Federal Income Taxation

by Robert Beard*
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I. INTRODUCTION

In the year 2015, the federal courts in the United States Court of Appeals for Eleventh Circuit's appellate jurisdiction addressed an issue of first impression involving tax credits for research expenditures, interpreted new Supreme Court precedent on the enforcement of summonses issued by the Internal Revenue Service (IRS), and applied state law doctrines of transferee liability in the context of "Midco" tax shelters. This Article surveys those decisions.[1]

II. *GEOSYNTEC CONSULTANTS, INC. V. UNITED STATES*

In *Geosyntec Consultants, Inc. v. United States*,[2] the United States Court of Appeals for the Eleventh Circuit addressed a question of first impression in the Circuit about a taxpayer's entitlement to research tax credits under § 41 of the Internal Revenue Code (Code).[3] Adopting the approach of the United States Court of Appeals for the Federal Circuit in *Fairchild Industries, Inc. v. United States*,[4] the Eleventh Circuit held that a taxpayer may only claim the research tax credit if the taxpayer bears the economic risk when the research fails to yield the desired

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1. For an analysis of federal taxation cases decided during the prior survey period, see Robert Beard, *Federal Taxation, Eleventh Circuit Survey*, 66 MERCER L. REV. 1035 (2014).
2. 776 F.3d 1330 (11th Cir. 2015).
3. I.R.C. § 41 (2012). Unless otherwise indicated, all "section" references are to the Code, as amended.
4. 71 F.3d 868 (Fed. Cir. 1995), *modified* (Feb. 23, 1996).

outcome.[5] If the taxpayer stands to be recompensed for its research even in the event of such failure, it may not claim the credit.[6]

A. Background

First introduced as part of the Economic Recovery Tax Act of 1981,[7] the research tax credit of § 41 provides a twenty-percent tax deduction for certain "qualified research expenses."[8] The credit is available both for expenses incurred on in-house research and for a portion of expenses paid to third parties for "contract research."[9] To be "qualified research," the research expenses must meet three criteria.[10] First, the expenses must qualify as expenses under § 174,[11] which means they must have been incurred within the taxable year.[12] Further, "qualified research" must be "undertaken for the purpose of discovering information—(i) which is technological in nature, and (ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer."[13] Finally, "substantially all of the activities" of the research must "constitute elements of a process of experimentation" for the purposes of functional innovation or improvement, performance, or reliability or quality.[14]

A taxpayer may not claim a credit for otherwise-qualifying research if the research is "funded by any grant, contract, or otherwise by another person (or governmental entity)."[15] The Treasury Regulations clarify that an expense only qualifies for the research tax credit if the taxpayer "bear[s] the expense even if the research is not successful."[16] To determine the extent to which research is funded by another person, Treasury Regulation § 1.41-4A(d)[17] provides that "[a]mounts payable under any agreement that are contingent on the success of the research and thus considered to be paid for the product or result of the research

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5. *Geosyntec Consultants*, 776 F.3d at 1335-36.
6. *Id.* at 1336.
7. Pub. L. No. 97-34, 95 Stat. 172 (1981).
8. I.R.C. §§ 41(a), (b)(1).
9. I.R.C. § 41(b)(1).
10. I.R.C. § 41(d)(1).
11. I.R.C. § 174 (2012).
12. I.R.C. § 41(d)(1)(A); *see also* I.R.C. § 174(a)(1).
13. I.R.C. § 41(d)(1)(B).
14. I.R.C. §§ 41(d)(1)(C), 41(d)(3)(A).
15. Treas. Reg. § 1.41-4(c)(9) (2015) ("Qualified research does not include any research to the extent funded by any grant, contract, or otherwise by another person (or governmental entity).").
16. Treas. Reg. § 1.41-2(e)(2)(iii) (2015).
17. Treas. Reg. § 1.41-4A(d) (2015).

(see § 1.41-2(e)(2)) are not treated as funding."[18] Likewise, "[a]n expense is paid or incurred for the performance of qualified research only to the extent that it is paid or incurred pursuant to an agreement that . . . [r]equires the taxpayer to bear the expense even if the research is not successful."[19] Therefore, "[i]f an expense is paid or incurred pursuant to an agreement under which payment is contingent on the success of the research, then the expense is considered paid for the product or result rather than the performance of the research, and the payment is not a [qualified] research expense . . . ."[20]

In *Fairchild Industries*, the Federal Circuit summarized the § 41 rules on entitlement to the tax credit when the research is performed pursuant to a contract with another party:

> The regulations contain "mirror image" rules for determining when the customer for the research, rather than the researcher, is entitled to claim the tax credit. In accordance with Treasury Regulation § 1.41-2(e)(2) the contractual arrangement is the factor that determines who is entitled to the tax benefit, for the customer may claim the credit only if the agreement requires the customer to pay for the research even if it is unsuccessful. If, however, the customer need not pay unless the research is successful, the customer has "paid for the product or result rather than the performance of the research" and can not claim the tax credit because it has assumed no risk. Thus, the regulations implement allocation of the tax credit to the person that bears the financial risk of failure of the research to produce the desired product or result.[21]

The court in *Fairchild Industries* applied the above rule to a fixed-price incentive contract under which the taxpayer, Fairchild Industries, Inc. (Fairchild), would design and produce a training aircraft for the Air Force.[22] The taxpayer's dispute with the IRS centered on whether expenses incurred by Fairchild in producing prototype aircraft were borne by Fairchild (and therefore eligible for the research tax credit) or whether the Air Force's payments under its contract with Fairchild should be treated as reimbursements of those expenses.[23]

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18. *Id.* Although, on its own terms, Treasury Regulation § 1.41-4A only applies to "[q]ualified research for taxable years beginning before January 1, 1986," *id.*, Treasury Regulation § 1.41-4(c)(9) incorporates by reference Treasury Regulation § 1.41-4A(d). *See* Treas. Reg. § 1.41-4(1)(9) (2015).

19. Treas. Reg. § 1.41-2(e)(2)(iii).

20. Treas. Reg. § 1.41-2(e) (2015).

21. 71 F.3d at 870 (quoting Treas. Reg. § 1.41-2(e)(2)) (internal citations omitted).

22. *Id.*

23. *Id.* at 872.

The United States Court of Federal Claims held Fairchild was not the at-risk party for the failure of the research because it received advances and progress payments during the course of the contract.[24] The United States Court of Appeals for the Federal Circuit, however, reversed.[25] Because the contract was clear that Fairchild could only keep the progress payments if the research was successful, Fairchild bore the burden of failure.[26] The fact that the Air Force's advances financed the research was not determinative because Fairchild would have had to reimburse the Air Force in the case of failure. Under these facts, the research was funded by Fairchild within the meaning of § 41.[27]

B. The Geosyntec Opinion

In *Geosyntec Consultants*, the Eleventh Circuit applied the holding of *Fairchild Industries*.[28] The taxpayer, Geosyntec Consultants, Inc. (Geosyntec), was an environmental consulting and engineering firm that carried out research activities pursuant to hundreds of different contracts with clients. Mercifully, the parties were able to identify six representative contracts for detailed review by the court. Some of the contracts were fixed-price contracts, pursuant to which Geosyntec was paid an agreed price for a specified scope of work. The district court found, and the IRS ultimately conceded, expenses incurred pursuant to these agreements constituted qualifying research expenses. Three of the contracts were "capped contracts," under which Geosyntec would be reimbursed for labor costs and expenses actually incurred, plus a markup, subject to a maximum price cap. As in *Fairchild Industries*, the question was whether the research performed pursuant to these capped contracts was "funded" by a third party within the meaning of § 41. The district court found that capped-contract research was funded by the client and therefore was not eligible for the research tax credit. The taxpayer appealed with respect to two of the capped contracts.[29]

The Eleventh Circuit first summarized the two contracts Geosyntec presented on the appeal.[30] Under the "Cherry Island Contract," Geosyntec was to design and engineer the expansion of the Cherry Island Landfill. Geosyntec's total payments under the Cherry Island Contract were capped at approximately $10 million, and payments for

24. *Id.* at 872-73.
25. *Id.* at 874.
26. *Id.* at 873.
27. *Id.*
28. 776 F.3d at 1332.
29. *Id.* at 1332-33.
30. *Id.* at 1336, 1337.

different aspects of the project were subject to additional, separate caps. Geosyntec received monthly payments based on its incurred costs.[31]

Under the second contract, the "WM Contract," Geosyntec was to "evaluate technology for remediating groundwater beneath a warehouse in Niagara, New York" for Waste Management, Inc (WM).[32] The contract required Geosyntec to "(1) perform laboratory bench tests to evaluate the feasibility and performance of enhanced in situ bioremediation (EISB) for groundwater cleanup and (2) prepare a report describing its methodology, tabulating the results, interpreting the data collected, and discussing site conditions and potential pilot-test designs."[33] The WM Contract was capped at approximately $19,000.[34] The WM Contract, like the Cherry Island Contract, required Geosyntec to submit monthly invoices for which it would be reimbursed "upon proper performance of each task at fixed unit prices as set forth in Geosyntec's estimated budget."[35] The WM Contract provided for some modifications of the fixed unit prices as well as of the tasks Geosyntec was required to perform.[36]

In evaluating these agreements, the Eleventh Circuit applied the reasoning of *Fairchild Industries*:

> If Geosyntec was entitled to payment under both or either contract regardless of the success of its research, it is *not* eligible to claim the research tax credit; conversely, if payment to Geosyntec under both or either contract was contingent on Geosyntec's successful research or development of a product or process, Geosyntec is eligible to claim the research tax credit.[37]

Relying on a comparison with the fixed-price incentive contract in *Fairchild Industries*, the Eleventh Circuit ultimately determined both contracts were "funded" within the meaning of § 41.[38] The court first rejected Geosyntec's argument that, because its compensation under the contracts was capped and its billing was tied to its costs, "it ran the risk of not receiving the full ceiling price or, conversely, of exceeding its own budget"[39] This, the court noted was the wrong sense of "risk" for § 41 purposes: "[c]ost-of-performance is not the financial risk with which we

31. *Id.* at 1333, 1336, 1337.
32. *Id.* at 1333.
33. *Id.* at 1337-38.
34. *Id.* at 1338.
35. *Id.* (internal quotation marks omitted).
36. *Id.*
37. *Id.*
38. *Id.* at 1339.
39. *Id.*

are concerned because 'the only issue is whether payment was contingent on the success of the research'—that is, the financial risk of failure."[40] The court further noted on this point that, under certain circumstances, additional compensation would be available to Geosyntec under the contracts.[41]

The court next pointed out "neither the Cherry Island Contract nor the WM Contract expressly made [payment] to Geosyntec contingent on the success of Geosyntec's research."[42] In other words, Geosyntec would be paid for the research work carried out under the contracts even if the result of the research was unfavorable to the client.[43] This payment scheme seems to have been the key factor distinguishing *Geosyntec* from *Fairchild Industries*. If Fairchild had been unable to produce an aircraft satisfying the Air Force's requirements due to an unexpected technical or scientific hurdle, it would have received no payment under its contract. By contrast, Geosyntec would have been paid even if its research produced an unfavorable result.

Geosyntec argued its payments under these contracts were subject to certain conditions, namely quality standards relating to the performance of its services.[44] The court dismissed this argument, emphasizing the distinction between "proper performance" and "successful performance."[45] The court summarized:

> Geosyntec was entitled to payment under both the Cherry Island Contract and the WM Contract regardless of success. Both DSWA and WM contracted with Geosyntec to reimburse Geosyntec for labor and costs for pre-defined tasks at pre-defined rates. Neither the Cherry Island Contract nor the WM Contract provided that DSWA or WM was obligated to reimburse Geosyntec only if Geosyntec produced results that met the contracts' specifications. Similarly, Geosyntec was not entitled to payment only for work product delivered to and accepted by its clients. Because payment to Geosyntec was not contingent on the success of its research, Geosyntec did not bear the financial risk of its own failure, and the two capped contracts were funded by Geosyntec's clients.[46]

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40. *Id.*
41. *Id.* at 1339-40.
42. *Id.* at 1340.
43. *Id.* at 1341.
44. *Id.*
45. *Id.*
46. *Id.* at 1343 (internal citations, quotation marks, and brackets omitted) (quoting *Fairchild Industries*, 71 F.3d at 871).

Accordingly, no research tax credit was permitted. The Eleventh Circuit's holding is a logical extension of *Fairchild Industries*, and its application of that case to several different economic arrangements is instructive.

III. *UNITED STATES V. CLARKE*

Pursuant to its investigative authority, the IRS may issue summonses.[47] When the IRS issues a summons, but the summonsed party "neglects or refuses to obey such summons," the IRS may seek judicial enforcement of the summons.[48] The federal district courts have jurisdiction to enforce those IRS summons.[49] In a summons enforcement proceeding, it is initially the IRS's burden to make a prima facie showing that "the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Commissioner's possession, and that the administrative steps required by the Code have been followed."[50] Once the IRS has met that burden, the party who has been issued the IRS summons "may challenge the summons on any appropriate ground."[51] Courts have generally concluded it is within the district court's discretion to determine whether an evidentiary hearing is warranted when there is such a challenge. However, the Eleventh Circuit was, until recently, bound by old Fifth Circuit precedent that held the summonsed party was entitled to "a limited adversary hearing where the taxpayer may question IRS officials concerning the Service's reasons for issuing the summons."[52]

A 2015 order[53] from the United States District Court for the Southern District of Florida is the latest episode in the federal courts' attempt to determine whether Dynamo Holdings Limited Partnership (Dynamo) and four individuals associated with it (collectively, the Dynamo Parties) are entitled to an adversary hearing on their allegations the IRS had an improper motive in issuing summonses to them.

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47. I.R.C. § 7602(a) (2012).
48. I.R.C. § 7604(b) (2012).
49. I.R.C. §§ 7402(b), 7604(a) (2012).
50. United States v. Powell, 379 U.S. 48, 57-58 (1964).
51. Reisman v. Caplin, 375 U.S. 440, 449 (1964).
52. United States v. Se. First Nat'l Bank of Miami Springs, 655 F.2d 661, 667 (5th Cir. 1981) (footnote omitted).
53. United States v. Clarke, Nos. 11-80456-MC-RYSKAMP/HOPKINS, 11-80457-MC-KLR/JMH, 11-80459-MC-KLR/JMH, 11-80460-MC-KLR/JMH, 11-80461-MC-KLR/JMH, 2015 U.S. Dist. LEXIS 33312 (S.D. Fla. Feb. 18, 2015), *aff'd*, No. 15-11663 (11th Cir. Mar. 15, 2016).

A. *Initial Proceedings in the District Court and Eleventh Circuit*

The *United States v. Clarke*[54] dispute arose from an IRS examination of the large interest deductions Dynamo reported on its tax returns for 2005–2007.[55] Dynamo agreed to two one-year extensions of the statute of limitations period but refused to agree to a third in 2010. The IRS issued summonses in September and October 2010 to the Dynamo Parties. The Dynamo Parties refused to comply with the summonses. Notwithstanding the failure to comply with the summonses, the IRS timely issued a Final Partnership Administrative Adjustment that denied some of Dynamo's interest deductions, which Dynamo challenged in the Tax Court in a suit filed in February 2011. Separately from that litigation, the IRS filed suit in the Southern District of Florida in April 2011, seeking to compel the Dynamo Parties to comply with the summonses.[56]

At the district court summons-enforcement proceedings, the IRS submitted affidavits from the investigating agents to make the required showing under *United States v. Powell*,[57] and the Dynamo Parties responded with various challenges. In particular, the Dynamo Parties argued the circumstantial evidence supported their position that the IRS had issued the summonses as retribution for Dynamo not agreeing to the third extension of the statute of limitations. Those summonses were issued despite the fact that the IRS had not recently requested any information from the Dynamo Parties. The Dynamo Parties further alleged the IRS sought to enforce the summonses in the district court only after Dynamo challenged the IRS's adjustment in the Tax Court as an underhanded way of subverting the Tax Court's discovery rules. The Dynamo Parties moved to depose the IRS agents who had made the affidavits in the hopes of establishing that improper motivations were behind the summonses. The district court denied that request and ordered the Dynamo Parties to comply with the summons.[58]

On appeal, the Eleventh Circuit reversed the district court in a short per curiam opinion.[59] Citing binding Eleventh Circuit precedent that "an allegation of improper purpose is sufficient to trigger a limited adversary hearing where the taxpayer may question IRS officials

54. 134 S. Ct. 2361 (2014).
55. *Id.* at 2365.
56. *Id.* at 2365, 2365-66, 2366.
57. 379 U.S. 48 (1964).
58. *Clarke*, 134 S. Ct. at 2366.
59. United States v. Clarke, 517 F. App'x 689 (11th Cir. 2013).

concerning the Service's reasons for issuing the summons,"[60] the court held that the Dynamo Parties were "entitled to a hearing to explore their allegation of an improper purpose."[61] The reasoning behind that rule, the court explained, was that "requiring the taxpayer to provide factual support for an allegation of an improper purpose, without giving the taxpayer a meaningful opportunity to obtain such facts, saddles the taxpayer with an unreasonable circular burden, creating an impermissible 'Catch 22.'"[62] Thus, the court remanded so the Dynamo Parties could question the IRS agents about any improper motive in issuing and seeking to enforce the summonses.[63]

The United States then filed a certiorari petition with the United States Supreme Court, which was granted.[64]

B. The Supreme Court Vacates and Remands

Noting that "[e]very other Court of Appeals has rejected the Eleventh Circuit's view that a bare allegation of improper motive entitles a person objecting to an IRS summons to examine the responsible officials," the Supreme Court vacated and remanded the case.[65]

In a unanimous opinion authored by Justice Kagan, the Court explained that although summons proceedings are adversarial rather than ex parte, they are nonetheless "summary in nature."[66] In the tax context, the summons "is a crucial backstop in a tax system based on self-reporting."[67] Thus, it is sensible "that courts may ask only whether the IRS issued a summons in good faith, and must eschew any broader role of 'oversee[ing] the [IRS's] determinations to investigate.'"[68] The Court set out the applicable rule:

> As part of the adversarial process concerning a summons's validity, the taxpayer is entitled to examine an IRS agent when he can point to specific facts or circumstances plausibly raising an inference of bad faith. Naked allegations of improper purpose are not enough: The taxpayer must offer some credible evidence supporting his charge. But circumstantial evidence can suffice to meet that burden; after all, direct evidence of another person's bad faith, at this threshold stage, will

60. *Id.* at 691 (quoting *Se. First Nat'l Bank of Miami Springs*, 655 F.2d at 667).
61. *Id.*
62. *Id.*
63. *Id.*
64. United States v. Clarke, 134 S. Ct. 895 (2014).
65. *Clarke*, 134 S. Ct. at 2367.
66. *Id.* (quoting United States v. Stuart, 489 U.S. 353, 369 (1989)).
67. *Id.*
68. *Id.* (quoting *Powell*, 379 U.S. at 56).

> rarely if ever be available. And although bare assertion or conjecture is not enough, neither is a fleshed out case demanded: The taxpayer need only make a showing of facts that give rise to a plausible inference of improper motive. That standard will ensure inquiry where the facts and circumstances make inquiry appropriate, without turning every summons dispute into a fishing expedition for official wrongdoing.[69]

Because the Eleventh Circuit had "viewed even bare allegations of improper purpose as entitling a summons objector to question IRS agents," it applied the incorrect standard.[70] Rather than that incorrect categorical rule, the Supreme Court instructed the Eleventh Circuit to determine whether the circumstantial evidence produced by the Dynamo Parties raised a plausible inference of bad faith.[71]

The Supreme Court mentioned the two theories of improper motive that the Dynamo Parties had put forward but, noting that the legal sufficiency of those theories was beyond the scope of its review, remanded the case to the Eleventh Circuit for further proceedings.[72] The Eleventh Circuit further remanded the case to the district court so that it could apply the Supreme Court's standard.[73]

C. *Proceedings Upon Remand*

The district court applied the Supreme Court's standard to "determine whether Respondents point to specific facts or circumstances that plausibly raise an inference of improper purpose and to determine whether the improper purposes alleged by Respondents are improper as a matter of law."[74] The district court did not reach the factual issue because it found the Dynamo Parties' various challenges to the IRS summons failed as a matter of law.[75] First, "[t]hat a secondary use of the requested information may exist . . . does not render the request for the information improper."[76] Second, the court found "unsupported by any evidence" the allegation the summons were issued to punish Dynamo for not agreeing to the third statute of limitations waiver.[77] It stated that "[i]f information remains to be gathered and the statute of limitation has expired, the IRS has no alternative but to institute a

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69. *Id.* at 2367-68.
70. *Id.* at 2368.
71. *Id.*
72. *Id.* at 2369.
73. *See* United States v. Clarke, 573 F. App'x 826, 827-28 (11th Cir. 2014).
74. *Clarke*, 2015 U.S. Dist. LEXIS 33312, at *1.
75. *Id.* at *7.
76. *Id.* at *3.
77. *Id.* at *4.

formal summons process."[78] Third, the district court rejected the argument that "the Government's power to enforce a summons terminates when a taxpayer petitions the Tax Court because such could allow the Government to obtain more information than it could by Tax Court discovery rules."[79] The court explained that "[t]he validity of a summons is tested at the date of issuance, and events occurring after the date of issuance but prior to enforcement should not affect enforceability."[80] The district court further disposed of the Dynamo Parties' argument that comity prevented enforcement of the summons in the district court "because enforcement of the summons is the same proceeding pending before the Tax Court."[81] Because the Tax Court lacks jurisdiction over summons proceedings, the court noted that the two proceedings were not the same.[82] Finally, the Dynamo Parties' argument that "the issuance of the summons may have violated the intent of the Internal Revenue Manual" was rejected because the Internal Revenue Manual "confers no rights on [taxpayers]."[83] With that, the district court ordered that the summonses would be enforced.[84]

With the resolution of the *Clarke* litigation, the Eleventh Circuit has now been brought into line with its sister circuits on the evidentiary standard to apply in summons-enforcement proceedings where the summonsed party seeks to question the IRS examiners.

IV. MIDCO SHELTERS AND TRANSFEREE LIABILITY

The third notable area of tax decisions within the Eleventh Circuit involves "Midco" tax shelters and state law doctrines of transferee liability. Two cases, decided in the Tax Court but appealable to the Eleventh Circuit, addressed this issue.

A. *Midco Transactions*

A Midco transaction is a tax shelter that attempts to circumvent the fundamental tax conflict between buyers and sellers in the sale of a corporate business.[85] The basic structuring question in such a sale is whether to accomplish the transaction through a sale of the corporation's

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78. *Id.*
79. *Id.* at *4, *7.
80. *Id.* at *4.
81. *Id.* at *4, *7.
82. *Id.*
83. *Id.* at *5, *6.
84. *Id.* at *7.
85. *See* Diebold Found., Inc. v. Comm'r, 736 F.3d 172, 176 (2d Cir. 2013).

stock by the shareholders or through a sale of the corporation's assets by the corporation itself.[86] When shareholders transfer a corporation through a stock sale, they will recognize gain equal to the difference between their bases in the stock and the purchase price.[87] The corporation pays no tax since it continues to own all of its assets.[88] Thus, there is only one layer of taxation in a stock sale. The buyer, however, will inherit the corporation's historic basis in its assets, no matter how much the buyer paid for the corporation's stock.[89] If the corporation's assets have appreciated in value compared to their tax basis, the buyer will generally not be able to recoup its tax investment through depreciation deductions going forward because corporate stock is not depreciable and the tax basis of any depreciable corporate assets is unaffected by the transactions.[90]

For this reason, the buyer may be willing to pay a higher price if it can purchase assets from the corporation and then have the corporation liquidate and distribute the after-tax sales proceeds to the shareholders. This structure gives the buyer a purchase price basis in any depreciable property of the corporation, but it also introduces a second layer of taxation: first on the corporation when it sells the assets, then on the shareholders when the corporation distributes the cash in liquidation.[91] Thus, the shareholders selling the corporation generally prefer to structure the transaction as a stock sale, rather than an asset sale, but the buyer generally prefers the opposite.[92]

The Midco transaction purports to allow both parties to receive their preferred treatment: sellers get a stock sale and buyers get an asset sale.[93] The structure of a Midco tax shelter has been summarized by the Second Circuit:

> "Midco transactions" or "intermediary transactions" are structured to allow the parties to have it both ways: letting the seller engage in a stock sale and the buyer engage in an asset purchase. In such a transaction, the selling shareholders sell their C Corp stock to an

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86. *See id.* at 175.

87. *Got Stock? Cost Basis Rules May Impact Taxes*, FORBES (Jan. 19, 2012, 12:24 PM), www.forbes.com/sites/kellyphillipserb/2012/01/19/got-stock-cost-basis-rules-may-impact-taxes/#10bdbd7616d6.

88. *Diebold*, 736 F.3d at 175.

89. *Asset Sale vs Stock Sale: What's The Difference?*, ALLIED BUSINESS GROUP, www.alliedbizgroup.com/resources/publications/asset-sale-vs-stock-sale.html (last visited Mar. 1, 2016).

90. *Id.*

91. *Id.*

92. *See Diebold*, 736 F.3d at 175.

93. *Id.*

> intermediary entity (or "Midco") at a purchase price that does not discount for the built-in gain tax liability, as a stock sale to the ultimate purchaser would. The Midco then sells the assets of the C Corp to the buyer, who gets a purchase price basis in the assets. The Midco keeps the difference between the asset sale price and the stock purchase price as its fee. The Midco's willingness to allow both buyer and seller to avoid the tax consequences inherent in holding appreciated assets in a C Corp is based on a claimed tax-exempt status or supposed tax attributes, such as losses, that allow it to absorb the built-in gain tax liability.[94]

If the IRS successfully challenges the claimed treatment of the Midco transaction, however, it may face additional challenges in collecting the unpaid tax:

> If these tax attributes of the Midco prove to be artificial, then the tax liability created by the built-in gain on the sold assets still needs to be paid. In many instances, the Midco is a newly formed entity created for the sole purpose of facilitating such a transaction, without other income or assets and thus likely to be judgment-proof. The IRS must then seek payment from the other parties involved in the transaction in order to satisfy the tax liability the transaction was created to avoid.[95]

In a successfully challenged Midco transaction, the primary taxpayer—the transferred corporation—has invariably been liquidated by the time the IRS is able to assess a tax against it.[96] The Midco, as noted above, is often judgment-proof.[97] The purchaser of the assets is typically in the position of having purchased assets in good faith for value, so it may be challenging to frame a case for secondary liability against the purchaser.[98] Faced with these facts, the government has sometimes chosen to pursue the selling shareholders under § 6901,[99] which allows the IRS to assess tax liabilities against certain transferees.[100] However, the Supreme Court long ago held, in discussing the predecessor statute to § 6901, that it "neither creates nor defines a substantive liability but provides merely a new procedure by which the Government may collect taxes."[101] Under the doctrine of *Erie Railroad*

94. *Id.* at 175-76.
95. *Id.* at 176.
96. *See id.* at 181.
97. *Id.* at 176.
98. *Asset Sale vs Stock Sale: What's The Difference?*, *supra* note 89.
99. I.R.C. § 6901 (2012).
100. I.R.C. § 6901(a).
101. Comm'r v. Stern, 357 U.S. 39, 42 (1958) (discussing former § 311).

Co. v. Tompkins,[102] "the existence and extent of liability should be determined by state law."[103] Thus, to impose the unpaid tax on one of the other parties to the Midco transaction, the IRS must first establish that party's liability under state law doctrines of transferee liability, much as any ordinary creditor would in pursuing the transferee of a debtor's assets.[104] Only then, if that party is a transferee for purposes of § 6901, may the IRS pursue it as liable for the unpaid tax.[105]

B. Two Tax Court Cases

Two 2015 cases decided in the Tax Court, but appealable to the Eleventh Circuit, addressed the issue of transferee liability in Midco transactions. In *Shockley v. Commissioner*,[106] the Tax Court applied the Wisconsin Uniform Fraudulent Transfer Act (WIUFTA)[107] in determining that the shareholders of a corporation sold through a Midco transaction were liable for the Midco's unpaid tax.[108] In *Alterman v. Commissioner*,[109] however, the Tax Court found numerous "evidentiary holes" in the IRS's contention that, under the Florida Uniform Fraudulent Transfer Act (FUFTA),[110] the selling shareholders of a corporation were liable.[111] Although both statutes adopt (with some modifications) the Uniform Fraudulent Transfer Act, these two cases show how that law can yield very different results in the context of Midco transactions, depending in large part on what evidence the IRS has of intent or bad faith.

In *Shockley*, the petitioners, now residents of Florida, were former shareholders of a closely held corporation that owned television and radio stations in Wisconsin. When the petitioners decided to sell the company, they engaged a media broker to help facilitate a stock sale. A particular challenge in the transaction was that purchasers were most likely expected to want either the corporation's television or radio assets, but not both. Because of the petitioners' desire for a stock sale and any potential purchaser's desire for a piecemeal asset sale, a Midco transaction was particularly appealing. Eventually, with the help of their broker, the petitioners negotiated a set of three agreements,

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102. 304 U.S. 64 (1938).
103. *Stern*, 357 U.S. at 45.
104. *See Diebold*, 736 F.3d at 184.
105. *See id.* at 183-84.
106. 2015 U.S. Tax Ct. LEXIS 26 (June 22, 2015).
107. WIS. STAT. ANN. §§ 242.01 to .11 (West 2015).
108. 2015 U.S. Tax Ct. LEXIS 26, at *55.
109. 2015 Tax Ct. Memo LEXIS 239 (Dec. 1, 2015).
110. FLA. STAT. ANN. §§ 726.101 to .201 (West 2014).
111. 2015 Tax Ct. Memo LEXIS 239, at *84-85.

pursuant to which they agreed (through a complicated series of steps, the details of which are not relevant to this discussion) to sell their shares in the company to an intermediary corporation formed specifically for that purpose, which would then sell the assets to two other companies.[112]

The petitioners in *Shockley* had been notified at the outset that these transactions are sometimes challenged by the IRS. They were even sent copies of IRS Notice 2001-16, 2001-1 CB 730,[113] which first identified Midco transactions as among those "listed transactions" the IRS can challenge legally.[114] Further, the petitioners had "[l]eading up to and throughout the closing, . . . engaged experienced professionals and attorneys to handle complicated areas of the transactions including . . . taxation."[115]

In the Tax Court, the IRS sought to disregard the form of the transaction and characterize it as an asset sale and further sought to collect unpaid taxes (including penalties and interest) from the former shareholders.[116] Despite the petitioners' argument that the substance-over-form doctrine was inapplicable under WIUFTA, the Tax Court, relying on a recent United States Court of Appeals for the Seventh Circuit opinion, held that "state fraudulent-transfer law is itself flexible and looks to equitable principles like 'substance over form,' just like the federal tax doctrines."[117] Further relying on the Seventh Circuit's interpretation of WIUFTA, the Tax Court noted that "subjective intent and good faith play no role in the application of WIUFTA's constructive fraud provisions."[118] Thus, the Tax Court held the substance-over-form principle applied to the transaction.[119]

Having set out that principle as its guide, the Tax Court had little trouble determining that the complex structure of the series of transactions involving entities created for no other purpose than tax avoidance was "a prime example of how a transaction can be structured so that its form might meet the letter of the law, but it nevertheless is being used in a manner incongruous with the intent of that law."[120] The court concluded, "The Midco transaction is therefore disregarded," and

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112. *Shockley*, 2015 U.S. Tax Ct. LEXIS 26, at *3, *4, *7-8. One of the companies was formed by the Shockleys themselves to facilitate the transaction. *Id.* at *3.

113. I.R.B. Notice 2001-16, 2001-1 C.B.730.

114. *Shockley*, 2015 U.S. Tax Ct. LEXIS 26, at *9, *14.

115. *Id.* at *21.

116. *Id.* at *28.

117. *Id.* at *33 (quoting Feldman v. Comm'r, 779 F.3d 448, 459 (7th Cir. 2015)).

118. *Id.* at *34.

119. *Id.* at *35.

120. *Id.* at *40.

recharacterized the transaction as an asset sale with subsequent distribution in de facto liquidation of the corporation.[121] Under this recharacterization, WIUFTA would clearly apply, and the IRS was permitted to assert the corporate-level tax liability against the former shareholders.[122]

A strikingly different conclusion was reached in *Alterman*, a consolidated set of cases involving another Midco transaction. In this case, the corporation operated a trucking business. After the death of its founder, his heirs decided to wind up the business. Over the course of 2003, the corporation sold off its business assets. Instead of liquidating the entity, however, the shareholders sold its stock to MidCoast, which represented itself as being engaged in the credit-card receivables business. According to MidCoast, it wanted to acquire the corporate shell because the nature of its business would permit it to defer the tax liability associated with the 2003 asset sales and obtain a refund of the estimated 2003 taxes that had been paid by the corporation. The shareholders, who were represented by experienced counsel, conducted thorough due diligence on the acquirer and obtained extensive contractual undertakings that the acquirer would cause the corporation to pay its tax liabilities and remain in existence as an operating business entity for at least four years. On these terms, the shareholders sold their stock to MidCoast. Unbeknownst to the sellers, MidCoast had no intention of using the corporation for any business purpose and promptly resold the stock to another entity, which transferred the corporation's remaining cash assets to an offshore bank account and made no provision for payment of the tax liability from the 2003 asset sales. MidCoast was subsequently sued for fraud by the selling shareholders, and a number of MidCoast principals were federally indicted.[123]

The IRS asserted transferee liability under § 6901 against the sellers. As discussed above, § 6901 requires the IRS to demonstrate the transferee would be liable to a creditor of the transferor under the fraudulent conveyance or similar law of the applicable state (in this case, Florida). In attempting to make this showing, the IRS argued that the court should recast the transactions in accordance with federal substance-over-form principles prior to making the state law determination of whether transferee liability existed.[124] The Tax Court summarily refused to do this, deeming it "well established that the Commissioner cannot recast transactions under Federal law and then

121. *Id.* at *43.
122. *Id.* at *51.
123. *Alterman*, 2015 Tax Ct. Memo LEXIS 239, at *4, *6-7, *8, *11, *18, *27, *33.
124. *Id.* at *48.

apply state law to the transactions as recast."[125] The court further determined the form of the transaction would be respected under Florida fraudulent conveyance law because the sellers lacked actual or constructive knowledge of the intended fraud, exercised due diligence, and reasonably believed MidCoast would honor its contractual agreements to discharge the tax liabilities of the corporation.[126] The court noted that sellers of a corporation have only limited responsibilities in getting assurances from the buyer that any subsequent tax liabilities will be satisfied.[127] The Tax Court went on to dismiss a number of theories that might have established transferee liability under Florida law.[128]

At first glance, *Shockley* and *Alterman* seem hard to reconcile. In the first case, the Tax Court allowed the IRS to recast the facts of the transaction using federal tax law principles to establish the state law requirements for transferee liability. By contrast, the *Alterman* court held the IRS to the actual form of the transaction for conducting the state law analysis even if that form could be recharacterized for federal tax purposes. The likely resolution of this apparent inconsistency is that the recast permitted in *Shockley*, though made by applying federal tax principles, was (at least in the court's judgment) required by Wisconsin state law. That is to say, the Tax Court (relying on an Seventh Circuit precedent) concluded Wisconsin law calls for substance-over-form principles similar to those of federal tax law to be applied to determine when transferee liability exists. In *Alterman*, on the other hand, the court interpreted Florida law to permit a recast only where the transferee had actual or constructive knowledge of the entire scheme. Since the court found this requirement was not met in *Alterman*, the IRS was held to the form of the transaction and was subsequently unable to establish transferee liability.

125. *Id.* at *44-45.
126. *Id.* at *49, *51, *52, *60.
127. *Id.* at *57-58.
128. *Id.* at *47.

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