April 6, 2000

Report With Respect to the Regulations
That Define a "Statutory" Merger or Consolidation

This report, prepared by an ad hoc committee of the New York State Bar Association Tax Section,[1] addresses the question of whether the regulations that define a "statutory merger or consolidation" in Section 368(a)(1)(A) of the Internal Revenue Code should include mergers, consolidations and equivalent transactions effected wholly under foreign corporate law or should be limited, as they are now, to mergers and consolidations that are "effected pursuant to the corporation laws of the United States or a State or Territory, or the District of Columbia".[2]

This issue was among the items which members of the Tax Section suggested for the "business plan" for 2000,[3] and we are pleased that the Treasury and IRS saw fit to add the issue to the plan.[4] For the reasons set forth below, we recommend that the regulations be amended to include mergers, consolidations and equivalent transactions effected pursuant to foreign corporate law, as well as those effected pursuant to corporate laws of the United States. We believe that this can be dealt with as a narrow proposal which does not raise broad policy issues. If this change is not made, we would in any event recommend, as suggested in our letter with respect to the "business plan", that the treatment of a merger or consolidation between a foreign corporation and a U.S. corporation be clarified.

Primarily because of the growth of U.S. investment in publicly-traded foreign corporations, qualification of foreign-to-foreign mergers involving publicly-traded foreign corporations as "reorganizations" has become an increasingly important Federal income tax issue. Because of the limitation in the present regulations, a merger or consolidation of two

1 Consisting of Steven Bortnick, Ronald Creamer, Robert Loewy, Richard Reinhold, Willard Taylor and Diana Wollman. Helpful comments were received from Samuel J. Dimon, Peter L. Faber, Robert H. Scarborough and Michael L. Schler.

2 Regs. § 1.368-2(b)(1).

3 Letter dated February 14, 2000 from Robert H. Scarborough, Chair, to Stuart Brown and Eric Solomon.

4 Office of Tax Policy and Internal Revenue Service – 2000 Priority Guidance Plan – Corporations and Their Shareholders – Item 13.

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publicly-held foreign corporations can in general only qualify as a "D" or "C" reorganization, and a subsidiary merger between foreign corporations can generally qualify only as a "B" or "C" reorganization. Qualification as a "B", "C" or "D" reorganization imposes constraints that do not apply to a Section 368(a)(1)(A) merger or consolidation. As a consequence of these constraints, qualification may be unavailable.

Applying the amendments that we recommend to particular transactions may sometimes present interpretive questions. These include whether particular foreign statutes are "corporation laws" and whether particular transactions under those statutes are "mergers" or "consolidations". Our proposal will not create these issues, however, since the same issues may sometimes arise in applying Section 368(a)(1)(A) to wholly-domestic transactions. We also acknowledge that the policy grounds for the different requirements that apply to statutory mergers and consolidations and other forms of reorganizations may be unclear, but we do not think that it is necessary for this much broader policy question to be reexamined before our recommendation is adopted. Congress has determined that statutory mergers and consolidations are to be treated differently from other reorganizations. The narrow question addressed in this report is whether regulations should limit that treatment—as the Internal Revenue Code does not—to mergers and consolidations effected under domestic law.

Background

The rule that a "merger or consolidation" can be a reorganization only if it was "statutory" was added by the Revenue Act of 1934.[5] The purpose was to "conform" the definition "more closely to the general requirements of corporation law".[6] This and the other changes made by the Revenue Act of 1934 "removed the danger that taxable sales can be cast into the form of a reorganization."[7] The Senate Report which accompanied the change[8] makes reference to "State" corporate laws, and it is the case that "mergers" and "consolidations" are in

5 Section 112(g)(1)(A) of the Revenue Act of 1934. See, e.g., Paul, Studies in Federal Taxation, "Reorganizations" at 36-42 (3rd ed. 1940).

6 Before the Act, the definition included "a merger or consolidation", but without the word "statutory". H.R. Rep. No. 704, 73rd Cong., 2d Sess. 14 (1934).

7 Id.

8 S. Rep. No. 558 73rd Cong., 2d Sess. 16 (1934).

general concepts of U.S. corporate law, but the legislative history of the ’34 Act does not direct the exclusion of mergers or consolidations under foreign corporate law. It is possible that such transactions were not even contemplated at the time. In any event, neither the statute nor its legislative history specifies that the “statutory” basis for a merger or consolidation has to be domestic rather than foreign in order to qualify the merger or consolidation as a reorganization. Regulations issued in 1935 provided that a statutory merger or consolidation had to be one “effected in pursuance of the corporation laws of a State or territory or the District of Columbia”.[9] They were amended later in 1935 to add, before “a State”, the words “of the United States or”.[10] The regulations have remained essentially unchanged since then.

Limitations of Present Law

Absent qualification under Section 368(a)(1)(A), a merger, consolidation or equivalent transaction under foreign corporate law can ordinarily qualify as a reorganization only under Section 368(a)(1)(C) or Section 368(a)(1)(D). Qualification as a “C” or “D” reorganization requires compliance with tests not applicable in the case of an “A” reorganization principally, the “substantially all” the assets tests of Sections 368(a)(1)(C) and/or (D), the solely for voting stock requirement of Section 368(a)(1)(C) and the “control” requirement of Section 368(a)(1)(D). These may disqualify as a reorganization a transaction which, had it been effected under U.S. corporate law, would have qualified as an “A”.[11]

Suppose, for example, that X and Y, two publicly-held foreign corporations, amalgamate under foreign corporate law into a new entity, Z; that the sole consideration to the shareholders of X and Y is voting stock of Z; and that X’s former shareholders receive 60% of Z’s shares and Y’s former shareholders receive 40% of Z’s shares.

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[9] Art. 112(g)-2, Regulations 86 (1935).

[10] XIV-2 C.B. 54-55, T.D. 4585 (1935). The present regulations would still exclude mergers or consolidations under Puerto Rican corporate law, since Puerto Rico is not a territory.

[11] In addition, gain will be recognized in a “D” reorganization if liabilities exceed basis, but this will ordinarily not be relevant in a “D” reorganization involving publicly-held foreign corporations.

If this is the entire transaction, it will be a "C" reorganization as to Y[12] and its shareholders and a "D" reorganization[13] as to X and its shareholders.[14] But if the same transaction is preceded by X's distribution to its shareholders of significant assets,[15] it will be a reorganization as to X and its shareholders only if both the distribution and the amalgamation qualify under Section 355;[16] and if it is preceded by Y's distribution to its shareholders of significant assets, it will not be a reorganization as to Y and its shareholders. And if Y had outstanding non-voting preferred stock, the transaction would be a reorganization as to Y and its shareholders only if the non-voting stock was replaced by voting preferred stock of Z. None of these requirements would apply if the amalgamation could qualify as an "A".

Likewise, a subsidiary merger between two foreign corporations (*i.e.*, a transaction in which a subsidiary of the acquiring corporation is merged with or into the target corporation) that is effected under foreign corporate law cannot qualify as a reorganization under Section 368(a)(2)(D) or (E). In substance, these subsidiary merger rules relax the solely for voting stock requirements of a "C" and a "B" reorganization, albeit in the case of a Section 368(a)(2)(E) merger at the price of imposing a "substantially all" the assets requirement. Thus, one consequence of the unavailability of Sections 368(a)(2)(D) and (E) is the inability to use any cash.

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12 E.g., George v. Commissioner, 26 T.C. 396 (1956), holding that the consolidation of a Louisiana corporation and a Mississippi corporation into a new Louisiana corporation, although apparently not a consolidation that was permitted by the Mississippi and Louisiana corporate laws, was a "C" reorganization as to both of the old corporations.

13 E.g., Rev. Rul. 57-465, 1957-2 C.B. 250.

14 Assuming in each case that the distribution does not violate the continuity of business enterprise requirement.

15 What constitutes "substantially all" the assets for purposes of Section 368(a)(1)(D) may differ from what is required for purposes of Sections 368(a)(1)(C), 368(a)(2)(D) and 368(a)(2)(E).

16 Which would not be the case on the stated facts since the Z shares issued to the X shareholders would not represent "control" (unless they had disproportionate voting rights).

Recommendation

We have no doubt that Regs. § 1.368-2(b)(1) is a valid interpretation of the statute,[17] but we do not believe that the Treasury and the Internal Revenue Service are compelled by the statute or its legislative history to limit "statutory" mergers and consolidations to those effected under U.S. corporate law. Moreover, the deference that might otherwise be accorded a regulation first adopted in 1935 is less here since the meaning of Regs. § 1.368-2(b)(1) has changed considerably over the years with changes in State merger and consolidation laws. The appropriate inquiry, therefore, is whether such a restriction makes sense as a matter of tax policy.

In 1934, when the "statutory" requirement was added to the definition of a reorganization, not all States had merger or consolidation statutes. The new rule was therefore questioned on the basis that it discriminated to no apparent purpose between those States that did have such statutes and those that did not.[18] That objection has largely disappeared as all States have adopted such statutes, but the same question can still be asked about the exclusion in the regulations of mergers or consolidations effected pursuant to foreign corporate law.

We do not see any basis for continuing to differentiate between mergers and consolidations solely on the basis of governing corporate law. Apart from specific statutory constraints, such as the solely for voting stock requirement in Sections 368(a)(1)(B) and (C), the main restrictions today on qualification as a reorganization are non-statutory rules, such as continuity of shareholder interest and continuity of business enterprise, and general tax principles such as business purpose and substance over form. None of these are derived from or in any way related to the requirement of a "statutory" merger or consolidation and none would be affected if the regulations were, as we recommend, amended to include mergers and consolidations effected pursuant to foreign corporate law. The suggested amendment to the

[17] See Russell v. Commissioner, 40 T.C. 810, 882 (1963), aff'd per curiam 345 F.2d 534 (5th Cir. 1965) (stock-for-stock exchange not effected pursuant to a state merger or consolidation law was not a Section 368(a)(1)(A) reorganization); and Anderson v. Commissioner, 23 T.C.M. (CCH) 589 (1964) (liquidation of corporation owned by individuals was not a statutory merger or consolidation).

[18] See Fahey, Income Tax Definition of "Reorganization", 39 Colum. L. Rev. 933 (1939). See also, S. Rep. No. 558, 73rd Cong., 2d Sess. 16 (1934).

regulations would in no way limit the scope of Section 367 and the regulations issued under that Section.

The requirement of a "statutory" merger or consolidation in Section 368(a)(1)(A) is not a substantive requirement. Qualification as a merger or consolidation under U.S. corporate law is not enough for there to be a "reorganization", as Rev. Rul. 2000-5, 2000-5 I.R.B. 436,[19] and other authorities[20] have concluded. Whatever function the requirement serves is not enhanced by restricting a "statutory" merger or consolidation to one effected pursuant to U.S. corporate law. The non-divisive principle announced in Rev. Rul. 2000-5 would police foreign merger statutes that differ significantly from traditional U.S. merger statutes, and the limited extension of the regulations should not undercut any important requirement for a tax-free reorganization.

The change we recommend would also mean that a subsidiary merger under foreign corporate law could qualify as a reorganization under Section 368(a)(2)(D) or (E). Absent the change, such a transaction could only qualify as a "C" reorganization, if the merger subsidiary survives, or a "B" reorganization, if the target survives—in substance, the same rules that applied to subsidiary mergers under U.S. corporate law prior to the 1968 and 1971 amendments that added Sections 368(a)(2)(D) and (E).

Our specific proposal would be to add to the present regulations, after "or the District of Columbia", the words "or a foreign country or a political subdivision of a foreign country". It would also be appropriate to address three other points:

First, the meaning of the "corporation laws". We believe that this refers to the laws governing entities which the jurisdiction of organization regards as corporations. We recognize that this definition of "corporation laws" may be uncertain in particular cases, as it may be within the United States, but we believe, for example, that a merger or consolidation involving foreign entities that are <u>per se</u> corporations (within the meaning of Regs.

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[19] Holding that a statutory merger in which assets and liabilities were retained by the merged corporation was not a reorganization under Section 368(a)(1)(A).

[20] <u>E.g.</u>, Rev. Rul. 78-250, 1978-1 C.B. 83.

§ 301.7701-2(b)(8)) would necessarily be covered by this definition, and that the uncertain cases would thus as a practical matter be limited.

Second, a transaction cannot be a reorganization within the meaning of Section 368(a) unless the parties are corporations for U.S. tax purposes. Our recommendation would affect only mergers of such parties, and we suggest that the amended regulations expressly provide that Section 368(a)(1)(A) would apply only to a foreign entity that is treated as an association under Regs. § 301.7701-2(b).[21] Thus, the amendment that we propose would not treat a merger or consolidation under foreign corporate law as a Section 368(a)(1)(A) reorganization if, because it was not between because it was not between persons treated as corporations for United States tax purposes, it would not qualify here.

Third, because of the different terms (such as “amalgamation”, “scheme” or “scheme of arrangement”) used to describe foreign transactions that are equivalent to mergers and consolidations, the regulations should also specify that a merger or consolidation includes its equivalent under foreign corporate law—that is, in the case of a merger, a transaction in which the assets and liabilities of one corporation are absorbed by another and, in the case of a consolidation, a transaction (such as amalgamation) in which the assets and liabilities of two or more corporations are absorbed by a new legal entity. At one point, the regulations defined a reorganization as a transaction in which “two (or more) corporations unite their properties”[22] and this kind of definition might usefully be employed here.

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[21] With this exception, we do not believe our recommendation involves the issues considered in our <u>Report on Reorganizations Involving Disregarded Entities</u> (August 27, 1998).

[22] Reg. 45, Art 1567 (1921). <u>See</u> Paul, “Reorganizations”, <u>Studies in Federal Taxation</u> (3rd Ed. 1940), at 20-21.

Alternative Recommendation

If our first recommendation is not accepted, we believe that it would be useful at a minimum to have published guidance as to whether a "statutory merger or consolidation" as defined in Section 368(a)(1)(A) of the Internal Revenue Code encompasses a merger between a U.S. corporation and a foreign corporation, notwithstanding that it is pursuant to foreign as well as U.S. corporate law. There is, however, no positive authority on the question—a merger of two U.S. corporations in which stock of a foreign corporation parent is issued can meet the requirements of Section 368(a)(1)(A) for purposes of Sections 368(a)(2)(D) and (a)(2)(E),[23] but not on the theory that merger of the U.S. corporation with the foreign parent would satisfy the "statutory" merger requirement of the regulations under Section 368(a)(1)(A).

The policy question raised by our alternative recommendation is whether, if there is a reason to include in a "statutory" merger or consolidation only one effected pursuant to U.S. corporate law, that purpose is served so long as U.S. law applies to the U.S. corporation involved in a merger or consolidation with a foreign corporation. As a matter of interpreting the present regulations, it would seem that a cross-border merger or consolidation is no less "effected pursuant" to domestic corporation laws by reason of the fact that it is effected pursuant to foreign law as well as U.S. corporate law.

[23] Rev. Rul. 74-297, 1974-1 C.B. 84.