NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON TEMPORARY REGULATIONS § 1.368-2T RELATING TO "A" REORGANIZATIONS INVOLVING DISREGARDED ENTITIES

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New York State Bar Association Tax Section Report on Temporary Regulations §1.368-2T Relating to "A" Reorganizations Involving Disregarded Entities

This report, prepared by the New York State Bar Association Tax Section Committee on Reorganizations,[1] comments on Temporary Regulations §1.368-2T, issued by the Internal Revenue Service (the "IRS") and the Treasury Department on January 23, 2003 (the "Temporary Regulations").[2] The Temporary Regulations, which define the term "statutory merger or consolidation" for purposes of Section 368(a) of the Internal Revenue Code of 1986, as amended (the "Code")[3], update the pre-existing regulations to address merger transactions involving "disregarded entities" and corporations that own disregarded entities.

We applaud the IRS and Treasury for issuing the Temporary Regulations and believe they have significantly improved and clarified the rules regarding reorganizations. The widespread use of disregarded entities and the importance of mergers and acquisitions to our economy make this an important subject on which guidance is extremely valuable.

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[1] The principal drafter of this report was Diana L. Wollman. Helpful comments were received from Kimberly Blanchard, Karen Gilbreath, Martin D. Ginsburg, Michael Schler and Lewis Steinberg.

[2] T.D. 9038 (Jan. 23, 2003). The Temporary Regulations were simultaneously issued as Proposed Regulations (REG-126585-01). The Temporary Regulations were preceded by two sets of proposed regulations (REG-126485-01, 66 Fed. Reg. 57400 (Nov. 15, 2001), and REG-106186-98, 65 Fed. Reg. 31115 (May 16, 2000)). Prior the issuance of these proposed regulations, we submitted our Report on Reorganizations Involving Disregarded Entities, August 27, 1998, reprinted at 98 TNT 171-12.

[3] All "Section" references herein are to sections of the Code, unless otherwise noted.

The Preamble to the Temporary Regulations noted that the IRS and Treasury were continuing to study a number of the comments received on the prior proposed regulations and that changes may be made to the Temporary Regulations before they are finalized. This report provides a few comments and suggested clarifications with respect to the Temporary Regulations and also comments on how these regulations might be coordinated with recent guidance on post-reorganization asset transfers.[4]

This report does not address the broader question of whether "A" reorganizations should include transactions effected under foreign corporate laws, or be limited, as they are currently are by Treasury Regulations, to transactions effected under domestic corporate laws. The Tax Section has submitted two prior reports on that subject[5] and we understand that the IRS is hoping to issue guidance this business plan year (*i.e.*, before June 30, 2004).

I. Clarify the Prohibition on Transfers of Transferor Assets or Liabilities to Transferee Foreign Disregarded Entities (Temp. Regs. §1.368-2T(b)(iii))

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[4] The 2003-2004 IRS business plan does not include finalizing the Temporary Regulations, although before they were issued the Regulations project had appeared on the 2002-2003 IRS business plan. We understand from informal public comments made by IRS personnel that this was based upon an IRS decision regarding the optimal allocation of IRS resources. We believe the Temporary Regulations have addressed many of the most pressing issues and that our comments could be addressed without revising the regulations by, for example, a Notice, Announcement or one or more Revenue Rulings.

[5] *See* NYSBA Tax Section, Report #1010, "Report on the Effect of the International Provisions of the Internal Revenue Code of Defining "Statutory" Mergers and Consolidations Under Section 368(a)(1)(A) To Include Those Effected Under Foreign Law", May 9, 2002, reprinted at 2002 TNT 99-17; NYSBA Tax Section, Report #969, Report with Respect to the Regulations That Define a "Statutory" Merger or Consolidation, April 6, 2000, reprinted at 2000 TNT 82-22.

Recommendations

In Temp. Regs. §1.368-2T(b)(iii), (i) change the phrase "assets and liabilities of a combining entity of a transferor unit" to "assets and liabilities of any member of the transferor unit"; and (ii) add, immediately before "is organized under the laws of the United States ...", "other than disregarded entities through which the combining entity of the transferor unit held its interests in such disregarded entities".

Clarify (in the final Regulations, the Preamble thereto or in other published guidance, such as a Revenue Ruling) that these regulations do not prohibit transfers of transferor unit assets and liabilities to foreign disregarded entities after the merger, whether or not planned or anticipated at the time of the merger, that would otherwise be permitted.

Discussion

We understand that the Temporary Regulations generally did not address transactions involving foreign corporations and foreign disregarded entities because those matters were still under consideration. Temp. Regs. §1.368-2T(b)(1)(iii) allows pre-merger assets or liabilities of the target corporation (the "combining entity" of the "transferor unit") to become assets or liabilities of a foreign disregarded entity that is a member of the transferee unit after the merger only if that foreign disregarded entity was a member of the transferor unit. We believe that there may be a technical ("drafting") error in this section, however.

The prohibition on transferor assets and liabilities being transferred to non-transferor foreign disregarded entities technically appears to apply only to assets or liabilities that were held directly by *the transferor corporation*, as opposed to the entire "transferor unit". This is because Temp. Regs. §1.368-2T(b)(1)(iii) refer to "assets and liabilities of the combining entity of a transferor unit" as opposed to assets and liabilities of a transferor unit (or, of all of the members of a transferor unit). We believe that the prohibition should, and was intended to, apply with respect to the assets and liabilities of every member of the transferor unit. While the Temporary Regulations could be interpreted as so applying (because, for U.S. Federal income tax purposes, the assets and liabilities of the disregarded entities are treated as if owned by the corporation), because they make a distinction between the "combining entity" of the transferor unit and the disregarded entities that are members of that unit,[6] the prohibition could be read literally to mean only those assets and liabilities held directly by the transferor corporation.

Under that interpretation, assets and liabilities held directly by a transferor unit disregarded entity (whether domestic or foreign) could be transferred directly to a transferee unit foreign disregarded entity (although assets and liabilities held directly by the transferor corporation could not be). We believe that the prohibition was intended to prevent any assets or liabilities of the transferor corporation or any of its disregarded entities from being transferred directly to a transferee foreign disregarded entity. To clarify this, we recommend the reference, in Temp. Regs. §1.368-2T(b)(iii), to "any of the assets and liabilities of a combining entity of the transferor unit" be changed to "any of the assets or liabilities of any member of the transferor unit".[7]

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[6] *See, e.g.*, Temp. Regs. §1.368-2T(b)(ii)(A) (referring to "all of the assets ... and liabilities... of each member of one or more combining units").

[7] As we interpret the domestic-only rule, if, as of the effective time of the domestic "A" merger, there is a simultaneous merger of a transferor disregarded entity with a transferee foreign disregarded entity, the domestic-only rule would be violated unless the legal survivor of the merger was the transferor's disregarded entity. As discussed below, if the

If this change is made we believe one additional clarifying change would be necessary. Currently, there is exception from the domestic-only requirement for a foreign disregarded entity that was part of the transferor unit immediately prior to the transaction. As written, the exception applies only to a foreign disregarded entity that holds transferor assets or liabilities directly. It does not apply to an intermediary foreign disregarded entity that owns the entity that holds the assets or liabilities directly, even if the two-tiered entity structure was part of the transferor unit.[8]

If the provision is reworded, as we suggest above, to apply to assets and liabilities of any member of the transferor unit, it could then be viewed as causing the continued existence of the transferor's intermediary foreign disregarded entity to violate the requirement.[9] We believe that the exception was intended to, and should, permit the parties to leave in place any foreign disregarded entities (including tiered-structures) that were part of the transferor unit. Thus, we recommend that you add, immediately before "is organized under the laws of the United States ...", "other than disregarded entities through which the combining entity of the transferor unit held its interests in such disregarded entities".

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disregarded entities merger occurred *after* the effective time, we believe there should be no such prohibition.

[8] This is because the domestic-requirement is stated as applying to "such disregarded entities [those that hold assets and liabilities of the combining entity of the transferor unit] other than entities that were disregarded entities of the transferor unit immediately prior to the transaction, and each business entity through which the combining entity of the transferee unit holds interests in such disregarded entities". Temp. Regs. §1.368-2T(b)(1)(iii).

[9] This is because the intermediary would be a "business entity through which the combining entity of the transferee unit holds interests in such disregarded entities" (Temp. Regs. §1.368-2T(b)(1)(iii)), even though it would also be in the group of "such

We also believe that it would be helpful if it could be clarified, whether in the final Regulations, the Preamble thereto or in other published guidance (such as a Revenue Ruling) that these regulations do not prohibit transfers of assets and liabilities that occur after the merger, whether or not planned or anticipated at the time of the merger, that would otherwise be permitted. Recently, various Treasury Regulations, Proposed Treasury Regulations and Revenue Rulings have clarified that post-reorganization "drop-downs" to "controlled" corporate subsidiaries will not disqualify a reorganization that otherwise qualifies under various provisions Section 368(a).

The prohibition in the Temporary Regulations on transferor assets and liabilities landing in transferee foreign disregarded entities could be seen as preventing post-merger drop-downs of transferor unit assets or liabilities to a transferee unit's foreign disregarded entity, even though a drop-down to a foreign corporate subsidiary of the transferee unit would be permitted under other guidance and even though a drop-down to a disregarded entity is for virtually all other purposes treated as a non-event and the owner of the disregarded entity is treated as continuing to own the assets and liabilities for U.S. Federal income tax purposes. We do not believe that the Temporary Regulations are intended to, or should, prevent such transfers.[10]

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disregarded entities" because it would hold a transferor unit asset, namely the interest in the lower-tier disregarded entity.

10 The Temporary Regulations require that the specified "events occur simultaneously as of the effective time of the transaction" and "as a result of the operation of [domestic] laws". Temp. Regs. §1.368-2T(b)(1)(ii). This would appear to not prohibit transfers occurring after the effective time and not by operation of the state merger statute, but confirmation of this would still be helpful. We do not see any reason why such transfers should be prohibited. In this regard, we note that the it is our understanding that the reason why transfers to transferee foreign disregarded entities as part of the legal merger are currently not permitted by the Temporary Regulations stems from issues involving the statutory language in Section 368(a)(1)(A), and not from broader concerns about

The types of drop-downs we think are and should continue to be permitted include the following:

(1) T and A, both domestic C corporations, merge, with A surviving, in what is so-far a good "A" reorganization. As part of the same plan and immediately following the effective time of the merger, T's foreign branch is transferred to A's pre-existing or newly-formed foreign disregarded entity.

(2) Same as (1) except T merges with and into a domestic disregarded entity owned by A and the foreign disregarded entity into which the branch is transferred is owned by the domestic disregarded entity.

(3) Same as (1) or (2) except T holds the branch through a foreign disregarded entity and, after merger, that entity is transferred to the transferee foreign disregarded entity (or merged with it).

(4) Same as (1), (2) or (3), except that the transferor foreign branch or foreign disregarded entity is transferred to transferee unit "controlled" corporate subsidiary (which would otherwise be permitted under the other recent guidance), followed by a transfer from that corporate subsidiary to a foreign disregarded entity.

Before the Temporary Regulations came out, it would have been fairly clear that each of these (other than situation (2)) was a good A reorganization. The subsequent transfers to the disregarded entities would have been considered non-events. We believe

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transfers to foreign disregarded entities. We understand you may have separate concerns about such transfers, but that those are being addressed separately. *See, e.g.*, Announcement 2004-4, 2004-4 I.R.B. 357 (proposal to require reporting by taxpayers of their ownership of foreign disregarded entities); and Notice 2003-46, 2003-28 I.R.B. 53 (discussing a study on possible uses of the entity classification regulations to achieve results inconsistent with the policies and rules of particular Code or treaty provisions).

it would be helpful, however, if it were clarified that the Temporary Regulations do not change this result.[11]

II. Election to Apply Temporary Regulations Retroactively (Temp. Regs. §1.368-2T(b)(1)(v))

Recommendations

(1) Permit the election to apply the Temporary Regulations retroactively to be made only jointly by the target and acquiring and (2) require, where it is made, that (a) all shareholders of both corporations treat the transaction consistently and (b) the corporations take reasonable efforts to notify the target shareholders who participated in the transaction that such an election has been made.

Discussion

The Temporary Regulations provide that they apply to transactions occurring on or after January 24, 2003, but that any taxpayer may elect to apply the Temporary Regulations to transactions occurring prior to January 24, 2003, provided that if the taxpayer is the target or the acquiring corporation (or a shareholder of either "whose tax treatment of the transaction reflects the tax treatment by the target [or acquiring]

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11 The domestic-only rule in the Temporary Regulations does not, by terms, require that a transferor foreign disregarded entity have been held by the transferor for any specified minimum time period to qualify for the exception. Nor does it prohibit the transfer of any assets or liabilities *into* such an entity. We believe the formation of a transferor foreign disregarded entity pre-merger followed by a transfer of assets or liabilities to the entity (pre- or post-merger) should not disqualify an otherwise qualifying A reorganization. This is based upon a number of considerations: our understanding of the reason for the domestic-only requirement, the fact that the Temporary Regulations require the specified events to occur simultaneously as of the effective time and pursuant to the domestic merger statute, and our view that pre-merger transactions should be treated in the same manner as post-merger transactions for this purpose.

corporation"), both corporations (and all such shareholders) must apply the Temporary Regulations to the transaction.

Although it is not clear, the election might naturally be read to be available to *any* taxpayer subject to consistency as between the target and acquiror corporations, but extending the consistency requirement to their *shareholders* only where the target or acquiror is an S corporation or, perhaps, a member of a consolidated group.[12] Thus, a shareholder of a C corporation target (other than a member of the same consolidated group) involved in a pre-January 24, 2003 merger could elect to apply the Temporary Regulations even where the target and acquiring do not, or could refrain from making the election (instead, treating the transaction as taxable) while the target and acquiring elect tax-free treatment under the Temporary Regulations. For example, a shareholder of even a closely-held C corporation target could claim a loss on the transaction, while the target and acquiror could treat it as a tax-free A reorganization. Or, a shareholder who wanted to avoid taxable gain could elect-into the Temporary Regulations, while the target treated the transaction as a taxable, offsetting gains (or tax) with NOL carryforwards or other deductions or credits.[13]

We recognize that requiring consistent treatment from every shareholder as a condition to permitting the target and acquiring to apply the Temporary Regulations

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[12] The Temporary Regulations give S corporation shareholders as one example of shareholders "whose tax treatment of the transaction reflects the tax treatment by the target [acquiring] corporation". The only other type of shareholder we can imagine who would fit this requirement would be a member of the same consolidated group.

[13] Under current law, whether the shareholder elected-in (without the corporations doing so) or elected-out (while the corporations elected-in), the shareholder would not even be required to report the inconsistent treatment on his return. The reporting rules in Treas. Regs. §§1.368-3(b) and (c) apply only to a taxpayer who reports a tax-free exchange, but

would allow any shareholder (no matter how small his holding) to hold the corporations hostage. On the other hand, permitting C corporation shareholders (other than consolidated group members) to take positions that differ from the treatment adopted by the target and the acquiring corporations allows for intentionally inconsistent treatment at the corporate and shareholder levels. We believe that allowing this type of inconsistency is inappropriate as a policy matter and is not necessary in this case as a practical or administrative matter. We also strongly believe that the rules should not provide an opportunity for a single shareholder to hold the other parties hostage.

Our suggestion therefore is to provide: (1) that the election to apply the Temporary Regulations retroactively may be made only by the target and acquiring jointly and (2) if it is made, (a) all shareholders of both corporations must also apply the Temporary Regulations to the transaction (although the failure on the part of any shareholder to do so, other than a S corporation shareholder or a consolidated group member, will not invalidate the corporations' elections)[14] and (b) the corporations must take reasonable efforts to notify the target shareholders who participated in the transaction that such an election has been made.[15]

Our suggestion would, thus, alter the existing rule principally in two ways: first, it would clarify the existing requirement that both the target and acquiror corporations must make the election in order for it to be applicable to either by phrasing the election as a

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do not require disclosure of inconsistent treatment as between the reporting taxpayer and any other taxpayer involved in the transaction.

14 We think it is unlikely in this context that the statute of limitations for reporting the transaction by any shareholder would already be closed. We also expect that the retroactive election will be made only with respect to transactions that the parties (and the shareholders) had originally expected would be tax-free.

"joint" election; and second, it would completely eliminate the ability of shareholders to make the election and replace that with the requirement that all shareholders follow the corporations' election and that the corporations attempt to notify the shareholders if the corporations have made the election.

III. Conclusion

We appreciate your consideration of our comments and would be pleased to provide further comments or assistance with regards to these matters if requested.

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15 Where target shares were held in street name, notification to the broker which was the record owner should be sufficient.