Fifth Circuit Upholds IRS's Substance-Over-Form Attack On Intermediary Transaction Shelter

◆ *Enbridge Energy Company, CA-5, November 15, 2009*

The U.S. Court of Appeals for the Fifth Circuit recently upheld a major decision applying the substance-over-form doctrine to an intermediary tax shelter scheme (often referred to as a "midco" transaction). The court found that the transaction was designed solely for the purpose of avoiding taxes and presented no non-tax business purpose. The court also upheld the imposition of a 20 percent penalty on the taxpayer due to underpayment of taxes.

■ ***Comment.*** Intermediary transactions have been designated by the IRS as "listed transactions." Notice 2008-20 defined the key components of an intermediary tax shelter.

Midco transaction

The taxpayer at issue sought to purchase the assets of a competing owner and operator of natural gas pipelines. However, the competitor wished to engage in a direct stock sale. To settle this disagreement, an investment bank engaged by the parties created a shell corporation to obtain a loan secured by the taxpayer and purchase the target's stock. The taxpayer then purchased the target corporation's assets from the shell corporation. As a result of using the intermediary shell corporation, the taxpayer claimed a cost-basis in the target assets and claimed large deductions based on depreciation of those amounts. The IRS disallowed the deductions claimed by the taxpayer resulting in a $5.4 million tax liability. A federal district court upheld the liability, ruling that the transaction was a midco transaction, the abusive tax shelter described in Notice 2001-16.

Appellate analysis

The Fifth Circuit agreed with the IRS, as well as the lower court, and applied the substance over form doctrine to the taxpayer's transaction. "The uncontroverted evidence supports the district court's conclusion that this was a sham conduit transaction, and that [the taxpayer] is not entitled to claim a stepped-up basis for assets it purchased," the court held. While the taxpayer obtained the services of a bank to facilitate the transaction, the bank formed a special purpose vehicle to actually buy the target stock and sell the assets to the taxpayer. The court held that the special purpose vehicle was "merely an intermediary without a bona fide role in the transaction." The court also rejected all three purported business reasons asserted by the taxpayer for using the midco transaction rather than a direct purchase of the assets.

References: FED ¶(to be reported); TRC SALES: 3,150.

AFRs Issued For December

Rev. Rul. 2009-38

The IRS has released the short-term, mid-term, and long-term applicable interest rates for December 2009.

Applicable Federal Rates (AFR) for December 2009

Period for Compounding	Annual	Semiannual	Quarterly	Monthly
Short-Term				
AFR	0.69%	0.69%	0.69%	0.69%
110% AFR	0.76%	0.76%	0.76%	0.76%
120% AFR	0.83%	0.83%	0.83%	0.83%
130% AFR	0.90%	0.90%	0.90%	0.90%
Mid-Term				
AFR	2.64%	2.62%	2.61%	2.61%
110% AFR	2.90%	2.88%	2.87%	2.86%
120% AFR	3.16%	3.14%	3.13%	3.12%
130% AFR	3.44%	3.41%	3.40%	3.39%
150% AFR	3.97%	3.93%	3.91%	3.90%
175% AFR	4.64%	4.59%	4.56%	4.55%
Long-Term				
AFR	4.17%	4.13%	4.11%	4.09%
110% AFR	4.59%	4.54%	4.51%	4.50%
120% AFR	5.02%	4.96%	4.93%	4.91%
130% AFR	5.44%	5.37%	5.33%	5.31%

Adjusted AFRs for December 2009

Period for Compounding	Annual	Semiannual	Quarterly	Monthly
Short-term adjusted AFR	0.86%	0.86%	0.86%	0.86%
Mid-term adjusted AFR	2.25%	2.24%	2.23%	2.23%
Long-term adjusted AFR	4.14%	4.10%	4.08%	4.07%

The Code Sec. 382 adjusted federal long-term rate is 4.14%; the long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months) is 4.16%; the Code Sec. 42(b)(2) appropriate percentages for the 70% and 30% present value low-income housing credit are 7.79% and 3.34%, respectively, however, the appropriate percentage for non-federally subsidized new buildings placed in service after July 30, 2008, and before December 31, 2013, shall not be less than 9%; and the Code Sec. 7520 AFR for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest is 3.2%.

References: FED ¶(to be reported); TRC ACCTNG: 36,162.05.