More "Midco" Transaction Advice: Part II

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The Four Horsemen of an Intermediary Transaction

Under Notice 2008-111, there are four components of an intermediary transaction. Notably, a transaction must have all four of these components to be considered the same as or substantially similar to the listed transaction described in Notice 2001-16. This is so even if the transaction is engaged in pursuant to the type of plan described above. The four components follow.

1. Built-in Gain Assets

A target corporation directly or indirectly (and this may include pass-through entities or members of consolidated groups) owns assets the sale of which would result in taxable gain (built-in gain assets); and as of the stock disposition date (*see* component 2 below), target has insufficient tax benefits to eliminate or offset its tax on that sale. The tax that would result from that sale is referred to as the target's built-in tax. However, the target will not be considered to have a built-in tax if, on the stock disposition date, the amount of that built-in tax is less than five percent of the value of the target stock disposed of in the stock disposition.

2. Eighty Percent by Vote or Value

Under the second component, at least 80 percent of the vote or value of the target's stock must be disposed of by the target's shareholders other than in the liquidation of target, in one or more related transactions, within a 12-month period. The first date on which at least 80 percent of the target's stock (by vote or value) has been disposed of by the target shareholder in a stock disposition is called the "stock disposition date."

3. Assets vs. Stock

Under the third component, either within 12 months before, simultaneously with, or within 12 months after, the stock disposition date, at least 65 percent by value of the target's built-in gain assets are disposed of to one or more buyers in one or more transactions in which gain is recognized with respect to the sold target assets.

4. Tax Avoidance

Under the fourth component, at least half of the target's built-in tax that would otherwise result from the disposition of the sold target assets is purportedly offset, avoided or not paid.

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Four Components Plus "Plan"

A transaction that has all four of these components is an intermediary transaction only with respect to a person who engages in the transaction pursuant to the plan. A person does so if that person knows or has a reason to know that the transaction is structured to effectuate the plan.

Moreover, any shareholder who is at least a five-percent shareholder of the target (by vote or value), or any shareholder who is an officer or director of the target, does so if any of the following knows or has reason to know that the transaction is structured to effectuate the plan:

- any officer or director of the target;
- any of target's advisors engaged by target to advise target or the shareholders with respect to the transaction; or
- any advisor of the shareholder engaged by that shareholder who advised with respect to the transaction.

Safe Harbors

Notice 2008-111 includes certain safe harbors which can take an otherwise bad transaction out of the pejorative category and into the haven of a safe harbor. A transaction is not an intermediary transaction with respect to the following persons under the following circumstances:

- Any shareholder, if the only target's stock of which it disposes is traded on an established securities market, and before the disposition of the shareholder (including related persons), that person did not hold five 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 of the target stock is the issuer of stock or securities that are publicly traded on an established securities market in the United States, or is consolidated for financial reporting purposes with such an issuer.
- Any buyer, if the only sold target assets it acquires are either (1) securities that are traded an on established securities market and represent a less than five-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. §1.1060-1(b)(2).

These safe harbors are described in Notice 2008-11, §5.01.

Participation

If one of these safe harbor exceptions does not apply to a person, and that person engaged in a transaction pursuant to the plan, and the transaction has all of the necessary four components described in Notice 2008-111, then the determination whether that person participated in an intermediary transaction for purposes of Reg. §1.6011-4 in any particular tax year is made under the rules set forth in Reg. §1.6011-4(c)(3)(i)(A).

Effective Date

Notice 2008-111 is generally effective on January 19, 2001, the original effective date of Notice 2001-16. However, Notice 2008-111 imposes no requirements with respect to any obligation under Code Sec. 6011, 6111 or 6112 due before December 1, 2008. As Notice 2008-111 supersedes Notice 2008-20, any disclosures filed pursuant to Notice 2008-20 will be treated as made pursuant to Notice 2001-16.

Reporting Requirements

The major effect of Notice 2008-111 may be a kind of continuing *in terrorem* effect about intermediary transaction shelters. Most such transactions probably no longer occur. Nevertheless, it is worth revealing what the shelter designation means in terms of reporting requirements.

Under Code Sec. 6011, taxpayers must disclose their participation in reportable shelter-type transactions by attaching an information statement to their tax returns. Moreover, under Code Sec. 6111, material advisors must disclose reportable transactions. Under Code Sec. 6112, these material advisors must also prepare and maintain lists of reportable transactions, identifying each person with respect to whom the advisor acted as a material advisor for the transaction.

These various obligations are triggered, of course, when the transaction is a listed one, meaning a reportable transaction which is the same as (or substantially similar to) a transaction identified by the IRS as a tax-avoidance transaction under Code Sec. 6011. Among the transactions included as listed transactions are the intermediary or Midco transactions described in Notice 2001-16, 2001-1 CB 730.

Court Cases

There is probably an insufficient volume of case law on this topic to discern trends. However, the District Court in *Enbridge Energy* (*Enbridge Energy Co., Inc.* Tax Analysts Document 2008-7171, 2008 TNT 64-9 (S. D. Texas, March 31, 2008)) 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 non–tax avoidance business purpose to the intermediary's participation in the transaction?

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 (PricewaterhouseCoopers) 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). 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). The intermediary in *Enbridge Energy* 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).]

Conclusion

The IRS has materially objectified the standards for determining the existence of an intermediary transaction tax shelter. At least that is good. Many practitioners had complained that it was difficult to tell what was permitted and what was not, and that many legitimate transactions might be inappropriately scooped into the net intended for intermediary shelter transactions. Notice 2008-111, superseding Notice 2008-20, seems to help.

Whether it will be enough for most practitioners remains to be seen.

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