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IRS Revises Tax Shelter Reporting Rules Applicable to Some Merger and Acquisition Transactions Tax

By Wayne R. Strasbaugh (Ballard Spahr Andrews & Ingersoll, LLP)

The IRS has recently issued new guidance (IRS Notice 2008-111, the "New Notice") on the types of corporate acquisitions that it considers subject to the tax shelter reporting rules. The new guidance revises prior guidance issued at the beginning of 2008 (IRS Notice 2008-20, the "Former Notice") that would have caused unwitting participants in tax-motivated corporate transactions to be subject to these reporting requirements and to substantial penalties imposed for noncompliance.

Several years ago, promoters devised a strategy to help corporations avoid large potential tax bills that would otherwise be due upon a sale of their business. The strategy was a so-called intermediary transaction. An intermediary (M) with unused tax benefits (such as net operating loss carryforwards) would acquire the stock of the corporation with the potential tax bill and then immediately sell off its appreciated assets to the "real" purchaser, using the intermediary's tax benefits to shelter the tax that would otherwise be due.

Not surprisingly, the IRS took a dim view of this loss of tax revenue and in 2001 (in IRS Notice 2001-16) included intermediary transactions among its "listed transactions," meaning that they are subject to penalties for nondisclosure by their promoters and participants. The Former Notice attempted to define more precisely the type of transactions that were subject to disclosure, but appeared to impose the tax shelter reporting obligations on parties that were ignorant of the tax motivation of the deals in which they were participating.

Intermediary Transactions

The New Notice retains the four definitional elements of an intermediary transaction that were contained in the Former Notice, but describes them with greater precision:

1. At least 80 percent of the stock (by vote or value) of a corporation (T) is cumulatively disposed of by T's shareholders (X) in related transactions within a 12-month period.

2. T, through direct or indirect ownership of assets, has a potential, unrealized gain (built-in gain) the tax liability for which cannot be eliminated with the tax benefits T enjoys as of the date that the 80 percent disposition threshold has been reached (the Stock Disposition Date). However, if T's potential tax liability from a sale of its built-in gain assets (built-in gain tax) is less than 5 percent of the value of the T stock that has cumulatively been disposed of, this requirement will not be satisfied, and (regardless of any other facts) T will not be deemed to have participated in an intermediary transaction. At the current corporate income tax rate of 35 percent, this de minimis rule means that corporations with less than one-seventh of their equity value represented by built-in gain will generally not have to be concerned with inadvertent participation in an intermediary transaction tax shelter.

Any person unaware of a plan will not be deemed to participate in an intermediary transaction.

3. Either within 12 months before, simultaneously, or within 12 months after the Stock Disposition Date, at least 65 percent (by value) of T's built-in gain assets are disposed of to one or more unrelated buyers (Y) in one or more transactions in which gain is recognized.

4. At least half of the built-in gain tax that T would otherwise have paid is purportedly offset or avoided or not paid.

A person (X, T, M, or Y) engaging in a transaction that contains all four of these elements will nevertheless not be considered to engage in an intermediary transaction unless his participation is pursuant to a "plan." The New Notice helpfully adds that any person unaware of a plan will not be deemed to participate in an intermediary transaction, regardless of any amounts reported (or, by inference, any tax benefits claimed) in his return. This statement in the New Notice apparently supersedes the general regulatory rule that establishes participation in a listed transaction through the reporting of the tax consequences of the listed transaction in the taxpayer's return (see Treas. Reg. Sec. 1.6011-4((c)(3)(i)(A)). In emphasizing the need for a plan, the New Notice undoubtedly intends to rely upon existing legal standards regarding "plans" that have developed in the corporate reorganization area (to test continuity of interest and continuity of business enterprise, for example) in determining whether a person is an intermediary

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transaction participant. Unfortunately, the legal standards surrounding the existence of plans in the reorganization area are themselves less than clear, and the New Notice makes them murkier. Presumably, the existence of a plan implies a prior understanding among participants. However, the New Notice indicates that X (the seller) may engage in a transaction pursuant to a plan to which Y (the Buyer) is not privy, and that, correspondingly, Y may act pursuant to a plan of which X is unaware. Also, the New Notice acknowledges that some Xs and some Ys may be acting pursuant to a plan, while other Xs and Ys may not be so acting.

Participation in a Plan

From the standpoint of the sellers' participation in a plan, the New Notice implies that X must, at minimum, act in concert with the target corporation (T) and that T's intent may be inferred from the knowledge of its officers, directors, and advisers. The New Notice states that any X that is at least a 5 percent shareholder or officer of T will be engaged in a transaction pursuant to a plan if any officer or director of T, any adviser of T, or any adviser of X knows that the transaction has been structured to effectuate a plan of tax avoidance that possesses the four definitional elements. Likewise, an X that is not at least a 5 percent shareholder and disposes of his T shares on a public exchange is not acting as part of the plan. The New Notice assumes that all 5 percent shareholders, even those of a non-publicly traded corporation and those forced to take merger consideration, know or should know T's reasons for agreeing to an acquisition.

From the standpoint of the intermediary's participation in a plan, the New Notice implies that M must act in concert with either X or T. If M's shares are publicly traded, the New Notice exempts M from participation in the plan, apparently reasoning that M would have to disclose the tax motives for its acquisition to its shareholders. Moreover, in this circumstance, the New Notice also exempts all Xs and T (but no Ys) from participation.

Difficulties for Buyers of Assets

From the standpoint of the buyers' participation in a plan, the New Notice contains no implications of the degree of concert Y must have with any of the other parties. It only exempts Y if Y acquires (a) publicly traded securities

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from T that represent a less than 5 percent interest in the class of traded security or (b) non-security assets that do not constitute a trade or business capable of generating goodwill. Beyond these limited exemptions, Y may demonstrate that it did not participate in a plan only by showing that it did not know or have reason to know that its tax benefits were derived from an intermediary transaction under the general participation rule of the regulations for listed transactions (Treas. Reg. Sec. 1.6011-4((c)(3)(i)(A)). It would appear that any buyer of a trade or business with depreciable assets from a seller with a net operating loss carryforward (NOL) reflected in its public financial statements would have difficulty proving its entitlement to this exemption (and thus its lack of participation in an intermediary transaction) if "its tax benefits" are regarded as including future depreciation deductions stemming from a purchase transaction that was sheltered by an NOL of M.

In summary, while the New Notice provides some relief to acquired corporations and their shareholders from the reporting and penalty rules applicable to listed transactions, buyers of corporate assets are less favored. In many cases, buyers will still have to make inquiries about the tax history and objectives of their sellers to demonstrate that they had no reason to know that their purchase was part of an intermediary transaction.

The IRS is seeking comments on the definitions, components, and safe harbors contained in the New Notice for the purpose of determining more accurately which transactions are intermediary transactions and which parties are engaging in a transaction pursuant to a plan.

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