# Midco Deals and Litigation

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Readers of the M&A TAX REPORT will sympathize with the goal of a so-called Midco transaction. Selling shareholders of a C corporation almost invariably prefer to sell their stock rather than having the company sell its assets. The reason is the asset-level tax that would occur on the sale of the assets, followed by the shareholder-level tax on the ensuing distribution. That double tax has been standard fare since the repeal of the *General Utilities* doctrine in 1986.

Buyers, on the other hand, normally want to buy assets. They do so to avoid the historic liabilities of buying stock. Furthermore, they want to buy assets because an asset purchase gives them a stepped-up basis in the assets.

To give each side what they want, a middleman seems a logical choice. Typically, the Midco entity buys the stock from the selling shareholders, sells assets to the buyer, and covers the asset-level tax. But the devil is in the details, and in this case, the IRS may think of the Midco itself as the devil.

## Round 1

The IRS made its position about such transactions clear, immortalizing their status in Notice 2001-16, 2001-1 CB 730. The IRS targeted intermediary shelters by laying out the archetypal fact pattern. It involves a seller who wants to sell the stock of a corporation, a buyer who wants to purchase the assets, and an intermediary corporation. The seller sells the target stock to the intermediary. The intermediary, in turn, sells the assets to the buyer.

Generally, the intermediary has tax losses or tax credits. 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. For example, 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.

## Round 2

Exactly which types of Midco transactions were targeted by the IRS has been debated. In Notice 2008-20, IRB 2008-6, 406, Tax Analysts Document No. 2008-1029, the IRS identified four necessary components of what it called an intermediary tax shelter. The IRS viewed the matter from the perspective of the target, its shareholders, and from the point of view of the purchasers of the target corporation's assets. Notably, Notice 2008-20 lists four criteria that are meant to be objective and that will control whether the transaction is targeted:

- Built-in gain assets (in other words, a tax that would be triggered on an asset sale
- Vote and value requirement of 80 percent (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)
- Tax avoidance (at least half the target's built-in gain ends up not being taxed)

These four components plus a "plan" mean that the transaction is bad, in the IRS view. The "plan" requirement is also broad. In fact, one might say that it can exist in virtually any situation in which someone has a target company that is selling built-in gain assets, where the sale of assets is related to a sale of stock designed to avoid tax.

However, there are some safe harbors that can take the transaction out of the soup. [*See More "Midco" Transaction Advice: Part I,* M&A Tax Rep., Feb. 2009), at 7. *More "Midco" Transaction Advice: Part II,* M&A Tax Rep., Mar. 2009, at 6.]

## Round 3: Case Law

Although the IRS made its position on Midco transactions clear with the issuance of Notice 2001-16 and later guidance, it has also needed to litigate cases. For example, we covered *Enbridge Energy Co.,* CA-5 (unpublished, per curiam opinion), 2009-2 USTC ¶50,737 (2009). [*See Midco Deal Gets Worse Than Fair-to-Middling Treatment*, M&A Tax Rep., Jan. 2010, at 4.] The *Enbridge Energy* case represented a direct assault on the Midco transaction and its putative tax effects. The district court and the Fifth Circuit Court of Appeals both found that the form of this transaction could simply be disregarded, since it was designed and implemented solely for tax avoidance. It was the first appellate court case to strike down a midco transaction.

In *D.R. Diebold*, 100 TCM 370, Dec. 58,374(M), TC Memo. 2010-238 (2010), the IRS was at it again. This was a transferee liability case. In fact, one of the difficulties the IRS has had with Midco transactions is the basic problem of whom to pursue. In the aftermath of one of these deals, there may be no one with assets to pay tax debts.

## The Usual Suspects?

The most logical party from whom to seek collection is the original seller of the stock. Because that seller avoided two layers of tax, he arguably got a higher price and more net cash than he should have if the transaction had not involved an intermediary.

Procedurally, though, these cases can be a nightmare. The IRS can pursue a transferee liability theory, but such cases are not free from difficulty. In *Diebold*, for example, the IRS issued a notice of transferee liability to Mrs. Diebold. However, she did not own the stock of the corporation.

The stock was owned by a trust formed under New York law. There was no suggestion that this trust wasn't valid or legitimate. Nevertheless, the IRS tried to argue that Mrs. Diebold was either a direct transferee from the corporation or that she was a transferee of a transferee (through the trust). Essentially, the IRS argued that the trust was a "mere conduit." The court disagreed, refusing to disregard the trust.

## Round 4?

There are supposedly other Midco cases on the way. Some of them, perhaps even most of them, will be of this collection variety. The middleman may be gone or insolvent, and the best person on the scene is likely to be the original seller of the stock. That is the party who presumably gained the most. But transferee liability cases aren't easy, as the *Diebold* case proves.