Tax Report #935

New York State Bar Association

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August 27, 1998

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report of the New York State Bar Association Tax Section dealing with reorganizations involving disregarded entities. The report concludes that a merger of a corporation into a disregarded entity (such as a single member limited liability company) owned by a corporate parent in which the shareholders of the acquired corporation receive stock of the corporate parent of the disregarded entity should qualify as a reorganization under section 368(a)(1)(A) provided that a merger into the corporate parent would have so qualified. While there is general agreement among the members of the Executive Committee that this result does not violate sound tax policy, a significant minority believes, for a number of reasons discussed in the report, that section 368(a)(1)(A) should not apply to this transaction absent clear direction from Congress.

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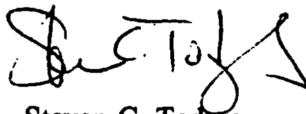
Please let me know if we can be of any further assistance in addressing these issues.

Sincerely,



Steven C. Todrys

Enclosure

cc: Internal Revenue Service
The Honorable Stuart L. Brown
Philip J. Levine, Esq.
William D. Alexander, Esq.

Department of the Treasury
The Honorable Jonathan Talisman
Joseph M. Mikrut, Esq.
Karen G. Gilbreath, Esq.

NEW YORK STATE BAR ASSOCIATION
TAX SECTION
COMMITTEE ON REORGANIZATIONS

Report on Reorganizations Involving Disregarded Entities

August 27, 1998

This Report [1] of the Committee on Reorganizations of the Tax Section of the New York State Bar Association comments on the possibility of effecting a tax-free "reorganization," as that term is defined under Section 368, [2] involving a corporation and a corporate-owned single member business entity (a "SME") that is disregarded as an entity (a "Disregarded Entity") under Treasury Regulation Section 301.7701-3 (the "Check-the-Box Regulations").

The Internal Revenue Service (the "Service") issued the Check-the-Box Regulations in December 1996. The regulations generally were effective January 1, 1997. Under the regulations, a Disregarded Entity can provide complete limited liability protection to its owner, yet be treated for federal income tax purposes as (i) a sole proprietorship of a noncorporate owner or (ii) a branch or division of a corporate owner.

This Report examines issues arising in connection with five hypothetical transactions involving corporations and Disregarded Entities. In analyzing each hypothetical transaction, the Committee provides its comments with regard to whether the transaction should qualify as a Section 368(a) reorganization.

The Committee believes a merger of a corporate-owned SME into a corporation should not qualify as a "statutory merger" under Section 368(a)(1)(A). In particular, the Committee believes the term "statutory merger" connotes a business combination where

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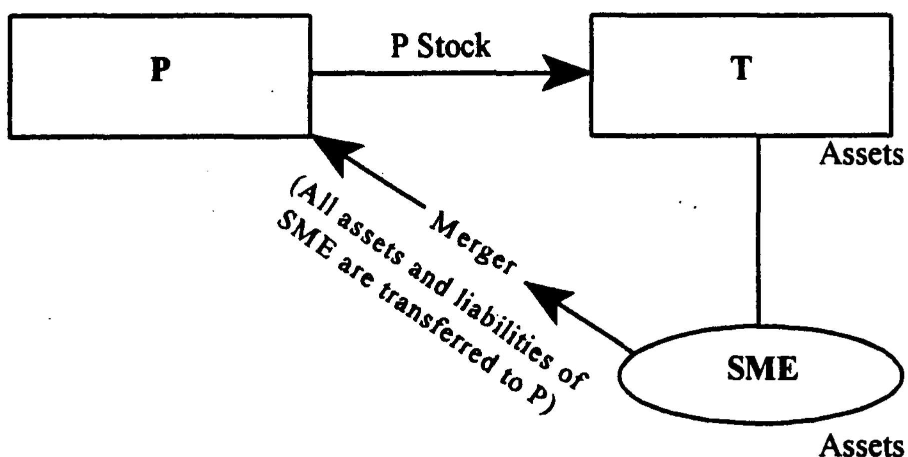
[1] The principal drafters of this Report were Eric Solomon and Michael Meisler. Lewis Steinberg participated in the drafting of this Report . Helpful comments were received from Harold Handler, Robert Jacobs, Glen Kohl, Carolyn Joy Lee, Dale Ponikvar, Richard Reinhold, Robert Scarborough, Michael Schler, David Sicular, Andrew Solomon, and Steven Todrys.

[2] All references are to the Internal Revenue Code of 1986, as amended (the "Code").

one corporation ("target") transfers all its assets and liabilities to a second corporation ("acquirer") and then liquidates, all by operation of state law; in the liquidation, the consideration received from the acquirer is distributed to the target shareholders. In the case of the merger of a corporate-owned SME into a corporation, the Committee believes that, while the transfer of the assets and liabilities of the SME to the acquiring corporation occurs by operation of state law, the fact that the state law does not provide for the automatic liquidation of, and distribution of the consideration by, the corporate parent of the SME prevents the transaction from qualifying under Section 368(a)(1)(A).

By contrast, a majority of the Committee believes a merger in the other direction (i.e., a merger of a corporation into a corporate-owned SME) should qualify as a "statutory merger" under Section 368(a)(1)(A) provided a merger of the target into the corporate parent of the SME would have so qualified. However, a significant minority of the Committee believes that, while treating the merger of a corporation into a corporate-owned SME as a "statutory merger" would not violate sound tax policy, it would be inappropriate for the IRS to issue regulations to that effect in the absence of clear direction from Congress.

Hypothetical Transaction #1



In the first hypothetical transaction, T, a domestic C corporation, owns SME. SME transfers all its assets and liabilities to P, a domestic C corporation, in a transaction that qualifies as a merger under state law.[3] T, as the owner of SME, receives P stock in exchange for its interest in SME.

Section 368(a)(1)(A) defines the term "reorganization" to include a "statutory merger." Section 354 provides that no gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are exchanged for stock or securities in another corporation a party to the reorganization. Section 361 provides that no gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property for stock or securities in another corporation that is a party to the reorganization. Section 368(b) defines a "party to a reorganization" to include both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

The Committee believes the phrase "statutory merger" in Section 368(a)(1)(A) is commonly understood to connote a business combination pursuant to which one corporation ("target")[4] transfers all its assets and liabilities to a second corporation

[3] A merger of a limited liability company and a corporation is allowed, for example, under the Delaware Corporation law. See Delaware General Corporation Law, § 264; see also Delaware Limited Liability Company Act, § 18-209.

[4] The Committee believes that, for purposes of determining whether a transaction constitutes a "statutory merger," an entity's status as a corporation for Federal income tax purposes, rather than for state law purposes, should be the relevant factor. Thus, entities that are treated as corporations pursuant to Sections 7701(a)(3) or 7704, including a SME that has elected to be taxed as a corporation under the Check-the-Box Regulations, should be treated as corporations, regardless of their corporate status (or lack thereof) under state law.

("acquirer") and then liquidates, all by operation of state law.[5] In the liquidation, the consideration received from the acquirer is distributed to the target's shareholders.

In Hypothetical Transaction #1, T is treated as the owner of SME's assets for federal income tax purposes. However, while the transfer of all or a portion of T's assets and liabilities (i.e., those held by SME) to P may occur pursuant to operation of state law, the second part of the definition set forth above, that the target corporation (T) be automatically liquidated pursuant to operation of the same state statute, is not satisfied. Accordingly, the Committee believes this transaction cannot qualify as a "statutory merger" for purposes of Section 368(a)(1)(A).

Furthermore, even if the merger of SME into P were to so qualify as a "statutory merger," T would not exchange stock of a corporation for P stock and therefore would not receive nonrecognition treatment under Section 354.[6] While it could be argued that T would be a "party to the reorganization" and would therefore receive nonrecognition treatment under Section 361, the fact that T, the ostensible transferor of the assets, remains in existence renders this application of Section 361 unique. Thus, the usual application of Sections 354, 356 and 361 breaks down in the context of the merger of a SME into a corporate acquirer, which suggests (once again) that the statutory scheme was not intended to accommodate transactions of this type and cannot be applied without first resolving a number of important collateral issues. The Committee believes this constitutes

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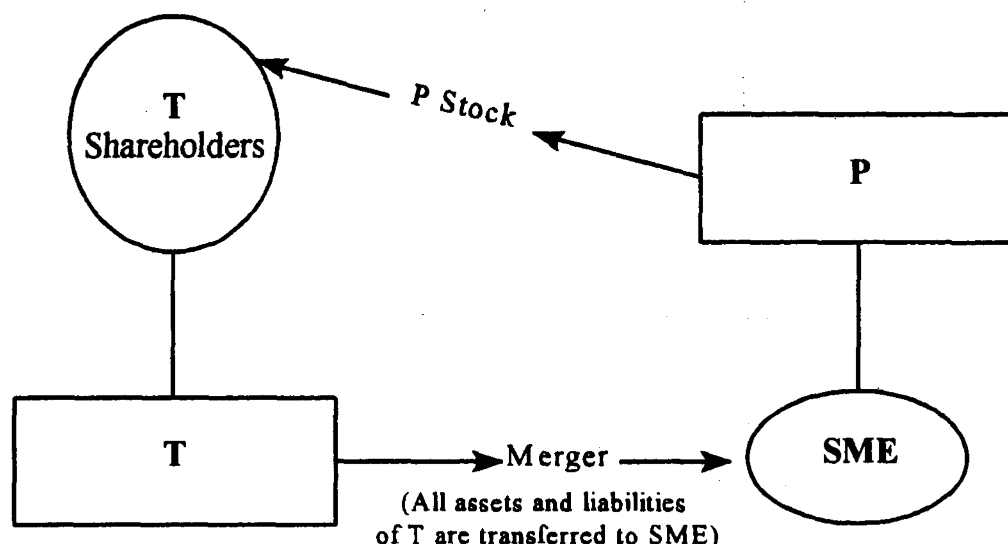
[5] Treasury Regulation Section 1.368-2(b)(1) provides that "[i]n order to qualify as a reorganization under section 368(a)(1)(A) the transaction must be a merger or consolidation effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia." [emphasis added]. The Committee believes the requirement that the transaction be effected under state corporate law (rather than, for example, under the state limited liability statute) is an anachronistic and unnecessary limitation on the scope of Section 368(a)(1)(A) and urges the IRS to amend the regulations to eliminate this requirement.

[6] Because T would remain in existence, there would be no need to apply Section 354 at the T shareholder level.

an additional reason why it would be unwarranted for the IRS to treat SME mergers into corporate acquirers as "statutory mergers" under Section 368(a)(1)(A).[7]

Consequently, the Committee believes Hypothetical Transaction #1 should not qualify under Section 368(a)(1)(A).[8]

Hypothetical Transaction #2



In the second hypothetical transaction, P, a domestic C corporation, owns SME. T, a domestic C corporation, transfers all its assets and liabilities to SME in a transaction that qualifies as a merger under state law. The T shareholders receive P stock in exchange for their T stock.

In analyzing whether a merger of T into SME should qualify under Section 368(a)(1)(A), the first issue is whether P must acquire the T assets directly, or whether it

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[7] If T received stock representing "control" of P under Section 368(c), the transaction could qualify for tax-free treatment under Section 351.

[8] For analogous reasons, the Committee believes that the merger of a qualified subchapter S subsidiary ("QSSS") or a qualified REIT subsidiary ("QRS") into a corporate acquirer cannot qualify as a "statutory merger" under Section 368(a)(1)(A).

is consistent with the basic principles of reorganizations that the acquired assets be acquired and held by a Disregarded Entity owned by the acquiring corporation. A merger is a combination of the target corporation's assets and liabilities with the assets and liabilities of the acquiring corporation. In a merger of T into SME, the combination of T's and P's assets and liabilities occurs for federal tax law purposes, but not for state law purposes. The issue is whether a combination for state law purposes is a requirement under Section 368(a)(1)(A).

As a policy matter, the Committee believes it is not necessary to have a state law combination of T's and P's assets and liabilities for the transaction to qualify under Section 368(a)(1)(A). While in the typical case of a direct merger of one corporation into another, the acquirer will succeed to the target's liabilities by operation of law, the Committee does not believe that transactions otherwise satisfying the definition of a "statutory merger" set forth above should be disqualified from Section 368(a)(1)(A) treatment merely because they insulate the corporate parent of the acquiring SME from claims with respect to the target's liabilities. In particular, the Committee can identify no tax policy objective that would be furthered by thus limiting the scope of Section 368(a)(1)(A).

Consequently, a majority of the Committee believes a merger of T into SME should qualify under Section 368(a)(1)(A) if a direct merger of T into P would have so qualified.[9] The majority believes such a merger satisfies the requirements for a "statutory

[9] The requirement that a direct merger would have qualified under Section 368(a)(1)(A) ensures that the participants are not able to achieve indirectly what they could not achieve directly. Accordingly, if P were an individual or a foreign corporation, a state law merger of T into a domestic SME would not qualify under Section 368(a)(1)(A). This standard would be more exacting than that found in Section 368(a)(2)(D)(ii) that generally allows a merger of a US corporation into the US subsidiary of a foreign corporation if the continuity of interest and other statutory and non-statutory reorganization requirements are satisfied.

merger" in that, as a matter of federal tax law, the transfer of T's assets and liabilities to SME (and T's liquidation and consequent distribution of P's stock to T's shareholders) by operation of state law should be viewed as a transfer of T's assets and liabilities to P, the corporation that is treated for federal tax purposes as owning what SME owns.[10] [11]

A significant minority of the Committee, however, disagrees with this conclusion. While agreeing with the majority that, as a tax policy matter, the merger of T into SME should qualify under Section 368(a)(1)(A), the minority believes that, absent clear direction from Congress, it would be inappropriate for the IRS to issue a regulation to that effect. The minority has two concerns.

First, the minority believes that the merger of T into SME in Hypothetical Transaction #2 does not qualify as a "statutory merger" under Section 368(a)(1)(A) because, unlike a typical "direct" merger of two corporations, one of the participants in the merger (SME) is not itself a corporation for federal tax purposes; the minority therefore believes that adopting the majority's position would represent a significant expansion of the scope of Section 368(a)(1)(A). Second, the minority is concerned about the creation of a regime in which a merger of a corporate-owned SME into a C corporation fails to qualify as a "statutory merger" under Section 368(a)(1)(A) (as discussed above), but a merger of a C corporation into a corporate-owned SME would so qualify. Until now, in determining whether a transaction qualifies as a "statutory merger," the tax law has not

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[10] Because a majority of the Committee views a merger of T with and into SME as, in essence, a "statutory merger" of T and P, the domestic or foreign status of SME should be irrelevant; instead, a majority of the Committee believes the transaction should be treated as a "statutory merger" provided the merger of T and SME is pursuant to the laws of the United States (or any State or Territory or the District of Columbia) and both T and P are domestic corporations.

[11] For analogous reasons, a majority of the Committee believes a merger of a domestic target into a QSSS or QRS should qualify as a "statutory merger" under Section 368(a)(1)(A). See PLRs 8903074 (October 26, 1988); 9411035 (December 20, 1993); 9512020 (December 29, 1994).

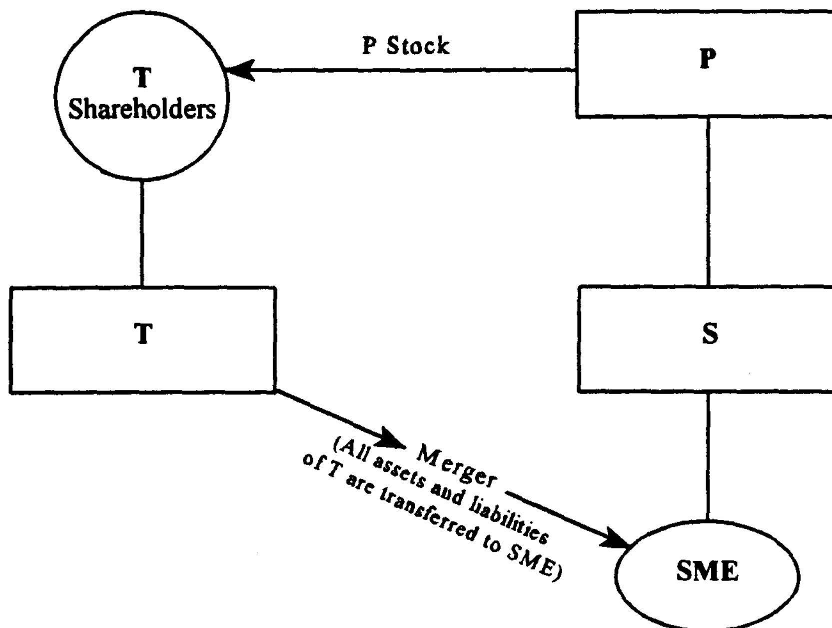
made a distinction based on the direction of the merger.[12] For both these reasons, the minority believes that, in the absence of clear direction from Congress, the IRS should not issue regulations treating a merger of a corporate target into a corporate-owned SME as a tax-free "statutory merger" under Section 368(a)(1)(A).[13] [14]

[12] While the direction of a merger may determine whether other requirements for reorganization treatment, such as the type of stock that must be issued, are satisfied, it has generally not been the case that whether a transaction constitutes a "statutory merger" in the first place turns on which entity is the survivor in the transaction.

[13] Because according "statutory merger" treatment to a merger of a target corporation into a corporate-owned SME would enable the corporate parent of the SME to insulate itself from the target's liabilities without having to satisfy the "substantially all the assets" requirement of Section 368(a)(2)(D), such a transactional structure may become a preferred alternative if the majority's proposal is adopted. Similarly, the ability to merge on a tax-free basis a US target corporation into a foreign law SME wholly-owned by a US corporate parent may potentially increase taxpayers' opportunities to use "hybrid entities" to achieve cross-border tax advantages. While the Committee minority does not believe that these results, standing alone, are inappropriate as a matter of tax policy, they do suggest the need for a balancing of multiple (and potentially competing) policy concerns that the minority believes is best left to Congress.

[14] Even if the merger of T into SME does not qualify as a "statutory merger" (as the minority suggests), it might still qualify under Sections 368(a)(1)(C) or (a)(1)(D), depending on the circumstances.

Hypothetical Transaction #3

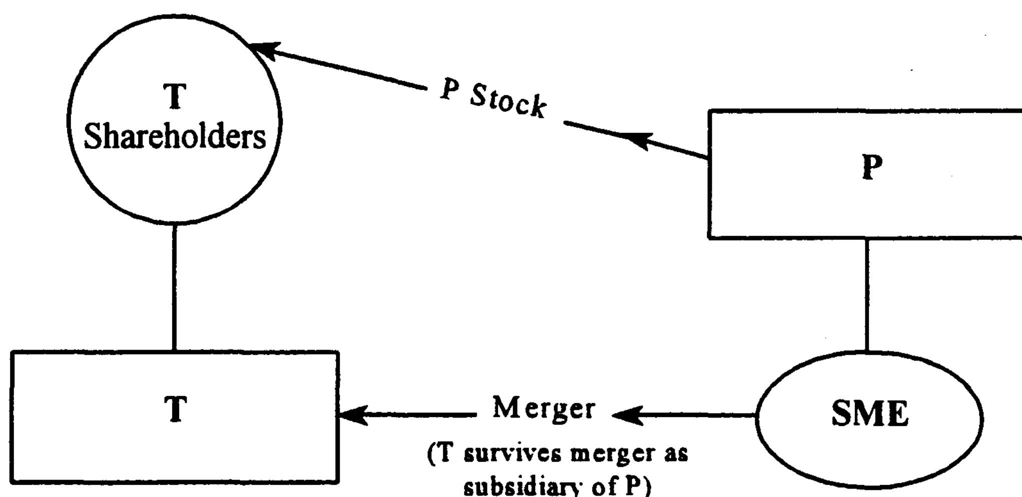


In the third hypothetical transaction, P, a C corporation, owns S, a domestic C corporation. S owns SME. T, a domestic C corporation, transfers all its assets and liabilities to SME in a transaction that qualifies as a merger under state law. The T shareholders receive P stock in exchange for their T stock.

Section 368(a)(2)(D) allows the use of the stock of a parent corporation to effect a merger under Section 368(a)(1)(A) of a target corporation into a subsidiary of the parent corporation. Specifically, Section 368(a)(2)(D) provides that the acquisition by one corporation, in exchange for stock of a corporation (the "controlling corporation"), which is in control of the acquiring corporation, of substantially all the properties of a target corporation will not disqualify a transaction under Section 368(a)(1)(A) if (i) no stock of the acquiring corporation is used in the transaction and (ii) the transaction would have qualified under Section 368(a)(1)(A) had the merger been into the controlling corporation.

Hypothetical Transaction #3 raises issues similar to those for Hypothetical Transaction #2. As with a merger of T into a SME owned by P, a majority of the Committee believes that a merger of T into a SME owned by S should qualify under Sections 368(a)(1)(A) and (a)(2)(D) if a merger of T into S would have so qualified. Nevertheless, for the reasons discussed above with respect to the merger of a corporate target into a SME and despite its views as to appropriate tax policy, a significant minority of the Committee believes that, in the absence of Congressional action, the IRS should not act to treat Hypothetical Transaction #3 as tax free under Sections 368(a)(1)(A) and (a)(2)(D).[15]

<u>**Hypothetical Transaction #4**</u>



In the fourth hypothetical transaction, P, a C corporation, owns SME. SME transfers all its assets and liabilities to T, a domestic C corporation, in a transaction that qualifies as a merger under state law. T survives the merger as a subsidiary of P. The T shareholders receive P voting stock in exchange for their T stock.

[15] Again, if the described transaction does not qualify as a "statutory merger," it might still qualify as a triangular Section 368(a)(1)(C) reorganization.

Section 368(a)(2)(E) allows the use of stock of a parent corporation to effect a merger under Section 368(a)(1)(A) of a subsidiary of the parent corporation into a target corporation. Specifically, Section 368(a)(2)(E) provides that a transaction otherwise qualifying under Section 368(a)(1)(A) shall not be disqualified by reason of the fact that stock of a corporation (the "controlling corporation") which before the merger was in control of the merged corporation (emphasis added) is used in the transaction if (i) after the transaction, the target corporation holds substantially all its property and substantially all the properties of the "merged corporation," and (ii) in the transaction, former shareholders of the target corporation surrender an amount of stock representing control of the target in exchange solely for voting stock of the controlling corporation.

Because of the language of Section 368(a)(2)(E), requiring that the transaction involve a "merged corporation," the Committee does not believe Hypothetical Transaction #4 could qualify as a reverse triangular merger.[16] There is a substantial question as to whether the IRS would have the authority to write regulations to change this result. In any event, the Committee believes Congress is better suited to decide whether this transaction should qualify under Section 368(a)(2)(E).

Section 368(a)(1)(B) includes as a reorganization "the acquisition by one corporation, in exchange solely for all or a part of its voting stock ... of stock of another

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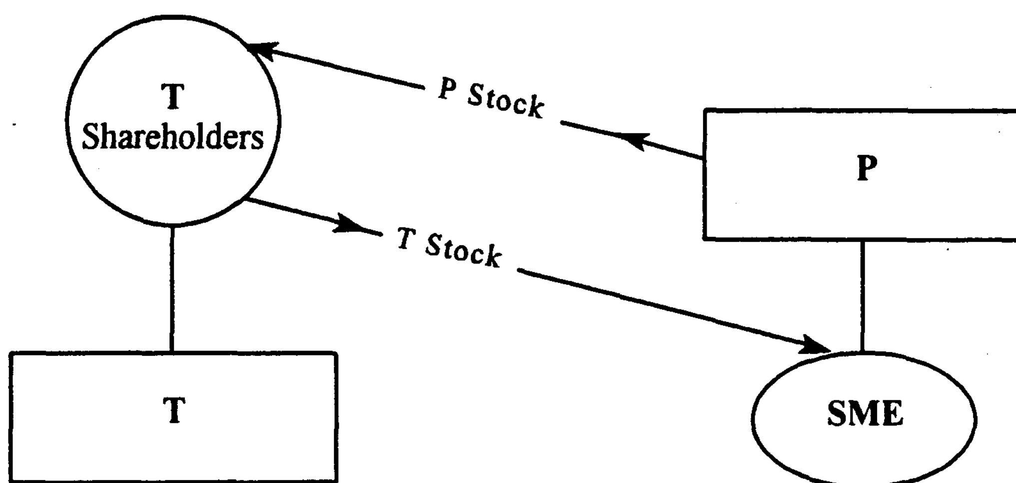
[16] As discussed above, the Committee believes the hallmark of a "statutory merger" is the transfer of assets and liabilities by one corporation to another and the first corporation's liquidation, all by operation of state law. In essence, this necessitates identifying an acquiring corporation (i.e., the transferee of the transferred assets and liabilities) and a merged corporation (i.e., the transferor of the transferred assets and liabilities, which then automatically liquidates pursuant to state law). T is an acquiring corporation in the hypothetical transaction, in that it acquires the assets and liabilities of SME. However, there does not appear to be a merged corporation in the proposed transaction. In particular, SME is not itself a corporation and, while P, for federal tax purposes, is treated as having transferred all or a portion of its assets and liabilities to T (i.e., those held by SME), it does not liquidate as part of the transaction. Thus, just as in the case of Hypothetical Transaction #1, discussed above, the Committee does not believe that Hypothetical Transaction #4 qualifies as a "statutory merger".

corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)." Hypothetical Transaction #4 could qualify under Section 368(a)(1)(B).[17] Alternatively, the transaction could qualify under Section 351 if T's former shareholders control P immediately after the exchange.[18]

Hypothetical Transaction #5



In the fifth hypothetical transaction, P, a C corporation, owns SME. SME acquires the stock of T, a C corporation, in exchange for P voting stock.

Because SME is treated as a branch or division of P for federal income tax purposes in accordance with the Check-the-Box Regulations, P should be deemed to

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[17] Unlike Section 368(a)(2)(E), the consideration in a (B) reorganization must consist solely of voting stock.

[18] P's deemed transfer to T of the assets and liabilities held in SME should constitute a capital contribution by P to T. This portion of the transaction should qualify as a Section 351 transaction in which the property contributed by P is the SME's assets. (Any deemed capital contribution would not violate the "solely for voting stock" requirement of Section 368(a)(1)(B). Rev. Rul. 72-522, 1972-2 C.B. 215.) P's adjusted basis in the T stock should be increased to the extent of P's basis in the SME assets .

acquire any T stock acquired by SME in connection with this transaction. Accordingly, P would acquire shares of T solely in exchange for P voting stock. Because SME acquires control of T as a result of the exchange, the transaction would satisfy the requirements of Section 368(a)(1)(B).[19]

[19] Alternatively, the transaction would qualify under Section 351 if T's former shareholders "control" P immediately after the exchange.