Report #1010

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON THE EFFECT ON 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

New York State Bar Association
Tax Section

Report on the effect on 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

This report, prepared by an ad hoc committee of the New York State Bar Association Tax Section,[1] responds to the request in the preamble to the proposed regulations relating to mergers involving disregarded entities (the "2001 Proposed Regulations")[2] for comments on how Section 367, Section 897 and other international provisions of the Internal Revenue Code would be affected if the Treasury changed the definition of a statutory merger or consolidation to include mergers or consolidations effected under foreign law.[3] In addition to the issues raised in the preamble, we understand that the IRS is concerned about the ability to prove how the relevant foreign law works and with the collection of any U.S. tax that may be due if assets of a U.S. corporation leave the United States in a merger or consolidation involving a foreign corporation.

---

[1] Consisting of Ronald Creamer, Ralph Gerra and Willard Taylor. Helpful comments were received from Samuel J. Dimon, Kathleen L. Ferrell, Richard O. Loengard, Jr., Michael L. Schler and Diana L. Wollman.

[2] 66 Fed. Reg. 57400 (Nov. 15, 2001).

[3] Treas. Reg. § 1.368-2(b)(1), which now provides that "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". The proposed regulations would drop the reference to "corporation" laws and to a "territory".

If the definition of a statutory merger or consolidation is changed to include mergers and consolidations effected under foreign law, there are, as set out below, cross-references in the Section 367 and Section 897 regulations to the reorganization provisions of the Internal Revenue Code that will need to be changed. In addition, a definition of the term "consolidation" should be added to the proposed regulations with respect to mergers involving disregarded entities. Apart from these changes, we do not think that changes are needed in the Section 367 or Section 897 regulations. As discussed more fully below, we do not think that special rules are needed to address proof of foreign law or tax collection issues.

Prior Tax Section Report

In our comments on the 2000 "business plan", we recommended that consideration be given to whether a statutory merger or consolidation should include a merger or consolidation under foreign law.[4] When this was put on the business plan, we recommended in our April 2000 Report (the "April 2000 Report") that such a change be made.[5] We did not think that limiting mergers and consolidations to those effected under U.S. law, as Regs. § 1.368-2(b)(1) now do, was

[4] Letter of February 14, 2000 to Stuart Brown, 2000 TNT 34-20, which was reiterated in the Tax Section's letter of January 16, 2001 to Stuart Brown and Eric Solomon, 2001 TNT 22-42.

[5] NYSBA Tax Section, Report With Respect to the Regulations that Define a 'Statutory' Merger (April 6, 2000), 2000 TNT 82-22. The recommendation in the April 2000 Report would, in the alternative, have clarified that a merger or consolidation of a foreign corporation with a U.S. corporation could qualify as a statutory merger or consolidation under Section 368(a)(1)(A), notwithstanding that the transaction was pursuant to foreign as well as U.S. law.

compelled by the statute or its legislative history or that it imposed a substantive (as opposed to a procedural) requirement -- unlike for example the continuity of shareholder interest requirement. The case for changing the regulations has since been taken up by others, all of whom have recommended such a change.[6]

The 2001 Proposed Regulations which would permit mergers involving disregarded entities to qualify as reorganizations under certain circumstances, underscore the point that qualification as a "statutory merger or consolidation" is not a substantive requirement of the reorganization provisions. If adopted, those proposed regulations will also specify what non-tax law must provide in order for there to be a statutory merger or consolidation.[7] These same requirements[8] could obviously be used to evaluate foreign as well as U.S. law.

Section 367

In general, the regulations under Section 367 apply after a determination has been made that there is a tax-free reorganization and operate in specified circumstances to override the non-recognition and other rules that would

---

[6] *E.g.*, Evans, Respecting Foreign Mergers under U.S. Tax Law, 88 Tax Notes 93 (July 3, 2000); and Bank, A Transcontinental "A" Train? Foreign mergers under Section 368(a)(1)(A), 54 The Tax Lawyer 555 (Spring 2001).

[7] Prop. Regs. § 1.368-2(b)(1)(ii). If adopted, the proposed regulations would also eliminate the need to identify foreign laws as "corporation" laws. *See* the April 2000 Report.

[8] Generally, the 2001 Proposed Regulations require that the following occur simultaneously as of the effective time of the transaction: (1) all the assets (other than those distributed in the transaction) and liabilities (other than those satisfied or discharged in the transaction) of the target become the assets and liabilities of the acquiror and (2) the corporate target ceases its separate legal existence for all purposes.

otherwise apply. They do this now in the case of transactions that qualify under other subparagraphs of Section 368(a)(1) -- for example, as "B" or "C" reorganizations -- and their application should be no different if the definition of a statutory merger or consolidation is expanded to include transactions effected under foreign law.

Thus, suppose that A and B, both foreign corporations, merge or consolidate under foreign law and that, by virtue of an amendment to the regulations under Section 368(a)(1)(A), the merger or consolidation qualifies as a statutory merger or consolidation under Section 368(a)(1)(A). Section 367 and the related international provisions of the Code should apply in the same manner as if that merger or consolidation had been a reorganization under Section 368(a)(1)(C) or (D).

For example, if X, a U.S. person, owns shares of A, and A merges into B or consolidates with B into a new foreign corporation in a merger or consolidation that satisfies Section 368(a)(1)(A), X would not recognize gain on an exchange of shares of A unless X is a "Section 1248 shareholder" of A[9] or the merger or consolidation involves a drop-down of assets described in Section 368(a)(2)(C) and X is a 5% or greater shareholder who fails to enter into the gain recognition agreement required by the regulations.[10] If X is a "Section 1248 shareholder" of A, X would recognize the "Section 1248 amount" with respect to its shares in A if B, or the new foreign corporation into which A and B consolidate, is not a controlled foreign corporation or X is

[9] Regs. § 1.367(b)-1(b)(1).

[10] Regs. §§ 1.367(a)-3(a) and -3(b)(1).

not a Section 1248 shareholder of that corporation.[11] X would also recognize gain if the merger or consolidation involves a drop-down of assets described in Section 368(a)(2)(C), X is a 5% or greater shareholder and X fails to file a gain recognition agreement.[12] Neither A nor B would recognize gain or loss if the merger is treated as a statutory merger or consolidation.[13] These results are consistent with the way in which the Section 367 regulations apply to reorganizations under other subparagraphs of Section 368(a)(1).

There are cross references in the Section 367 regulations that will need to be changed if the Section 368(a)(1)(A) regulations are amended in accordance with our recommendation -- for example, references that will have to be broadened to include Section 368(a)(1)(A) mergers and consolidations include (1) the reference to "asset reorganizations" in Regs. § 1.367(b)-3(a), relating to acquisition of assets of a foreign corporation by a U.S. corporation; and (2) the references to specific reorganizations in Regs. § 1.367(b)-(4)(a), relating to an acquisition by one foreign corporation of the assets or stock of another. "Indirect transfers" within the meaning of Regs. § 1.367(a)-3(d)(1) will also have to be broadened to include Section 368(a)(1)(A) mergers and consolidations in which a U.S. corporation is absorbed by a foreign corporation and assets of the U.S. corporation are transferred to a U.S. subsidiary under Section 368(a)(2)(C), and the reference to

---

[11] Regs. § 1.367(b)-4(b).

[12] Regs. § 1.367(a)-3(d). The amount of X's gain is uncertain -- the indirect transfer rules apply "only to the extent" of the assets dropped down. Regs. § 1.367(a)-3(d)(1)(v).

[13] Regs. § 1.367(b)-1(b).

specified reorganizations in Regs. § 1.367(a)-3(a) will have to be broadened to include Section 368(a)(1)(A).

Section 897 regulations

Like the Section 367 regulations, the relevant Section 897 regulations apply after a determination has been made that there is a tax-free reorganization and operate in specified circumstances to override the non-recognition rules that would otherwise apply. Specifically, under the Section 897 regulations, non-recognition provisions apply to an exchange of an interest in United States real property, including shares of a United States real property holding corporation, only if (1) what is received in exchange is an interest in United States real property and the disposition of what is received would be taxable[14] or (2) the exchange is for stock of a foreign corporation, the transferee foreign corporation would be taxable on the disposition of the interest in United States real property and specified other conditions are met.[15]

As in the case of the Section 367 regulations, conforming changes will need to be made in the Section 897 regulations. Specifically, the references to Sections 368(a)(1)(C) in Regs. § 1.897-6T(b)(1)(ii) should be broadened to include references to Section 368(a)(1)(A).

These rules too would continue to apply if the definition of a statutory merger or consolidation was amended to include a merger or consolidation effected under foreign law. For example, consistent with the present Section 897 regulations (and assuming the recommended change in cross-

[14] Regs. § 1.897-6T(a), which implements Section 897(e).

[15] Regs. § 1.897-6T(b).

references), if A, a foreign corporation, merged into B, a foreign corporation, and A's assets included shares of a United States real property holding corporation, A would not recognize gain in respect of that asset if the stock ownership requirements of Regs. § 1.897-6T(b)(1)(ii) were met, the merger qualified as a statutory merger or consolidation and certain other conditions were met.

Consolidations

In a consolidation, two or more corporations combine into a new corporation -- that is, none of the consolidating corporations survives as such. Since neither Section 367 nor Section 897 applies unless there has been an exchange, it will be important for the regulations to distinguish between mergers and consolidations if the regulations are amended in accordance with our recommendation. The definition in the proposed regulations relating to mergers involving disregarded entities does not do so.[16]

For example, a "Section 1248 shareholder" of A, a controlled foreign corporation, does not recognize gain or income under Section 367 if that corporation survives in a merger or other reorganization with another foreign corporation, B, notwithstanding that the merger has the effect of terminating A's status as a controlled foreign corporation.[17] If A and B consolidate into a new foreign corporation, however, there would be an exchange by the United States shareholders of A, and as a consequence the

[16] Prop. Regs. § 1.368-2(b)(1)(ii).

[17] Both Sections 897 (in Section 897(c)(1)(A)(ii)) and 1248 do, however, have five year look-back rules.

recognition of the "Section 1248 shareholder's" Section 1248 amount.

Forward mergers into disregarded entities

If the decision is made to permit mergers or consolidations under foreign law to qualify as statutory mergers or consolidations, there is no reason why a merger under foreign law of a corporation into a disregarded entity should not be covered, to the same extent as one under U.S. law, by the proposed regulations with respect to mergers involving disregarded entities. As those regulations are now written, however, such a merger must not only be effected under U.S. law but, in addition, the corporations involved, the disregarded entity and any entity between the disregarded entity and its corporate owner must be organized under U.S. law.[18] If the definition of a statutory merger is changed to include a merger effected pursuant to foreign law, the organizational requirement should be dropped.

If the organization requirement were dropped and the definition of a statutory merger changed to include a merger effected pursuant to foreign law, a merger effected pursuant to foreign law of a corporation into a foreign disregarded entity owned by a foreign or domestic corporation could qualify as a reorganization under Section 368(a)(1)(A). Section 368(a)(1)(A) could also apply to a merger of a U.S. corporation into a U.S. disregarded entity owned by a foreign corporation and to a merger of a U.S. corporation into a foreign disregarded entity owned by a foreign corporation.

[18] More specifically, Prop. Regs. § 1.368-2(b)(1)(iii) (66 Fed. Reg. 57400) requires that both corporations (*i.e.*, the "combining entities"), the disregarded entity into which there is a merger, and any business entity between that entity and the acquiring corporation be organized under U.S. law.

Sections 367 and 897 would, of course, apply to these transactions and require the recognition of gain or income in appropriate circumstances.

Proof of foreign law

Considerations of proof of foreign law should not prevent the Treasury and IRS from including mergers and consolidations effected pursuant to foreign law in the definition of a statutory merger or consolidation. To begin with, satisfying the requirement is the taxpayer's -- not the government's -- burden. More importantly, however, establishing that there has been a merger or consolidation should not be a source of dispute -- determining whether a purely domestic transaction is a statutory merger or consolidation has not in our experience been difficult and there is no reason why it should become contentious if the definition of a statutory merger or consolidation is broadened to include transactions effected pursuant to foreign law. If the corporations are publicly-traded, there likely will be disclosure to shareholders of the principal features of the transaction. If U.S. shareholders are meaningful, this is likely to include an opinion on the U.S. tax consequences that will require an analysis of the transaction. If the corporations are closely-held and have significant U.S. shareholders, it is likely that those shareholders will be in a position to provide information on the transaction.

We considered and rejected the possibility that the Treasury and IRS might evaluate foreign laws and issue guidance on specific foreign statutes relating to mergers and consolidations. It seemed to us that the effort that this would require would be disproportionate to the problem. In

addition, any such guidance would quickly be out of date as foreign law evolved. We do not think that expanding the filing requirements that apply to shareholders and parties to reorganizations under Regs. § 1.368-3 would be necessary or useful in this regard.

The collection of tax

Nor should tax collection considerations prevent the Treasury and IRS from including mergers and consolidations under foreign law in the definition of statutory mergers and consolidations. Under current law, depending on the facts, a merger or consolidation of a U.S. corporation with or into a foreign corporation may be fully taxable to the U.S. corporation, because it is not a reorganization, or it may qualify as a reorganization under Section 368(a)(1)(F) or (a)(1)(C). Notwithstanding qualification of the transaction under Section 368(a)(1), the U.S. corporation will ordinarily (under the Section 367(a) regulations) recognize gain on any assets that are not transferred to a U.S. subsidiary of the foreign corporation.[19] This rule would continue to apply if the Section 368(a)(1)(A) regulations were amended to permit a merger or consolidation under foreign law to qualify under Section 368(a)(1)(A).

Thus, permitting a merger or consolidation with or into a foreign corporation to qualify under Section 368(a)(1)(A) does not add any new tax collection issues. The IRS might, as a general matter, decide that there is a tax

---

[19] See Temp. Reg. § 1.367(a)-1T and Reg. § 1.367(a)-3(d). As an exception no gain would be recognized on assets, other than intangibles, that are used in the active conduct of a trade or business outside of the United States. Temp. Reg. § 1.367(a)-2T.

collection issue when a corporation and its assets leave the U.S., whether or not in a reorganization,[20] but this is not an issue that is specifically related to a change in the definition of a statutory merger or consolidation and it is not a reason to decide that the regulations should not be changed.

[20] The issue comes up in other contexts -- for example, if a foreign corporation operating through a U.S. branch closes the branch.