Midco Deal Gets Worse Than Fair-to-Middling Treatment

By Robert W. Wood • Wood & Porter • San Francisco

The middle of the road may be safe political territory. It may even be safe in fashion, in pricing goods and services, and in following other pursuits. But in the tax world, the middle of the road is sometimes less than an enviable position, particularly when words like "conduit" or "middleman" are ascribed.

That's one lesson from the Fifth Circuit's decision affirming the district court's grant of summary judgment to the IRS in *Enbridge Energy Co.*, 2009 U.S. App. LEXIS 24713 (5th Cir. Nov. 10, 2009).

Harsh but Fair?

This is the first appellate court to strike down a so-called midco deal—we'll try not to use the pejorative label "tax shelter." Apart from its first appellate court foray into these deals, the summary judgment procedural context of this unhappy case makes this a particularly painful loss for the defenders of the arrangement.

The Fifth Circuit found that uncontroverted evidence supported the district court's conclusion that this was a sham conduit transaction. Ouch. The district court had ruled that Midcoast was not entitled to claim a stepped-up basis for the assets it purchased.

Can't We All Just Get Along?

Rodney King may have popularized that phrase, but the midco transaction is arguably a variant on this timeless theme. After all, it involves parties having different needs. The NOL rules that restrict the use of trafficking in NOLs are firm, indeed harsh. So why not inject a little reverse engineering, something that might be suggested in Super Freakonomics?

In *Enbridge Energy*, our cast of characters begins with Dennis Langley, Bishop Group's sole shareholder. Langley wanted to sell his stock in Bishop. Langley knew that a direct asset sale would have negative tax consequences for him. After all, Bishop's assets had appreciated considerably.

That meant the corporation would have to pay significant taxes on those gains. Then Langley in turn would have to pay taxes on distributions he took as a shareholder from Bishop. How to address this quandary? Midcoast provided an answer.

Middleman to the Rescue

Midcoast submitted a bid of $157 million for Langley's Bishop stock. Midcoast subsequently increased its bid to $184.2 million. Upon further reflection, though, Midcoast lowered its offer to $163 million. Langley found this offer unacceptable.

When Langley rejected Midcoast's reduced offer, Midcoast asked its tax advisor, PwC, for suggestions about improving its bid. PwC suggested that the parties use a third-party intermediary for the transaction, and suggested Fortrend to fill this pivotal role. Fortrend had done a number of these so-called conduit transactions. PWC then brought Fortrend to the table.

Midcoast understood that Fortrend would buy Langley's stock, and that Fortrend would then sell the Bishop assets to Midcoast. So far, so good. Each party arguably gets what it wants. Yet the devil is in the details.

Pipeline

Rather than buying the stock and selling the assets itself, Fortrend formed a special vehicle solely for this purpose: K-Pipe. K-Pipe existed for no other purpose than to accomplish this transaction. It did no substantive business before or after it finished this transaction. Midcoast was behind it all the way.

Indeed, although K-Pipe obtained financing for its purchase of Langley's stock, that financing was wholly secured by Midcoast's funds, equal to the loan deposited in escrow accounts. Although this was technically a loan, the district court and appellate court saw this arrangement as effectively no different than purchasing the stock with Midcoast's funds. The financing was obtained through a foreign bank known to finance these types of midco transactions.

The rest of the facts were of the same ilk. K-Pipe did not exist prior to the transaction. K-Pipe was created solely to buy the stock and then to sell the Bishop assets. The evidence showed that Langley and Midcoast were discussing the purchase prior to K-Pipe's involvement. Indeed, they had met together (along with the advisers from PwC) to discuss the deal.

Timeline

Proximity in time was another obvious issue. As the court pointed out, the two transactions occurred within 24 hours of each other. The court found that this evidence supported the inference that K-Pipe was merely an intermediary having no *bona fide* role in the transaction. Indeed, Midcoast conceded that it was Midcoast that wanted to acquire the Bishop assets.

Yet 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 these assets to Midcoast.

It's Just Business

As anyone who has ever worried over an Internal Revenue Code Section ("Code Sec.") 355 transaction knows, business purpose is important. Of course, the concept comes up frequently in other contexts too. Some reasons are better than others, and some reasons are more purely business (and divorced from tax) than others.

Sometimes one must enunciate business reasons for a transaction or structure. Midcoast asserted that there were three business reasons why it used a conduit transaction rather than a direct asset purchase.

First, Midcoast stated that K-Pipe sought to earn a profit. The court didn't think too highly of this one, since this assertion did not answer the question of why any party was willing to pay K-Pipe to be an intermediary. Moreover, the mere profit by the intermediary does not prevent finding that the transaction was a sham.

Second, Midcoast argued that it used the Midco arrangement because it wanted to acquire and operate the Bishop pipeline assets at a price it was willing and could afford to pay. The court did not consider this to be a tax-independent business consideration. The money Midcoast saved by lessening its tax burden allowed it to pay more for the assets.

Finally, Midcoast contended that this transaction limited its exposure to litigation. Unlike other assertions, there's a certain appeal to this. In fact, it reminds me a little of the classic Code Sec. 355 business purpose of protecting one business from the risks and vicissitudes of another.

After all, had Midcoast simply purchased the Bishop stock, it would have been liable for claims against Bishop. By purchasing only the assets, Midcoast argued, it could avoid liability for both known and unknown claims that might be asserted against the Bishop corporate entity.

Big Oops

The court pointed out that there was one little problem with this pearl of corporate wisdom. It simply didn't explain why an intermediary was necessary in the first place. Indeed, the parties could have achieved the same result if Midcoast had simply bought the assets directly from Langley and Bishop without using an intermediary.

Of course, that would have produced some tax. All in all, the Fifth Circuit didn't think this was a close case. To it, the uncontroverted facts supported the district court's ruling. It had determined that the IRS was entitled to disregard the form of the transaction and to simply treat it as a direct sale of stock.

Conclusion

To the court, this transaction was designed solely for the purpose of avoiding taxes. Plus, Midcoast offered no adequate nontax reason for using a conduit entity. Consequently, the court found that the district court did not err in finding that the IRS appropriately disregarded the form of the transaction.

We should stay tuned for further forays into the land of intermediaries. We might expect that other taxpayers may present themselves in a somewhat more sophisticated way.