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The Boomerang Tax Problems of Midco Acquisitions — Part 1

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Paying a combination of corporate- and shareholder-level taxes on the proceeds of a business sale is never desirable, making intermediary transactions appealing. Wood looks at midco transactions and considers the IRS's varied transferee liability assertions against participants.

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Selling shareholders of a C corporation almost invariably prefer to sell stock rather than have the company sell assets. The latter involves a corporate tax on the asset sale followed by shareholder-level tax on the distributions. That double tax has been standard fare since the repeal of the *General Utilities* doctrine in 1986.

Buyers, on the other hand, normally prefer to purchase assets. They hope to avoid corporate liabilities and get a stepped-up basis in the assets. Use of a middleman is a logical way for buyers and sellers alike to get what they want. And that is where midco transactions, also known as intermediary transaction tax shelters, come in.

Typically the midco entity buys stock from the selling shareholders, sells assets to the buyer, and covers the asset-level tax. One might ask how there could be anything wrong with that. If the midco entity is rich enough, foolish enough, or tax-loss-bloated enough to do it, how and why does the IRS attack these transactions?

The devil is in the details, and given the way the fact patterns have developed, it is easy to see why. The IRS views the midco entity as a type of devil, not the savior that the parties — particularly the seller — might perceive. The Service's experience shows that midco entities have questionable ways of offsetting taxes due and that they may have very limited assets.

Of course, this kind of arbitrage is not new. In fact, whether selling shareholders sold the stock of a corporation or instead caused the corporation to sell its assets is a classic tax question, one nearly metaphysical in scope. Although the shareholders may be pulling the strings, the corporation is a separate taxpayer and is taxed on its own sales.[1]

Nevertheless, the typical midco transaction looks bad on its face. The IRS stated its position about these transactions and immortalized their status over a decade ago in Notice 2001-16.[2] The IRS targeted intermediary shelters by laying out the archetypal fact pattern.

The players are a seller who wants to sell stock, a buyer who wants to purchase assets, and an intermediary. The seller sells the stock to the intermediary. The intermediary in turn sells the assets to the buyer. Generally the intermediary has tax losses or credits. The target and the intermediary thereafter file a consolidated return to use the losses or credits against the corporate gain triggered on the sale.

Theoretically, everyone goes away happy except the IRS. There are many variations on this theme. For example, the intermediary may be an entity not subject to tax, and the target corporation may liquidate in a transaction that is not intended as a taxable liquidation.

Ultimately, regardless of the variation, Notice 2001-16 warns against midco or intermediary shelters, including "substantially similar" ones, which it labels as listed transactions. Exactly which types of midco transactions were targeted by the IRS has

[1]*See, e.g., J.T.S. Brown's Son Co. v. Commissioner*, 10 T.C. 840 (1948).
[2]2001-1 C.B. 730, *Doc 2001-2019*, *2001 TNT 13-3*.

been debated. In Notice 2008-20,[3] the IRS identified four necessary components of what it called an intermediary tax shelter:

- built-in gain assets (in other words, a tax that would be triggered on an asset sale);
- 80 percent vote and value requirement (80 percent of the stock being sold within 12 months);
- assets versus stock (65 percent or more of the target's assets being disposed of within 12 months after the stock transaction); and
- tax avoidance (at least half the target's built-in gain ends up not being taxed).

Those four components plus a "plan" mean the transaction is suspect in the IRS's view. The plan requirement is broad. In fact, it is arguably present virtually any time a target is selling built-in gain assets when the sale of assets is related to a sale of stock designed to avoid tax.

However, a critical element of Notice 2008-111[4] is that a person must know or have reason to know that a transaction is structured to effectuate the plan in order for the transaction to be a midco transaction for that person. Does a buyer have reason to know that a target has previously engaged in a midco transaction if a reasonable person would have discovered it by exercising due diligence?

It is appropriate to question whether there is any duty to inquire, but the answer isn't obvious. Similarly, should a seller inquire into the buyer's future intentions for the target or seek to prevent the buyer from making subsequent dispositions? In the face of those imponderables, safe harbors may take a transaction out of the soup.

Midco Safe Harbors

Notice 2008-111 includes safe harbors that can take an otherwise questionable transaction out of the pejorative category and into protected status. A transaction is not an intermediary transaction for the persons under the following circumstances:

- any shareholder if the target stock the shareholder sells is traded on an established securities market, and if before the shareholder's disposition, that person (and related persons) did not hold 5 percent or more by vote or a value of any class of the target stock disposed of by that shareholder;
- any shareholder or target if after the acquisition of the target stock, the acquirer is the issuer of stock or securities that are publicly traded on an established U.S. securities market or the acquirer is consolidated for financial reporting purposes with such an issuer; or
- any buyer if the target assets it acquires are either (1) securities that are traded on an established securities market and represent a less than 5 percent interest in that class of security, or (2) assets that are not securities and do not include a trade or business as described in reg. section 1.1060-1(b)(2).[5]

***Enbridge Energy* and the Importance of Form**

Although the IRS made its position on midco transactions clear with the issuance of Notice 2001-16 and later guidance, it has also litigated cases. Of all those cases, the most important for the Service is *Enbridge Energy Co. v. United States*.[6] There the Fifth Circuit affirmed the district court's grant of summary judgment for the IRS.

This was the first appellate court to strike down a midco deal. In *Enbridge Energy*, Dennis Langley sought to sell all the stock of his pipeline business, Bishop Group Ltd., but knew a direct asset sale would incur both corporate and individual taxes. MidCoast Energy Resources Inc. offered to buy the stock for $163 million, but Langley rejected the offer. MidCoast asked its tax adviser, PricewaterhouseCoopers LLP, for suggestions about improving its bid.

PwC suggested that the parties use a third-party intermediary, Fortrend International LLC, which had done several other conduit transactions. MidCoast understood that Fortrend would buy Langley's stock and that Fortrend would thereafter sell the Bishop assets to MidCoast. However, rather than buying the stock and selling the assets itself, Fortrend formed a special vehicle solely for this purpose: K-Pipe Merger Corp.

K-Pipe did no substantive business before or after the transaction. Indeed, although K-Pipe obtained financing for the stock purchase, the financing was 100 percent secured by MidCoast's funds. While that was technically a loan, the district and appellate courts saw it as indistinguishable from purchasing stock with MidCoast's funds. Proximity in time was also suspect. The transactions occurred within 24 hours of each other, further suggesting that the special purpose K-Pipe was merely an intermediary with no bona fide role.

Still, the only way MidCoast could acquire the Bishop assets at a price MidCoast was willing to pay was if a third party (K-Pipe) acquired Bishop's stock from Langley and then sold the assets to

[3]2008-1 C.B. 406, *Doc 2008-1029*, *2008 TNT 13-5*.
[4]2008-2 C.B. 1299, *Doc 2008-25274*, *2008 TNT 232-9*.
[5]*Id.* at section 5.01.
[6]No. 08-20261 (5th Cir. 2009) (unpublished), *Doc 2009-24917*, *2009 TNT 217-10*.

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MidCoast. MidCoast maintained that business reasons supported using a conduit transaction and that K-Pipe had a profit motive. Nevertheless, the court thought it was a sham.

MidCoast also claimed the transaction limited its exposure to litigation. Had MidCoast purchased the Bishop stock, MidCoast would have been liable for claims against Bishop. By purchasing only assets, MidCoast could avoid liability for known and unknown claims that might be asserted against Bishop, it argued.

The court said that failed to explain why an intermediary was necessary in the first place. The parties could have achieved the same result if MidCoast had bought the assets directly without an intermediary. Of course, that would have produced some tax.

The Fifth Circuit did not think this was a close case. The district court had held that the IRS was entitled to disregard the form of the transaction and treat it as a direct sale of stock. The Fifth Circuit found that uncontroverted evidence supported the district court's conclusion that this was a sham conduit transaction.

The district court held that MidCoast was not entitled to claim a stepped-up basis for the assets it purchased. This transaction was designed solely to avoid taxes, the appellate court concluded. Further, MidCoast offered no adequate nontax reason for using a conduit entity. Consequently, the court upheld the IRS's ability to disregard the form of the transaction. This, it should be stressed, was a big victory for the IRS.

The Problem of Transferee Liability

In *Diebold v. Commissioner*,[7] the IRS attacked another midco transaction, this time in a transferee liability case. One of the difficulties the IRS has had with midco transactions is who to pursue. In some ways, the most logical party to target is the original seller of the stock. Because that seller avoided two layers of tax, he got a higher price and more net cash than he should have received without the intermediary in the transaction.

Procedurally, these cases can be a nightmare for the IRS. In late 2002 the IRS classified midco transactions as a coordinated issue and instructed its auditors to use the economic substance and step transaction doctrines to disallow losses claimed to offset gains from the sale of the target's assets.[8] A coordinated issue paper directed auditors to consider all facts and circumstances to determine if a transaction should be characterized as a stock sale or an asset sale.

According to the directive, IRS auditors should focus on which party was responsible for involving the intermediary and paying its fees. However, it soon became apparent to the IRS that intermediaries would provide insufficient sources for collection. The IRS then directed auditors to focus on the potential liability of other parties involved in these transactions.[9]

One possibility was transferee liability under section 6901 against the selling shareholders or buyers.[10] In Notice 2008-111, the IRS staked out its position that any person who participates in an intermediary transaction under a plan may be subject to transferee liability for the unpaid corporate-level tax of the target.

However, transferee liability cases can be tough for the IRS, even though Notice 2008-111 tried to connect the dots. A person engages in an intermediary transaction if he knows or has reason to know that the transaction is structured to effectuate the plan. This is so even if the person does not know the actual mechanics of the transaction or the relationships between the parties.

The IRS must first determine the transferor's liability and amount due if it wishes to mount a transferee liability case. Because the liability is derivative, only then can the IRS turn its collection efforts to the transferee. The burden of proof is on the IRS to establish the technical requirements for transferee liability under section 6901.

This gets messy. The IRS must resort to state law or to the Federal Debt Collection Act. The Service has generally fared poorly because of the high hurdles it must clear.[11] For example, in California, the California Uniform Fraudulent Transfer Act sets forth the elements of a fraudulent transfer. It is a transfer or obligation undertaken with an actual intent to hinder, delay, or defraud any creditor of the debtor, and when reasonable equivalent value is not received in exchange for the transfer or obligation if either:

- the debtor was engaged in or about to engage in a business or transaction for which the debtor's remaining assets were unreasonably small in relation to the business or transaction; or

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[7]T.C. Memo. 2010-238, *Doc 2010-23203*, *2010 TNT 207-16*.

[8]IRS, "Coordinated Issue All Industries: Intermediary Transaction Tax Shelters" (Dec. 19, 2002).

[9]*See* IRS, "Examination of Multiple Parties in Intermediary Transaction Tax Shelters as described in Notice 2001-16" (Jan. 12, 2006), *Doc 2006-890*, *2006 TNT 10-74*.

[10]*Id*.

[11]*See Vendig v. Commissioner*, 229 F.2d 93 (2d Cir. 1956).

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- the debtor believed, or reasonably should have believed, he would incur debts beyond his ability to pay as they became due.[12]

Part 2 of this article will appear in a coming issue of Tax Notes.

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[12]*See* Cal. Civ. Code section 3439.04(a).

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