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**SUMMARY:**
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**TEXT:**

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On May 11, the Treasury and the IRS proposed to amend reg. section 1.368-2(b)(1) by installing parameters on the type of "statutory merger" required for a reorganization to qualify under code section 368(a)(1)(A). (For a summary or the full text of the proposed regulation (REG-106186-98), see Doc 2000-13226 (13 original pages), 2000 TNT 93-9.) The current regulation requires a merger of two corporations under domestic "corporation laws." Satisfying this requirement has never been enough for reorganization treatment, because nonstatutory requirements like continuity of interest, continuity of business enterprise, and business purpose also apply. The proposed regulations undercut the certainty of meeting even this precondition through a formal merger of two state law corporations under state law.

The proposed rule can be paraphrased as follows:

> Section 368(a)(1)(A) applies to entities that are recognized as entities under domestic nontax statutes and that merge under domestic statutes, if each of these entities is also a "party" to the reorganization under section 368(b), as opposed to being just "part" of a potential party. A single-member limited liability company is an example of a part of its corporate parent.

The Specifics

First, the proposed regulation eliminates the references to "corporation" laws. This change accommodates the regulation to the fact that entities classified as corporations for federal tax purposes ("tax corporations") can merge under state noncorporate laws, such as LLC laws. Second, the proposed regulation requires that "corporations" merge, a somewhat elliptical way of saying that the merger of state law "entities" is not sufficient: the merging entities must themselves be tax corporations.

Another way to state the proposed rule, which highlights the fundamental call made by the government here, is that the pitcher- catcher "battery" in a statutory merger must be composed of two tax corporations. We can draw a ring around the actual battery of entities engaged in the statutory merger, and draw another ring around the two tax corporations engaged in the transaction (if there are two). If the two rings do not identically overlap, as in the illustration below, the statutory merger is not a qualifying merger for purposes of section 368(a)(1)(A), under the proposed regulations.

Illustration of a Nonqualifying Merger

[diagram omitted] **[*1368]** This means that a merger of two entities that are recognized as state statutory law corporations (for example, two qualified REIT subsidiaries (QRS) or two qualified subchapter S subsidiaries (QSSS)) will not qualify under section 368(a)(1)(A), because those entities are not tax corporations, although they are parts of tax corporations. Conversely, a merger of two entities that are not state law corporations for state law purposes (for example, two LLCs) can qualify under section 368(a)(1)(A) if both have checked the box to be treated as tax corporations.

The proposed regulation states both that it will be effective when finalized, and that it will apply to transactions occurring on or after May 16, 2000. The IRS has indicated that the May 16 date was erroneously added at the Federal Register and that the regulation will be effective when finalized.

Background

Letter rulings have found mergers involving REITs to be reorganizations under section 368(a)(1)(A). LTRs 8903074, 9411035, 9512020 (89 TNT 19-61, 94 TNT 54-35, 95 TNT 59-19, respectively). Presumably, these rulings relied on the view that the merger of two corporations under state law must be the state statutory merger that is required by the current regulations. No letter ruling had extended this view to

a merger of a corporation into an LLC, but practitioners had believed the same rule should apply.

The adoption of the check-the-box regulations in 1996 seemed to support this belief. Those regulations provide that an entity such as an LLC, with a single member (an "SME"), is disregarded, and its assets, liabilities, and tax items are treated as belonging to the single member. Reg. section 1.7701-2(c)(1). That regulation seems to support the view that a merger into an SME owned by a corporation is a merger into the corporation. After all, section 11 taxes the incomes of corporations, and only by virtue of this regulation is the income of the SME brought into the income of the corporation; arguably the same result as to mergers is not precluded by section 368(a)(1)(A).

The proposed regulation, however, would dash these hopes.

Merging an SME Out of Existence

The proposed regulation restates, but does not supercede, Rev. Rul. 2000-5, 2000-5 IRB 436, Doc 2000-2181 (3 original pages), 2000 TNT 13-4. This ruling requires that a statutory merger for purposes of section 368(a)(1)(A) must be the transfer of the assets of a target corporation to a single transferee corporation followed by the target ceasing to exist as a result of the "merger." While not involving an SME, this ruling suggests that a merger of an SME owned by a corporation into a corporation cannot be a section 368(a)(1)(A) reorganization, because it likely will be divisive and will not necessarily result in the disappearance of the member. The ruling views such a merger as simply an asset transfer. It may qualify as, for example, a section 368(a)(1)(C) reorganization, if the acquiring corporation receives "substantially all of the assets" of the merging corporation and its single member, in exchange for voting stock, and the member liquidates. The ruling so implies.

Under the proposed regulation, the merger of an SME (even a state law corporation like a QRS or a QSSS) into a tax corporation cannot qualify as a section 368(a)(1)(A) reorganization because the merging entity is not a tax corporation. This part of the proposed regulation, like Rev. Rul. 2000-5, has an antiabuse purpose. To allow the merger of an SME to satisfy section 368(a)(1)(A) would allow the SME's member to have it both ways: treat the SME as a division for all other purposes, but as a separate entity (a subsidiary) for the one purpose of disposing of the division tax-free under section 368(a)(1)(A). Rev. Rul. 2000-5 and the preamble to the proposed regulation both describe this abuse as an end run around the many requirements for divisive reorganizations. 1

Merging Into an SME

In contrast, denying reorganization treatment for a merger of a tax corporation into a corporate-owned SME (be it a QSSS, a QRS, or an LLC that has not checked the box) is not an antiabuse effort. Rather, it appears to be driven by a desire to follow what is seen as the technical requirement of the statute. The preamble observes that the IRC requires "parties" to the reorganization defined as such by section 368(b) to participate in the reorganization for various purposes. That is, the target shareholders can enjoy nonrecognition only if they swap stock of a party for stock of another party, specifically the "party resulting" from the reorganization. The SME is not the party resulting from the reorganization; rather its member is that party. Consequently, as a technical matter the merger into an entity that is not a party to

the reorganization would not satisfy section 368(a)(1)(A).

Policy?

The other obvious choice would have been to find that a merger into a part of the party to the reorganization is a merger into that party. 2 Normally, a technical reading of the statute like the reading Treasury chose **[*1369]** would be supported by some policy considerations, but none was expressed in the preamble. It observed that the merger might qualify under section 368(a)(1)(C), (D) or (F), or section 351. Another possibility, although not mentioned, would be qualification under section 332, where a corporation merges into its parent SME that is owned by a corporation. (If this occurs in a reincorporation situation, we could be back to a section 368(a)(1)(C), (D), or (F) reorganization, or even a taxable distribution. Telephone Answering Service Co. v. Commissioner, 546 F.2d 423 (4th Cir. 1976), aff'g 63 T.C. 423 (1975).)

The most strict of the other tax-free alternatives, and the only one that would apply to an acquisitive merger (as opposed to a related party merger), is section 368(a)(1)(C). Presumably the Treasury views the merger as an asset transfer without benefit of being a "statutory merger." Thus section 368(a)(1)(C) must be satisfied if tax-free treatment is to be obtained in acquisitive situations. Its requirements that do not appear in section 368(a)(1)(A) are principally: (1) acquisition of "substantially all" of the target's assets, (2) for voting stock, (3) with a boot relaxation rule that is intertwined with the liabilities assumed by the "acquiring corporation" (see section 368(a)(2)(B)). The preamble does not indicate a concern about a statutory merger failing any particular aspect of the section 368(a)(1)(C) reorganization requirements. Certainly the requirement of voting stock and "substantially all" are signal features of section 368(a)(1)(C).

Substantially All?

The "substantially all" requirement might be thought to have particular application due to the similarity between a merger into an SME and a forward subsidiary merger. Section 368(a)(2)(D) requires acquisition of "substantially all" of the merging corporation's assets in a forward subsidiary merger. 3 Furthermore, the IRS has indicated its concern with divisive transactions in this area in Rev. Rul. 2000-5, discussed above. That concern is based on Congress's desire to restrict tax-free divisions, as evidenced by the many amendments to section 355 in recent years.

Section 368(a)(1)(A) does not require the acquisition of substantially all of the target's assets; that aspect of the reorganization is policed only by the much more lenient continuity of business enterprise regulations. But the code imposes specific and stricter "substantially all" requirements on section 368(a)(1)(C) and nondivisive section 368(a)(1)(D) reorganizations, as well as on forward and reverse subsidiary mergers. Perhaps the government views the absence of a similar requirement from section 368(a)(1)(A) as an anachronism that should not be extended by treating the merger into the SME as qualifying under section 368(a)(1)(A).

If so, it seems that a fair accommodation of taxpayer interests and government concerns would be to impose by regulation a "substantially all" requirement on a merger of a corporation into a corporate-owned SME for the merger to qualify under section 368(a)(1)(A). This can be explained as a further implementation of the congressional intent that section 355 be the exclusive means to obtain tax-free

treatment of a division. Although this test cannot be found in the right places in the code, a regulation along these lines would be a sensible adaptation to new business realities -- in large part brought about by Treasury itself with the check-the-box regulations. It is true that such a rule would treat mergers of tax corporations into SMEs more favorably than mergers of corporate-owned SMEs into tax corporations (or of SMEs into other SMEs), but the difference would reflect the different policy considerations for each type of transaction.

Liabilities

The use of SMEs as acquisition vehicles may not be driven by a desire to avoid using solely voting stock, or even to get less than substantially all of the target's assets. Rather, a pervasive reason for using SMEs that are LLCs (and to some extent QSSSs and QRSs) is to isolate the liabilities of the acquired entity. The presence of this business purpose in many of these deals should play a large part in any policy considerations that might apply to the proposed regulations. And yet, if these transactions are tested against section 368(a)(1)(C), presumably they can qualify for reorganization treatment; at least the preamble to the proposed regulations implies that.

But is it clear that section 368(a)(1)(C) will apply? Interestingly, this question brings us head on into essentially the same question addressed and proposed to be resolved by these regulations: what is the "acquiring corporation" in a section 368(a)(1)(C) reorganization? Is it the corporate entity that is the "party" to the reorganization, or can it include a division of that entity, such as an SME is viewed to be? The view evidenced by the proposed regulation suggests that Treasury would view the SME assuming the liabilities of the target not to be the "acquiring corporation" issuing its stock to target shareholders. See Rev. Rul. 70-107, 1970-1 CB 78 (assumption of target liabilities by the wrong corporation in an attempted triangular acquisition blocked section 368(a)(1)(C) reorganization treatment -- a triumph of form over substance and a trap for the unwary). This result would mean that whenever the target had any liabilities at all, section 368(a)(1)(C) could not apply because only the acquiring entity can assume the target liabilities and have that assumption disregarded.

The 1999 amendment to section 357(d) does not necessarily resolve the issue. It provides that for purposes of section 368(a)(1)(C) an assumption includes an agreement by "the transferee" to pay the liability, and the receipt by "the transferee" of assets subject to the liability. Surely the transfer of assets and liabilities to an SME will result in assumption by the "transferee," for boot purposes, but does that mean that the "transferee" is also the "acquiring corporation" under section 368(a)(1)(C)? That is not necessarily so, although it would make a lot of sense. Rather, a transferee **[*1370]** is the entity to which assets are transferred, which nominally is the SME.

We suggest that the parent corporation of the SME should be viewed as taking the assets "subject to" the liabilities, even if they were recourse liabilities as to the target and are recourse as to the SME. Thus the "acquiring corporation" would assume the target's liabilities on the merger into its SME, and the merger could qualify as a section 368(a)(1)(C) reorganization, even if not as a section 368(a)(1)(A) reorganization. Otherwise, the merger of a corporation into an unrelated SME could almost never qualify for tax- free treatment. As the only good news here, this result could cause Treasury and IRS to rethink, and we hope retire, Rev. Rul. 70-107.

Through the Hoops?

It has been suggested that the same result sought by Type A reorganization treatment of a merge into an SME also can be obtained by merging the target into an LLC owned by the target's wholly owned subsidiary and then merging that subsidiary into the acquiring corporation, which would wind up owning target's assets (and owing its liabilities) in a wholly owned LLC (an SME). A problem with the initial reincorporation step is that where the subsidiary is transitory it may be disregarded. The described fact pattern does not clearly fall within Rev. Rul. 96-29, which involved a reincorporation following a merger where the reincorporated corporation did not cease to exist. 4

Conclusion

Pending final regulations, practitioners are left with difficult choices for combining a target corporation with the SME of a corporate acquirer. Those choices are (1) merge into parent and drop the assets and attempt to drop the liabilities; (2) merge into the SME and comply with section 368(a)(1)(C) and trust that the acquiring corporation has assumed the liabilities; or (3) attempt one of the "through the hoops" techniques, trying not to use a transitory corporation. We hope that the Treasury will amend the proposed regulation to allow a merger into an SME to be a Type A reorganization, at least if substantially all of the target's assets are acquired.

FOOTNOTES

1 An important policy of the acquisitive reorganization rules has long been to prevent end runs around section 355. This is why the acquired corporation in a reorganization under sections 368(a)(1)(C) and (D) must liquidate. See also Rev. Rul. 74- 545, 1974-2 C.B. 122 (an asset transfer may be "described" in section 368(a)(1)(D) even though it does not qualify as a reorganization under that provision, and so, because of section 368(a)(2)(C), cannot qualify as a section 368(a)(1)(C) reorganization either).

2See American Bar Association, Section of Taxation, Comments on Guidance Needed Concerning the Treatment of Mergers Involving Single Member Entities Owned by Corporations, Doc 98-24591 (6 pages), 98 TNT 151-11. This also is the view adopted by a majority of the executive committee of the New York State Bar Association in a report in 1998. A "significant minority" adopted a view consistent with the proposed regulation. New York State Bar Association Tax Section Committee on Reorganizations, Report on Reorganizations Involving Disregarded Entities, Doc 98-27147 (15 pages), 98 TNT 171-12. See also NYS Bar Assn Tax Section Ad Hoc Comm., Report With Respect to the Regulations that Define a "Statutory" Merger or Consolidation, Doc 2000-11830 (10 pages), 2000 TNT 82-22, recommending that section 368(a)(1)(A) reorganization treatment be available for mergers and similar transactions under foreign law.

3See R. Wellen, "New Guidance Is Needed for 'Substantially All' Rule as Applied to Acquisitions," 79 J. Taxation 280 (November 1993); "More Problems Complicate the Application of 'Substantially All' to Acquisitions," 79 J. Taxation 366 (December 1993).

4 J. Cummings & R. Wellen, "Mergers & Acquisitions: Questioning Rev. Rul. 96-29's

Scope," Tax Notes, Apr. 3, 2000, p. 103, Doc 2000-9383 (6 original pages), 2000 TNT 61-53.