Notice

CC-2001-023

April 26, 2001

Subject: Intermediary Transaction Tax Shelter   Cancellation Date: Upon incorporation into CCDM

PURPOSE

The purpose of this Notice is to assist Chief Counsel attorneys in addressing issues arising in connection with various intermediary transactions that are the same as or similar to those described in Notice 2001-16, 2001-09 I.R.B. 730 (Intermediary Transactions Tax Shelter).

SUMMARY

The intermediary corporation (M) is a conduit that is disregarded for federal tax purposes and the transaction is treated as if either (i) the target corporation (T) sold its assets directly to the ultimate buyer (Y) of the assets and made a liquidating distribution to its shareholder(s) (X), or (ii) X sold its T stock directly to Y followed by Y's liquidation of T. Whether the recast of the transaction is a direct asset sale by T of its assets to Y or a direct stock sale by X of its T stock to Y will depend on the facts and circumstances of the particular case.

DISCUSSION

The facts of the transaction are described in Notice 2001-16. The parties to the transaction are X, a seller that desires to sell stock of corporation T, M, a corporation that serves as an intermediary (as discussed below) that is not subject to tax, and Y, a buyer that desires to purchase the assets (and not the stock) of T. Pursuant to a plan, the parties undertake the following steps: X purports to sell the stock of T to M. T then liquidates into M, purportedly under section 332 of the Internal Revenue Code. M then sells some or all of the T assets to Y in a transaction in which M is not required to report any gain due to its tax status. Y claims a basis in the T assets equal to Y's purchase price.

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T's liquidation into M generally will be in a transaction that occurs prior to January 29, 1999 (the effective date of 1.337(d)-4 of the Income Tax Regulations) and, arguably, is not covered by section 337(b)(2).

A. Treatment of M as a Conduit

Several factors typically present in these intermediary transactions support treating M as a mere conduit. First, M will be an entity not subject to tax with no business purpose for engaging in the transaction except for facilitating X's stock sale and Y's asset purchase and sheltering the inherent gain on T's assets. Generally, M will be either formally or informally required to transfer the T assets to Y after purchasing the T stock. Thus, the second leg of the transfer (the asset transfer) typically will occur shortly after the first leg of the transfer (the stock sale) and will be at a predetermined price that was negotiated by X and Y (and possibly T) prior to the stock sale. Additionally, in many cases, X or Y may indemnify M from any tax liability. In essence, M never controls T's stock or assets and does not enjoy the normal benefits and burdens of ownership. *See Murry v. Commr.*, T.C. Memo 1984-670. Second, M often will not be using its own funds to finance the transaction. Rather, M may be relying on financing from a third party lender who will be repaid within a short period of time because the two legs of the transaction will occur within a short time period from one another. This financing often will be arranged or possibly provided by X or Y to help facilitate the transaction. Third, M will be paid a fee, directly or indirectly, for its participation and permitting X or Y to benefit from the use of its tax status in the transaction. Fourth, there often are promoters involved in structuring the transaction and non-disclosure agreements to protect the secrecy of the transaction. Finally, M's participation in these transactions often may provide benefits that may not be achieved in a section 338(h)(10) election. For instance, X may have a high stock basis but T may have a low inside basis in its assets so that a stock sale by X would produce less gain than an asset sale by T. Further, this intermediary transaction often may be used by taxpayers not eligible to make a section 338(h)(10) election (e.g., T is a C corporation with individual shareholders).

Given the typical fact pattern described above, the substance of M's participation in the transaction is to serve as a conduit and shelter the gain associated with the sale of T's assets for a fee. The seminal Supreme Court decision addressing intermediary arrangements is *Commr. v. Court Holding*, 324 U.S. 331 (1945). In *Court Holding*, the Court recognized that conduits may be disregarded in determining the true substance of a transaction by providing that:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. *A sale by one person cannot be transformed into a sale by another by using the latter as a conduit through which to pass title*. To permit the true nature of a transaction to be disguised by mere formalisms, which exists solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. (emphasis added). *Id.* at 334.

Several authorities have focused on the substance of the transaction in determining how a transaction should be treated for federal income tax purposes. *See Estate of Robert G. Kluener v. Commr.*, 154 F.3d 630 (6th Cir. 1998) (taxpayer's contribution of property to his controlled corporation followed by corporation's sale of property at a gain (that was offset by losses) and subsequent distribution of the sale proceeds to the taxpayer treated as a direct sale by taxpayer of the property; corporation treated as a mere conduit); *Davis v. Commr.*, 88 T.C. 122 (1987) (bank's foreclosure on partnership's property and bank's subsequent sale of property to another partnership related to the first partnership pursuant to an *understanding* between the bank and the first partnership treated as an indirect sale by the first partnership to the related partnership); Rev. Rul. 91-47, 1991-2 C.B. 16 (pursuant to an *understanding* between unrelated corporations P and D, P forms a new corporation ("Newco") that acquires D's outstanding debt at a discount and P subsequently sells the Newco stock to D in an attempt to help D avoid discharge of indebtedness income; stock sale disregarded and transaction recast so that D is treated as acquiring its indebtedness directly from P). *See also Del Commercial Properties, Inc. v. Commr.* TC Memo 1999-411; *Packard v. Commr.*, 85 T.C. 397 (1985)*; Malkan v. Commissioner*, 54 T.C. 1305 (1970); *West Coast Marketing Corp. v. Commr.*, 46 T.C. 32 (1966); and Rev. Rul. 70-140, 1970-1 C.B. 73.

In some instances, M may retain some of the T assets in an attempt to have the form of the transaction respected. This attempt should fail if the retained assets are directly or indirectly returned to X , transferred to Y, or serve as part or all of M's fee for serving as an conduit. If the retained assets are viewed as a payment of a fee to M for its participation in the transaction, depending on the facts and circumstances, this payment may be treated as being made by T, by T on behalf of X (which would be treated as distribution by T of such assets to X followed by X's transfer of those assets to M as payment of the fee), or by Y. Alternatively, to the extent M retains some of T's assets and such retention is not viewed as a payment of a fee, T should be viewed as directly selling such assets to M. Consequently, M still should be viewed as a mere conduit with respect to rest of the transaction with T being treated as directly selling its assets (except for the assets sold to M) to Y.

B. <u>Characterization of the Transaction: Turns on Facts and Circumstances</u>

In order to determine the characterization of the transaction as an asset or stock sale, all the facts and circumstances of a particular case must be examined.

1. <u>Substance is Asset Sale</u>

In some instances, the facts and circumstances of the transaction may favor recasting the transaction so that T is treated as selling its assets directly to Y followed by T's distribution of its assets (including the asset sale proceeds) to X in liquidation.

Some facts that may indicate an asset sale recast include (i) X and Y originally negotiated the transaction as an asset sale, (ii) X introduced M into the transaction, (iii) X is responsible for compensating M for its participation in the transaction, (iv) X agrees to indemnify M and/or Y for any federal tax liability that may result from the transaction, (v) X arranges financing for M to effectuate the transaction, and (v) X receives the primary benefit from M's participation in the transaction.

Under this recast, T will recognize the gain on the sale of its assets (including any sales of appreciated assets Y does not wish to acquire ("Unwanted Assets") to X (or M) or fee payments by T on its own behalf to M using Unwanted Assets), which will result in a corresponding federal tax liability to T. Additionally, to the extent that T is treated as distributing to X Unwanted Assets (including deemed distributions of Unwanted Assets to X so that X may pay M's fee) in liquidation and T's liquidation into X does not qualify for section 332 treatment, T will recognize gain on such distribution. However, because T is no longer in existence following the transaction and has in substance divested itself of the assets needed to pay its taxes by distributing those assets in liquidation to X in the form of the stock sale proceeds and possibly Unwanted Assets, X generally will be responsible for T's unpaid tax liability as a transferee, as discussed below.

Section 6901 provides a procedure whereby the Service can assess income taxes owing from a delinquent taxpayer against a person to whom the taxpayer has transferred its assets in such a manner as to render itself incapable of satisfying its own income tax obligations. Section 6901(h) defines a transferee as including a distributee and section 301.6901-1(b) makes clear that the shareholder of a dissolved corporation is a transferee. The determination of whether transferee liability can be imposed on X as a distributee shareholder is dependant on principles governing the rights of creditors as determined by applicable state law. A court generally will focus on the substance of the transaction in making its determination whether transferee liability will be imposed. *See Owens v. Commr.*, 64 T.C. 1 (1975) (taxpayer's sale of all of the stock in his wholly owned Subchapter S corporation not respected for transferee liability purposes; taxpayer treated as receiving the assets of the corporation as a transferee and held liable for any deficiency in income taxes of the corporation). Therefore, if the substance of the transaction is an asset sale by T followed by a liquidating distribution of its assets to X, X generally will be responsible for T's unpaid tax liability as a transferee under the applicable state law.

2. <u>Substance is Stock Sale</u>

Alternatively, in some instances, the facts and circumstances of the transaction may favor recasting the transaction so that X is treated as selling its stock directly to Y followed by T's distribution of its assets to Y in liquidation. This does not result in tax liability on an asset sale, but denies Y a fair market value basis in the T assets.

Some facts that may indicate a stock sale recast include (i) X and Y originally negotiated the transaction as a stock sale, (ii) Y introduced M into the transaction, (iii) Y is responsible for compensating M for its participation in the transaction, (iv) Y agrees to indemnify M and/or X for any federal tax liability that may result from the transaction, (v) Y arranges financing for M to effectuate the transaction, and (v) Y receives the primary benefit from M's participation in the transaction.

If the substance of the transaction is a stock sale recast and T's liquidation into Y qualifies as a section 332 liquidation, T generally will not recognize any gain or loss on the liquidating distribution under section 337(a) and Y will take a carryover basis in T's assets under section 334(b)(1). Consequently, adjustments may be required to Y's tax return(s) to reflect Y's carryover (rather than fair market value) basis in T's assets. These adjustments may result from Y taking larger depreciation and amortization deductions than would be permitted if a carryover (rather than a fair market value) basis in T's assets were used to calculate such deductions. Additionally, adjustments may result from Y reporting less or no gain (or loss) with respect to sales of T's assets in which Y measured its gain or loss on the sale of T's assets using a fair market value (rather than a carryover) basis in such assets.

In a minority of cases, T's distribution of its assets to Y may not qualify as a section 332 liquidation, and T will be taxable at the corporate level on the distribution of its assets under section 336 and Y will be taxable at the shareholder level under section 331. To the extent T has an unpaid federal tax liability resulting from its distribution of assets to Y in liquidation, Y generally will be liable with respect to such liability as a transferee.

Finally, to the extent T is treated as distributing (or selling) Unwanted Assets to X or selling (or paying a fee with) Unwanted Assets to M and recognizing gain, Y generally will be liable with respect to the tax liability resulting from such gain as a transferee.

C. Factual Development and Additional Arguments

The facts of each case should be developed and analyzed with these potential recasts in mind. In particular, we suggest that the facts be developed from the date the transaction was first contemplated up to the present and include an examination of: correspondence between the parties and any promoters; documents relating to the transaction, including any sale agreements as well as drafts of prior sale agreements, indemnification or liability sharing agreements, letters of intent, and any publicly filed documents such as filings with government organizations such as the SEC; the treatment of the transaction for financial statement purposes; and how M financed the transaction and whether any of the parties helped facilitate the financing. Because much of this information may be with persons other than the taxpayer, we advise obtaining such information from third parties. These third parties may include M, X or Y(depending on which taxpayer is under audit), any financial institution that loaned money to M, any promoter of the transaction, and any other person retained by the parties in connection with the transaction.

Additionally, field counsel are asked to advise agents that have identified these transactions to notify examining agents assigned to other parties to the transaction in order that proper examination and coordination is accomplished. *See* Handbook No. 4.2, section 8.13 and section 6103(k)(6). Furthermore, in order to protect the revenue resulting from the transaction, where the proper recast of the transaction is not certain field counsel should advise agents to consider asserting adjustments against both X and Y based on the recasts discussed above. Finally, field counsel should advise agents to consider asserting penalties against the parties in appropriate cases and developing those potential penalties as early in the audit as possible.

There may be arguments advanced by taxpayers that are not addressed in this Notice and there may be facts in a particular case that suggest additional arguments to be made by the Service. In such cases, the matter should be coordinated with the National Office.

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/s/
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