More "Midco" Transaction Advice: Part I

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Part II of this article will appear in the March 2009 issue.

The IRS has issued several Notices regarding what it refers to as intermediary transaction tax shelters. At its root, an intermediary transaction involves, well, an intermediary that enters the scene to facilitate a transaction. On its own, that shouldn't be bad.

Yet, at its root, a Midco transaction seeks to avoid corporate tax triggered on a sale of assets. Recently, in Notice 2008-20, IRB 2008-6, 406, Tax Analysts Document No. 2008-1029, the IRS identified four necessary components of an intermediary tax shelter. The IRS viewed the matter from the perspective of the target corporation, its shareholders, and from the point of view of the purchasers of the target corporation's assets.

Now, less than a year later, the IRS has issued Notice 2008-111, IRB 2008-51, Dec. 1, 2008, clarifying Notice 2001-16, and superceding Notice 2008-20. But our story really begins back in 2001.

Notice 2001-16

The IRS first targeted so-called intermediary shelters in Notice 2001-16, 2001-1 CB 730. This Notice dealt with the use of an intermediary to sell the assets of a corporation. Notice 2001-16 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. 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.

Bill Chill

There was a chilling effect to Notice 2001-16, but the market reaction was hardly a deep freeze. Transactions designed to achieve similar results continued, often with differing mechanics designed to avoid the "substantially similar" taint. In one variation, the target corporation sold its assets first. Then, a third party purchased the target stock in a closely held shell corporation (which by this time was typically holding only cash). The argument was that such a transaction should be ok, because there was no intermediary interposed between the asset buyer and the seller.

The asset sale would close prior to the third party becoming involved, so the third party might logically claim that it was not an intermediary with respect to the buyer and seller.

In contrast, many buyers and sellers who were not doing transactions substantially similar to Notice 2001-16 were becoming concerned that their transactions might be viewed as substantially similar. There is some evidence that some transactions were (perhaps unnecessarily) reported as listed transactions because of this fear.

Four Objective Criteria

Enter Notice 2008-20. Notice 2008-20 clarified which transactions need to be disclosed as achieving the same result as the Midco transaction outlined in Notice 2001-16. Now the IRS has superceded Notice 2008-20 with Notice 2008-111. The new notice shifts the focus from the intermediary toward four criteria that are meant to be objectively measurable.

Under the latest Notice, an intermediary transaction is defined in terms of its plan, and with respect to some objective criteria. A transaction will be treated as an intermediary transaction with respect to a particular person only if:

- that person engages in the transaction pursuant to the plan;
- the transaction contains the four objective components that indicate an intermediary transaction; and
- no safe harbor exception applies to that person.

What Is a Plan?

An intermediary transaction involves a target corporation that would have a federal income tax obligation with respect to the disposition of assets, the sale of which would result in taxable gain (defined as built-in gain assets) in a transaction that would afford the acquirer a cost or a fair market value basis in the assets. M&A TAX REPORT readers will readily note that this first element of an intermediary transaction could describe just about anyone. An intermediary transaction is structured to cause the tax obligation for the taxable disposition of the built-in gain assets to arise in connection with the disposition by the shareholders of all or a controlling interest in the target's stock, under circumstances where the person(s) primarily liable for the federal income tax obligation on the disposition of built-in gain assets will not pay that tax.

In other words, the plan is quite broadly characterized as simply having to do with a target selling built-in gain assets, where the sale of assets has something to do with a sale of stock and normal tax will not be paid.

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