DIEBOLD and the Not so Beautiful: Transferee Liability Trumps Tax Shelter

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EXECUTIVE SUMMARY

The Second Circuit, in *Diebold v. Commissioner*[1], describes the requirements for finding transferee liability under Section 6901[2], here specifically under New York law, as state law predominates the determination of whether a person will be liable for federal taxes as a transferee. This case involved a so-called "Midco"[3] transaction, whereby the goal was to avoid the corporate level taxes on the disposition of the assets of a C corporation.[4]

A sale by the shareholders of their C corporation stock and a sale by the C corporation of its assets were recharacterized as a sale by the C corporation of its assets and then a liquidating distribution of the sale proceeds to the shareholders of the C corporation. This recharacterization allowed the Second Circuit to hold that the

C corporation's shareholders had transferee liability under New York law with respect to the tax liability recognized by the C corporation on the sale of its assets. A remand to the Tax Court concerns whether such recharacterization satisfies federal law.

FACTS

Double-D Ranch, Inc. ("Double-D"), a C corporation, owned valuable marketable securities and real estate with low tax bases. If the assets were sold in arm's-length transactions, Double-D would incur substantial capital gains. Generally, shareholders of C corporations favor stock sales over the sale of the corporation's assets in order to avoid the consequent double tax, i.e., the tax at the corporate level on the sale of the C corporation's assets, and the second tax at the shareholder level, when the sale proceeds are distributed in liquidation of the corporation.[5] A stock sale, however, puts potential tax liability onto the buyer because the built-in gain that is inherent in the corporation's assets will be triggered when the assets are ultimately disposed of. As a result, the stock price generally reflects a discount for the potential tax liability.

Buyers prefer to purchase assets rather than stock to avoid the problem of owning a corporation with non-disclosed liabilities. In addition, there are tax reasons for buying assets which include not having to inherit the potential tax liability in the built-in-gain, and perhaps more importantly in a situation where the C corporation owns an operating business, obtaining a stepped-up basis (cost basis) for the acquisition of intangible assets such as goodwill, the cost of which can be amortized over the next succeeding 15 years. The present value of such amortization may provide the buyer with a substantial discount off the purchase price.[6]

Midco

A “Midco” transaction is structured to allow the parties to have it both ways: that is, having the seller sell stock while the buyer is purchasing assets. In a Midco transaction, the shareholders sell their C corporation stock to an intermediary entity (the “Midco”) at a purchase price that does not discount for the built-in gain tax liability as would generally happen in a stock sale to the ultimate purchaser. The Midco then causes the C corporation to sell its assets to the buyer, who gets a purchase price basis for the assets. The Midco keeps the price differential between the slightly higher asset sale price and the stock purchase price as its fee. The Midco’s willingness to facilitate the avoidance of the double tax consequences inherent in holding appreciated assets in a C corporation is based either on a claimed tax-exempt status or its possession of accommodating tax attributes, such as capital losses or net operating losses, that allow it to offset the recognized built-in gain. Without such offsetting tax attributes, the tax liability on the built-in gain will have to be satisfied.

Typically, the Midco is a newly formed entity (usually without other income or assets) created for the sole purpose of facilitating the disposition of the C corporation, and together with the C corporation, is likely to be judgment-proof at the conclusion of the series of transactions contemplated. The IRS generally has no choice but to seek payment from the other parties to the transaction in order to satisfy the tax liability the transaction was created to avoid.[7]

In May of 1999[8], Double-D’s shareholders, The Diebold Foundation Inc. (“Diebold New York”) and the Dorothy R. Diebold Marital Trust (the “Marital Trust”), decided to sell the stock of Double-D. The directors of Diebold New York and the trustees of the Marital Trust and their legal representatives consulted with various investment banking-brokerage type organizations who were promoting Midco arrangements since their respective interests were in earning brokerage or advisory fees by acquiring C corporations holding low basis high valued assets, and immediately disposing of same. After much investigation, the shareholders selected the promoter who established Shap Acquisition Corp. II ("Shap II") as the Midco for the purpose of acquiring the Double-D stock. Shap II then actually acquired all of the Double-D stock for cash in an amount equal to the fair market value of the corporation's assets minus a 4.25% discount.

Shap II borrowed from Rabobank the funds necessary to acquire the Double-D stock from Diebold New York and the Marital Trust and, simultaneously with its acquisition of the stock, Shap II caused Double-D to sell its marketable securities portfolio to Morgan Stanley pursuant to an agreement which required Morgan Stanley to pay the purchase price for the portfolio directly to Rabobank to repay the loan.[9] Shap II also caused Double-D to sell its real estate for fair market value to an entity owned by a member of the Diebold family.

After the sale, Diebold New York was dissolved and its assets were distributed equally among three newly created family charitable foundations - the Salus Mundi Foundation, the Ceres Foundation and Diebold Foundation, Inc. ("Diebold Foundation").

Shap II filed a consolidated income tax return with Double-D on which it reported the gains from the sales of the Double-D assets and it also claimed sufficient losses realized by Shap II to offset such gains resulting, lo and behold, in no tax liability. Shap

II's losses, however, were disallowed by the Tax Court as artificial losses from a so-called "Son-of-BOSS" transaction.

The IRS issued a notice of deficiency to Double-D based upon the IRS' recharacterization of the transaction as sales by Double-D of its assets to the buyers (Morgan Stanley and the family entity) followed by liquidating distributions to its shareholders, Diebold New York and the Marital Trust. The notice was issued more than three years after the consolidated return that Shap II and Double-D filed, and the IRS contended that the 6-year statute of limitations under Section 6501(e) was applicable. (Section 6501(e) provides for a 6-year assessment period if there has been a substantial, i.e., more than 25%, omission of gross income. The IRS' position that the 6-year statute was applicable was also supported by characterizing the transaction as an asset sale rather than a stock sale.) Double-D and Shap II basically ignored the notice of deficiency since there were no assets to satisfy the tax liability.

The IRS asserted transferee liability against Diebold New York as well as against Diebold Foundation, Salus Mundi Foundation, and the Ceres Foundation, as transferees of Diebold New York. As a shareholder, the Marital Trust was also a transferee. Initially the IRS claimed Mrs. Diebold was the transferee seemingly ignoring the existence of the Marital Trust. The Tax Court determined that the Marital Trust was the Double-D shareholder and, therefore, it would not ignore the trust's separate existence.[10] The three foundations contested the notices of deficiency and the Tax Court found in their favor holding that since Diebold New York was not liable as a transferee of Double-D, the three new foundations could not be transferees of a transferee. The IRS appealed.

COMMENT

Transferee Liability

Section 6901 provides with respect to a "transferee" that taxes may "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" and allows for the collection of "[t]he liability, at law or in equity, of a transferee of property…of a taxpayer." Section 6901 does not create the substantive tax liability but provides a procedure by which the federal government may collect taxes. The substantive liability must be found under applicable state law.

The IRS may assess transferee liability under Section 6901 only if the two prongs of the section are met: (1) the party must be a transferee under federal law, and (2) the party must be subject to liability under applicable state law, either at law or in equity. Rejecting the IRS position that the federal "substance over form" doctrine controls the determination of transferee liability, both the Tax Court and Second Circuit found that the two prongs of Section 6901 were independent of each other, so that even if a court determines that a party is a transferee by recharacterizing the transaction under federal law, it must separately determine whether applicable state law requires such recharacterization for the purpose of imposing liability on such party under the state law. In holding that the two prongs of Section 6901 are independent, the Second Circuit joined both the First Circuit and the Fourth Circuit[11] in such interpretation of Section 6901.

The Court looked to New York's Uniform Fraudulent Conveyance Act[12] since the transactions occurred in New York. Under New York law, regardless of intent there is a fraudulent conveyance and the transferee will be liable if the transferor (i) makes a conveyance, (ii) does not receive in exchange fair consideration, and as a result, (iii) is rendered insolvent. If Double-D had sold its assets and distributed the proceeds to its shareholders without retaining sufficient funds to pay its tax liability on the built-in gains, it would be a clear case of fraudulent conveyance under New York law. Since Double-D did not actually convey anything to the shareholders due to the Midco form of the transaction, the Second Circuit, addressed the circumstances under which the transactions could be collapsed.

Under the New York statute, multiple transactions may be collapsed and treated as part of a single, integrated transaction if the party seeking to recharacterize the transaction can show that the transferee had "actual or constructive knowledge of the entire scheme that renders [its] exchange with the debtor fraudulent."[13] The Tax Court found that the shareholders did not have actual or constructive knowledge of the entire series of transactions and therefore it respected the form of the transaction as a stock sale. The Second Circuit disagreed with the Tax Court.

The Second Circuit, based on a de novo review of the legal determination of whether the Double-D shareholders had constructive knowledge, found that unlike the application of the New York law to a single transaction where the intent of the parties is irrelevant, the knowledge and intent of the parties is relevant when seeking to collapse a series of transactions. In order to hold the selling shareholders (and their successors) liable, it had to be shown that they had actual or constructive knowledge of the entire plan.

In examining whether Double-D's shareholders had constructive knowledge, the Second Circuit stated "that the facts here demonstrate both a failure of ordinary diligence and active avoidance of the truth."[14] Constructive knowledge can also be found if, based on all the facts and circumstances, a party should have known about the entire scheme. In finding that the shareholders had constructive knowledge, the Court took looked at the totality of the circumstances, including that:

- the shareholders recognized the "problem" of the tax liability arising on the built-in gains in Double-D's assets.
- they specifically sought willing parties, i.e., the various brokerage firms consulted, that could help them avoid the tax liability.
- the shareholders were sophisticated and utilized "a stable of" tax attorneys.
- the shareholder's representatives had sophisticated understanding of the structure of the entire transaction. In this regard, the Second Circuit summarized the case law that "[i]n deciding whether to collapse the transaction and impose liability on particular defendants, the courts have looked frequently to the knowledge of the defendants *of the structure of the entire transaction and to whether its components were part of a single scheme.*"[15]

The Second Circuit discussed what the shareholder's representatives knew, what they did not want to know, and what they should have known after exercising reasonable diligence. In other words, the representatives should have known that the entire scheme was fraudulent in that it was designed to let both the buyer and seller avoid tax liability and that it would leave Double-D without assets with which to satisfy any potential tax liability if the transactions were collapsed. Particularly, in transactions where the express purpose is to limit or avoid tax liability, the Second Circuit stated that the parties have all the more duty to inquire when the surrounding circumstances indicate they should do so.

Finding that the shareholders had constructive knowledge, the transactions were collapsed resulting in state law liability. In collapsing the transactions the Second Circuit found that essentially Double-D sold its assets and then made liquidating distributions of the sales proceeds to its shareholders leaving Double-D insolvent. The Second Circuit remanded to the Tax Court the issue of whether Diebold New York is a transferee under the first prong (federal law) of Section 6901, and whether Diebold Foundation, the appellee, is a transferee of a transferee and which statute of limitations – 3-year, 6-year or other – is applicable.

Conclusion

In the corporate tax world, especially with regard to closely-held C corporations, there is great pressure on shareholders to circumvent the double tax system. Taxpayers deal with this issue in many different ways. For example, using creative debt instruments to create interest deductions, or reducing taxable income by paying substantial salaries and other compensation or engaging in bargain sales or leasing arrangements or through below market loans.

When it comes to disposing of the C corporation, one legitimate approach to avoid the double tax is to structure the transaction as a tax free reorganization pursuant to Section 361, et. seq. Another approach is the election provided by Section

338(h)(10) which if available treats a stock sale by a member of an affiliated group of corporations under Section 1504(a) as an asset sale.

The IRS is very mindful of all this and will challenge transactions if they appear to be without business purpose or not to comply with the statute or regulations and rulings.

The Midco transaction is a rather arrogant extension of the tools used to avoid the double tax. The fraudulent conveyance or fraudulent transfer rules may be the death knell of the Midco transaction.

CITES

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[1] *Diebold v. Commissioner*, Docket No. 12-3225-cv.

[2] All statutory references are to the Internal Revenue Code of 1986, as amended ("Code"), unless otherwise provided.

[3] The IRS considers Midco transactions as "listed transactions" that require registration as a tax shelter. See Notice 2001-16 (2001-C.8.730, January 18, 2001).

[4] Section 1361(a)(2) defines a C corporation as a corporation which is not an S corporation.

[5] See Sections 336 and 1001 for corporate level tax. See Sections 301, 302 and 1001 for shareholder level tax.

[6] Section 197. For example, if the business is worth $100 million of which $90 million represents the value of goodwill, taking into account the present value (at current interest rates) of the goodwill amortization a buyer's net purchase price would be in the neighborhood of $70 million.

[7] Second Circuit opinion at pp. 5-6.

[8] The transactions in *Diebold* occurred prior to Notice 2001-16 (2001-1 C.B. 730, January 18, 2001) which was issued to alert taxpayers and their representatives of certain responsibilities that may arise from participation in these transactions.

[9] The loan had to be repaid within 5 days. The loan was necessary to finance Shap II's acquisition of Double-D's stock. It is noteworthy that the loan was satisfied by the proceeds received from the sale of the assets. The closing had to occur within a very short time frame since Morgan Stanley was under a contractual obligation to deliver the portfolio of securities it was acquiring from Double-D it to its buyer. The closings between Shap II and the shareholders and Shap II and Morgan Stanley were originally scheduled for July 1st; however, the closing between Shap II and Double-D was delayed until July 2nd. As this closing did not occur, Shap II could not transfer the securities to Morgan Stanley. After reaching out to senior management at Morgan Stanley, the closing was allowed to be rescheduled. After all the transactions were completed, (i) the Double-D shareholders sold the stock for approximately $309 million in cash, (ii) Morgan Stanley purchased Double-D's securities and the family entity purchased the real estate, (iii) Shap II received approximately $319 million from the asset sale, (iv) Shap II paid no tax on the sale of Double-D's assets because it claimed losses to offset the built-in gain, and (v) after paying back its loan to Rabobank, Shap II netted a profit of approximately $10 million (Second Circuit Opinion, pp. 12-16).

[10] The IRS failed to raise the argument that Mrs. Diebold was a transferee of a transferee. The IRS chose not to appeal the decision.

[11] *Frank Sawyer Trust of May 1992 v. Commissioner*, 712 F.3d 597 (1st Cir. 2013); *Starnes v. Commissioner*, 680 F.3d 417 (4th Cir. 2012)

[12] Second Circuit opinion at p. 24; New York Debtor and Creditor Law, Section 273. A similar result would likely occur in those states that have adopted the Uniform Fraudulent Transfer Act.

[13] Ibid.
[14] Second Circuit opinion at p. 30.
[15] Second Circuit opinion at p. 32; emphasis in original.