"Midco" Intermediary Transactions Scrutinized

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Some may argue that it's not entirely fair to call the intermediary transactions made (in)famous by Notice 2001-16, 2001-1 CB 730, "tax shelters."

These constructs may in some sense be artificial, but as their name suggests, that is primarily in their interposition of an extra party and at least one extra step. Arguably, this is different from the kind of loss creation and basis shifting that characterizes much else in this nether world. Regardless of what moniker you give these transactions, however, M&A TAX REPORT readers are probably all aware of the IRS condemnation. Such transactions have in the past been attacked, and are still being carefully watched.

Notice 2001-16, of course, lays out the archetypal fact pattern, and it's worth revisiting how one of these transactions is designed to—but probably doesn't—work. Notice 2001-16 postulates a seller who wants to sell the stock of a corporation, a buyer who wants to purchase the assets (sound familiar?), and an intermediary corporation. The seller sells the stock of the target corporation to the intermediary, and the intermediary, in turn, sells the assets to the buyer. Generally, the intermediary has tax losses or tax credits, and the target corporation and the intermediary thereafter file a consolidated return to make use of these losses or credits against the corporate level gain triggered on the sale.

There are several variations on this theme. In one variation, the intermediary is an entity not subject to tax, and the target corporation will liquidate in a transaction that is not intended as a taxable liquidation. Regardless of which variation you choose, Notice 2001-16 warns that the IRS views this as a Midco or intermediary shelter. This transaction and "substantially similar ones" are listed transactions.

Where There's a Will, There's a Way

Notwithstanding the intended chilling effect of Notice 2001-16, the market reaction was hardly a deep freeze. Transactions designed to achieve similar results have continued, often with differing mechanics designed to fall outside the "substantially similar" taint. In one variation, the target corporation sells its assets first, and thereafter, a third party would purchase the target stock in what was then a closely held shell corporation (which by this time typically was holding only cash).

Proponents of this kind of deal take the position that this transaction is not "substantially similar" to the transaction described in Notice 2001-16. After all, the argument goes, there was no intermediary interposed between the asset buyer and the seller. The asset sale would (ostensibly) occur independently, and would close prior to the third party becoming involved. The third party, the reasoning went, could logically claim that it was not an intermediary with respect to the buyer and seller. How could it be?

Although these types of transactions were still cropping up, there is no question that Notice 2001-16 has had an *in terrorem* effect. Indeed, even many buyers and sellers who were *not* doing transactions substantially similar to Notice 2001-16 were concerned that their transactions *might* be viewed as substantially similar. There is some evidence that transactions were (perhaps unnecessarily) reported as listed transactions because of this fear.

Four Objective Criteria

Enter Notice 2008-20, IRB 2008-6, 406, Tax Analysts Document 2008-1029. Notice 2008-20 is meant to clarify which transactions need to be disclosed as achieving the same result as the midco transaction outlined in Notice 2001-16. Significantly, the new notice shifts the focus from the intermediary toward four criteria that are meant to be objectively measurable. The latest IRS notice also carves out safe harbors for certain transactions.

A transaction will be considered the same as (or substantially similar to) the listed intermediary shelter transaction if all four components are present in a transaction that attempts to avoid corporate tax on an asset sale. The four components include the following:

1. The target owns assets (directly or indirectly), and the sale of the assets would result in taxable gain at the time of the disposition of stock described in Paragraph 2 below; *and* the corporation (or consolidated group) has insufficient tax benefit to eliminate or offset (in whole or in part) that taxable gain. [The tax from such a sale is referred to as a "built-in tax." The "tax benefits" exclude benefits attributable to listed transactions or property with a built-in loss acquired within twelve months prior to the stock disposition described in Paragraph 2, to the extent the built-in losses exceed built-in gains acquired in the same transaction.]
2. At least 50 percent of the corporation's stock (by either vote or value) is disposed of by one or more sellers, other than in liquidation, in one or more related transactions within a 12-month period.
3. Within 12 months before or twelve months after the date on which one or more sellers

dispose of at least 50 percent of the stock (by vote or value), all or most of the corporation's assets are disposed of to one or more buyers, where gain is recognized with respect to the assets. (This 24-month window is extended for any time when the corporation is protected or hedged against price flucuations.)

4. All or most of the built-in tax that would otherwise result from the disposition is purportedly offset, avoided or not paid.

Formulaic Approach

Given the reaction to Notice 2001-16, and the fact that it is decidedly amorphous to try to discern whether one transaction is substantially similar to another, it may not be surprising that the IRS has now opted for a four-factor litmus test that is designed to be more or less mechanical. Despite being understandable, though, it is troubling that there seems to be no knowledge or intent element. A taxpayer could apparently run afoul of Notice 2008-20 quite innocently, and without any intent to engage in an abusive transaction.

Moreover, M&A Tax Report readers will discern the odd-speak of "all or most" which appears several times in the four factors. It is not exactly a phrase that trips lightly off the tongue, nor one that hearkens to established tax law standards with which we're familiar. "All or substantially all," for example, has a storied meaning. "All or most" may be a different (undefined) standard.

Case Law

It is impossible to write about intermediary transactions that are the subject of Notice 2001-16 and Notice 2008-20 without commenting on *Enbridge Energy Co., Inc.*, DC-TX, 2008-1 USTC ¶50,266 (2008). This case involved the contemplated sale of a company wholly owned by Mr. Langley to Midcoast Energy Resources, Inc. The transaction occurred in 1999, long before Notice 2001-16 was released.

The usual whipsaw was present, with Langley wishing only to sell his stock, and Midcoast only wanting to buy assets and to obtain larger depreciation deductions prospectively. In an effort to sweeten the deal economically, Midcoast's tax advisor (PricewaterhouseCooper) proposed to have Langley sell his stock to a third party, which would thereafter cause the target to sell its assets to Midcoast. Midcoast would thereby get a cost basis in the target's assets, while Langley would be subject to only a single level of tax (at capital gains rates, no less).

Accordingly, the two acquisitions occurred mere days apart in the waning days of 1999. Since this was a $198 million deal, there was a price differential between the stock purchased and the assets sold of $6.364 million. Challenging the transaction, the IRS characterized this price differential as a mere fee to accommodate the intended tax avoidance of the parties. The intermediary in the case was a separate purpose company formed for the deal. The intermediary's parent company had contributed high basis, low value assets that were used to offset the gain on the asset sale.

Crying foul, the IRS adjusted Midcoast's return to reflect an acquisition of the target's stock instead of its assets. Under the IRS approach, the target's assets retained their historical basis, so Midcoast's enhanced depreciation deductions were disallowed. The taxpayer went to District Court, and the IRS argued that the intermediary's participation had to be disregarded. By doing that, Midcoast should be deemed to have purchased the target stock from Langley; Midcoast should then be treated as having liquidated the target.

The primary legal doctrine discussed in the case was the conduit theory. Applying substance over form and conduit theories, the court agreed with the IRS. The conduit theory allows courts to disregard an entity (as well as its role in a transaction) if the entity is a mere conduit for the *real* transaction. Tax history buffs will remember an early invocation of the conduit concept in *Court Holding Co.*, SCt, 45-1 USTC ¶9215, 324 US 331 (1945).

With such hoary precedents, the court examined the aptly named Midcoast deal. The intermediary here was a mere conduit which the court felt it could flatly disregard. The sole purpose of the intermediary entity, said the court, was to attempt to alter the tax consequences of the transaction. The court cited several other cases underscoring the conduit concept. [*See Reef Corp.*, CA-5, 66-2 USTC ¶9716, 368 F2d 125 (1966); and *J.E. Davant*, CA-5, 66-2 USTC ¶9618, 366 F2d 874 (1966).]

Court Litmus Test?

It may be dangerous to suggest that there is sufficient law on this topic to set forth rules. Still, the District Court in *Enbrige Energy* laid out key considerations that it felt should be addressed in determining whether the conduit theory should be applied to disregard an intermediary role. These indices include the following:

- Have the principals agreed to a transaction before the intermediary is on the scene?
- Is the intermediary independent?
- Has the intermediary assumed any risk?
- Is the intermediary brought into the transaction at the behest of the taxpayer?
- Is there a nontax avoidance business purpose to the intermediary's participation in the transaction?

Against these standards, Langley's end-around sale to Midcoast failed to measure up. It was Midcoast's advisor (PwC) who invited the intermediary onto the scene. Then, disturbingly, the evidence failed to show that the intermediary negotiated the stock sale. Indeed, all the communications involved Midcoast and its tax advisors (the latter of whom undertook an agreement not to liquidate the target for two years following the sale of assets).

But that, as they say in infomercials, is not all. The intermediary's obligations were almost entirely indemnified by Midcoast, and the intermediary was in almost all respects a mere shell. The sole purpose the intermediary had in participating in the transaction was to allow Midcoast to step-up its basis in the assets.

Those who favor the aphorism "nothing ventured, nothing gained" may want to rethink its wisdom. After all, Midcoast got royally burned here. Not only was the transaction recast as Midcoast's purchase of the target stock directly from Langley, but the target was deemed liquidated. When the smoke cleared, Midcoast as the distributee ended up holding the assets it received in the liquidation at the same historic basis those assets had in the target's hands. Ouch!

Safe Harbors

They are unlikely to be of much use, but it is worth noting that Notice 2008-20 did carve out a couple of circumstances in which a transaction will not be subject to the four-pronged gauntlet of the notice. For one, a *seller* avoids being treated as a participant in one of these intermediary transactions if the stock you dispose of is traded on an established securities market, and if prior to the disposition, you (and related parties) did not hold five percent or more (by vote or value) of any class of the stock.

Moreover, in no event will a *buyer* be treated as a participant in one of these deals if the only target assets the buyer acquires (and then sells) are either securities traded on an established market representing less than five percent in that class of security, or assets that are not securities and that do not include a trade or business.

Conclusion

If Notice 2001-16 wasn't warning enough, it may be that Notice 2008-20 has (finally) put the kibbash on intermediary or midco transactions. Between *Enbridge Energy* and Notice 2008-20, it just may be a true double whammy.