Thus, the IRS was not required to prove what is often the most difficult element of this provision.

A tale of two notes

Griffin v. Commissioner[58] involved a typical intermediary transaction in which the target company (HydroTemp) sold most of its assets and the sole shareholder (Griffin) later sold the stock to an intermediary company. Typically, the seller does not receive transfers directly from the target company, instead receiving payment for his stock from the intermediary company. Thus, the IRS must argue to recast the transaction as a liquidating distribution by the target company to the shareholder. However, in this case Griffin did receive property directly from HydroTemp. After the asset sale, HydroTemp loaned $5 million to Griffin. The purpose of this loan was to allow the proceeds from the asset sale to be deposited into Griffin's interest-bearing account, as HydroTemp was temporarily unable to set up such an account. The loan was evidenced by an interest-bearing demand promissory note and Griffin maintained the funds in a separate account.

In the subsequent stock sale to the intermediary company, HydroTemp redeemed some of Griffin's shares in return for extinguishing $3.8 million of the loan. The promoter issued a note to Griffin, along with a small amount of cash, for the remainder of his stock. Griffin then assigned the promoter's note to HydroTemp to satisfy the remainder of the $5 million loan. The promoter also committed to satisfy any tax liabilities incurred by HydroTemp before the stock sale. After the IRS issued an assessment to HydroTemp and a subsequent transferee notice to Griffin, Griffin demanded that the promoter honor the agreement to pay HydroTemp's tax liabilities. Griffin incurred substantial legal fees and obtained a judgment against the promoter, but the promoter still did not pay the taxes.

The court identified two transfers by HydroTemp to Griffin – the $5 million loaned from the asset sale proceeds and the cancellation of Griffin's note in exchange for a portion of Griffin's shares and assignment of the promoter's note. The government argued for collapsing the two transfers, treating the transaction as an asset sale followed by a liquidating distribution of the sales proceeds, under the substance over form judicial doctrine. The court refused to do so, noting that the two transactions were not arranged in conjunction and each had independent legal significance. Further, Griffin had no plan to sell the HydroTemp stock to anyone when HydroTemp loaned him $5 million, and HydroTemp had other assets and continued to operate for approximately six months after the asset sale.

The court rejected the government's argument of actual fraud with respect to the initial $5 million loan. The court agreed that Griffin was an insider but concluded that

[58] T.C. Memo 2011-61.

the other badges of fraud favored Griffin. In particular, Griffin did not have possession of substantially all of HydroTemp's assets, and HydroTemp was not insolvent, as a result of the loan. The court respected the existence of Griffin's promissory note to HydroTemp, as the funds were readily available and maintained in a separate account; Griffin could have repaid the loan at any time.

The court also concluded that there was no actual fraud with respect to the second transfer, in which Griffin relinquished his stock and assigned a note from the promoter in return for his stock. HydroTemp still had approximately $1.2 million in cash, some other assets, and the promoter's note for approximately $1.4 million. The promoter was also legally and contractually liable to satisfy those tax liabilities. Even if the indemnity from the promoter were ignored, HydroTemp's cash and other business assets plus the promoter's note would be enough to satisfy the taxes due.

Finally, the court rejected the government's arguments for constructive fraud. As in the *Griffin* case, the court did not address whether the tax liabilities were a present claim at the time of the transfer for purposes of constructive fraud or whether transferee liability might be appropriate under the contemplation of insolvency category.[59] As in its analysis of actual fraud, the court concluded that the government had not proved that the transfers were not for reasonably equivalent value or that HydoTemp was insolvent at the time of or as a result of the transfers.

Because neither of the transfers qualified as fraudulent under either actual fraud or constructive fraud, Griffin was not subject to transferee liability.

The court's holding depended on respecting the validity and value of Griffin's note for $5 million. Given the circumstances surrounding the loan, that seems to be an appropriate conclusion. The court's analysis, however, also depended on respecting the validity and value of the promoter's note, although HydroTemp apparently never collected on it. The government might have argued that there was no reasonable expectation at the time of the transfer that HydroTemp would ever collect on that note. That could have been difficult to establish, but the government apparently didn't even try. The court noted that the government failed to present any evidence of a different value for the assets or that the tax debts exceeded the value of HydroTemp's cash, other business assets, and note from the promoter. This turned out to be a critical issue for the case.

Was there a transfer?

Starnes v. Commissioner [60] involved a more typical transferee liability case against the seller. While the target corporation (Tarcon), was in the process of selling its

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59 Given the court's conclusion that the target was not insolvent as a result of the second transfer, respecting the value of the promoter's note, it might have reached the same result even under the correct standard.

60 T.C. Memo 2011-63. Some of the facts described are from the parties' briefs on appeal.

assets, a broker serving as its agent and advisor was approached by the promoter. The promoter offered to purchase the stock for Tarcon's cash at closing less 56.25% of its tax liabilities for the year of the sale, plus $25,000 to reimburse the shareholders for legal and accounting fees. After the conclusion of the asset sales, Tarcon had approximately $3.1 million in cash and estimated tax liabilities of $0.9 million. The Tarcon shareholders, including Starnes, sold their stock for $2.6 million. The shareholders represented that Tarcon had no assets other than cash and no liabilities other than the tax liabilities. The shareholders were required to transfer Tarcon's cash "to the Purchasers." The promoter agreed to file Tarcon's tax returns and pay all taxes due.

The shareholders did not receive cash or other property directly from Tarcon at the closing on November 13, 2003. The promoter transferred the $2.6 million sale price for the stock into an attorney trust account; it was then disbursed to the Tarcon shareholders. At the same time Tarcon's $3.1 million of cash was transferred into the same attorney trust account. That amount was shown on the disbursement ledger for the attorney trust account as transferred to a new "post-closing" Tarcon bank account. In reality, it was transferred into the promoter's operating account on November 13, 2003, and only transferred to a new Tarcon bank account on November 14, 2003. On November 26, 2003, the $3.1 million was transferred again, to a Tarcon account at a different bank. The promoter sold Tarcon to a Bermuda company (Sequoia) in November. On December 1, 2003, most of the funds were removed from Tarcon's account. A small amount was transferred to the promoter but almost $3 million was transferred to another party's account at a bank in the Cook Islands.

Tarcon filed a tax return for 2003 reporting no tax due and net assets at the end of the tax year of $132,320 in cash. Presumably at some point either Sequoia or a subsequent owner removed the funds from Tarcon so that the IRS would be unable to collect the tax assessment from it. However, the opinion offers no detail on such a removal. The IRS later audited Tarcon's return and issued a notice of deficiency. After Tarcon did not file a Tax Court petition, the IRS assessed the tax liability. Collection efforts against Tarcon were unsuccessful and in December 2008 the IRS sent notices of transferee liability to the shareholders.

The IRS based its notices of transferee liability to the shareholders on a determination that in substance the transactions amounted to an asset sale followed by a liquidating distribution of the proceeds by Tarcon to its shareholders. The transfer giving rise to transferee liability was identified as the money the shareholders received for the stock sale.

The court ultimately held for the taxpayer, but the opinion is confused and confusing. The court did not begin by directly addressing a fundamental issue, briefed by both parties as described as a "threshold issue" by the government: whether Tarcon transferred property to the shareholders. In the analysis that followed, the court eventually decided that there had been no such transfer to the shareholders. That rendered the analysis of reasonably equivalent value and the badges of fraud superfluous, as the absence of a transfer negates transferee liability under all circumstances.

The court began its analysis of the contemplation of insolvency argument with a discussion of reasonably equivalent value and observed that "respondent must show that Tarcon did not receive reasonably equivalent value in exchange for the stock." Of course, Tarcon did not transfer stock to anyone; the shareholders sold their Tarcon stock to the promoter. The real question was whether Tarcon transferred funds to the shareholders through the promoter.

In effect, although the conclusion was expressed in terms of reasonably equivalent value, the court decided that the government failed to show Tarcon transferred funds to anyone, even the promoter. The disbursement schedule for the attorney trust account showed only a transfer of $3.1 million from one Tarcon bank account to another Tarcon bank account. The actual transfer to the promoter's account also did not demonstrate that Tarcon did not receive reasonably equivalent value; the promoter did not retain the funds and instead transferred them to Tarcon the next day. The court also rejected an argument based on the subsequent withdrawal of that money within three weeks, because collapsing transactions in that context would require that the transferee "had either actual or constructive knowledge of the entire scheme." The court concluded that the evidence did not establish actual knowledge. Constructive knowledge might be imputed where the transferee became aware of circumstances that should have led to further inquiry. That was likely warranted in this case because the shareholders received proceeds from the sale of their stock that exceeded Tarcon's assets less the calculated tax liabilities. The court concluded, however, that this was insufficient to find that the shareholders had constructive knowledge of the entire scheme, including the sale of Tarcon to Sequoia and the generation of tax losses through the purchase and sale of inflated basis assets. Tarcon had sufficient assets after the stock closing to pay the tax liabilities. Nothing in the record showed that Tacon did not receive a reasonably equivalent value.

The court also analyzed actual fraud and relied on the conclusion that the government had not shown a transfer from Tarcon to its shareholders.[61] Because Tarcon still had the same assets before the stock sale as after the stock sale, the government had not shown a transfer with intent to hinder, delay, or defraud the IRS. The court rejected the government's argument for constructive fraud, because the government had not shown that Tarcon made a transfer without receiving reasonably equivalent value in exchange. It also rejected the government's argument to apply North Carolina's trust fund doctrine, as the government had not shown that Tarcon was insolvent or that there had been a winding up or dissolution of Tarcon. As the government had not established

[61] In discussing the "transfer to an insider" factor, the court pointed out that "without collapsing the transactions, respondent has not shown that the transfers to the Tarcon shareholders were from Tarcon, not MidCoast [the promoter]." The court noted with respect to some of the other badges of fraud that "respondent failed to show that the transaction should be collapsed under North Carolina law" and "respondent has not shown that Tarcon transferred funds to the Tarcon shareholders leaving Tarcon with moneys insufficient to satisfy the tax liabilities."

that a fraudulent transfer occurred or that the trust fund doctrine should apply, the shareholders were not liable for the tax liabilities of Tarcon.

The government appealed the Tax Court's decision to the Fourth Circuit. The appellate briefs essentially frame a determination of transferee liability as a three-step process: (1) determine whether there was a transfer; (2) determine whether the transfer was fraudulent; and (3) apply Section 6901. Both parties agreed that the second step is based on state law. The government asserted that the first step is based on federal tax caselaw, in particular the substance over form doctrine. The shareholders argued that the first step must be decided under state law and argued that the substance over form doctrine is irrelevant. Thus, the case may implicate questions of federalism. The government's reply brief is due December 2nd; the Fourth Circuit has not yet scheduled oral arguments.

<u>Waiting in the wings</u>

One other intermediary transaction/transferee liability case, *Frank Sawyer Trust of May 1992 v. Commissioner*,[62] is currently awaiting decision. The court denied the petitioner's motion for summary judgment in 2009.[63] Trial was held in October 2010, and the parties filed final briefs in March 2011.

VI. CONCLUSION

The government lost most of these cases, but taxpayers should not take a lot of comfort from that even if the Fourth Circuit holds for the taxpayers in *Starnes*, which is far from certain. The cases demonstrate the complexity of a transferee liability case and how much the government must prove to prevail. In several of the cases above, the government apparently did not even present evidence concerning some of the important facts. However, the government also won on several of the discrete issues. It is not difficult to visualize the government winning future cases if it learns from these setbacks and prepares its case more carefully and thoroughly. Developing the facts surrounding the existence of a transfer (*Starnes*), the value of notes received when the promoter withdraws funds from the target (*Griffin*), and the promoter's intent and belief (*LR Development*) is likely to be critical for both the taxpayer and the government in future cases.

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[62] Tax Court Docket No. 5526-07. Interestingly, one of the intermediary transactions at issue is the one for which CHC Industries received a finders fee.

[63] *Frank Sawyer Trust of May 1992 v. Comm'r*, 133 T.C. 60 (2009). The IRS initially issued a notice of deficiency directly against the trust, the seller in multiple intermediary transactions, asserting that the stock sales should be treated as the sale of assets and deemed distributions in liquidation. The petitioner filed a Tax Court petition, which was subsequently dismissed by settlement and without any pertinent stipulations in the decision documents. The IRS also entered into a closing agreement with the target corporation, disallowing the claimed losses that offset the gains from the asset sales, and then issued notices of transferee liability against the trust. The trust unsuccessfully argued that a transferee liability determination was barred by *res judicata* or collateral estoppel.