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October 13, 2006

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3112 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Section 368(a)(1)(A) Regulations Defining a "Statutory Merger or Consolidation"

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

This letter, prepared by the Committee on Reorganizations of the New York State Bar Association Tax Section (the "Tax Section")[1], comments on the final regulations defining a "statutory merger or

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[1] The principal drafters of this letter were Linda Z. Swartz, Karen Gilbreath Sowell, and Richard M. Nugent, with assistance from Martin Huck. Helpful comments were received from Kimberly S. Blanchard, Kathleen L. Ferrell, Patrick C. Gallagher, Deborah L. Paul, Michael L. Schler, Jodi J. Schwartz, and Gordon E. Warnke.

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consolidation" in section 368(a)(1)(A)[2] to include certain merger transactions involving foreign entities and disregarded entities (the "Final Regulations").[3] Given the widespread use of disregarded entities and the growth of U.S. investment in foreign companies, the Final Regulations are a welcome advancement in the tax law. The Final Regulations provide taxpayers with the ability to accomplish legitimate business combinations which, in some cases, were not possible or were costly or difficult to accomplish.

Like the 2003 Temporary Regulations, the Final Regulations permit a corporation's merger into a disregarded entity of the acquiring corporation to qualify under section 368(a)(1)(A) as an "A reorganization".[4] In the preamble to the Final Regulations (the "Preamble"), the Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") requested comments on several aspects of the Final Regulations, including whether A reorganization characterization should be extended to transactions involving the acquisition of all of a target corporation's stock and, either (i) a related conversion of the target under state law into a limited liability company that is treated as a disregarded entity (an "LLC" and such transaction, a "Conversion") or (ii) an election to change the entity classification of the target to that of a disregarded entity (a "CTB Election", and with a Conversion, collectively, a "Tax Liquidation").[5]

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[2] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

[3] *See* Treas. Reg. § 1.368-2(b). Prior to the Final Regulations, the government issued several sets of temporary and proposed regulations under section 368(a). We submitted a report on the temporary regulations issued in January 2003 (the "2003 Temporary Regulations"). *See* NYSBA Tax Section, "Report on Temporary Regulations Section 1.368-2T Relating to 'A' Reorganizations Involving Disregarded Entities", May 26, 2004, *reprinted at* 2004 TNT 103-12. Separately from the regulations, we issued two reports on the appropriate treatment under section 368(a) of mergers effected under foreign corporate laws as well as a report on mergers involving disregarded entities. *See* NYSBA Tax Section, "Report on the Effect of the International Provisions of the Internal Revenue Code of Defining 'Statutory' Mergers and Consolidations Under Section 368(a)(l)(A) to Include Those Effected Under Foreign Law", May 9, 2002, *reprinted at* 2002 TNT 99-17; NYSBA Tax Section, "Report with Respect to the Regulations That Define a 'Statutory' Merger or Consolidation", Apr. 6, 2000 (the "NYSBA 2000 Report"), *reprinted at* 2000 TNT 82-22; NYSBA Tax Section, "Report on Reorganizations Involving Disregarded Entities", Aug. 27, 1998 (the "NYSBA 1998 Report"), *reprinted at* 98 TNT 171-12.

[4] In May 2000, the government issued proposed regulations (the "2000 Proposed Regulations") that declined to treat this transaction as an A reorganization. *See* REG-106186-98, 2000-1 C.B. 1226. The government changed course and withdrew the 2000 Proposed Regulations when it issued new proposed regulations in November 2001 (the "2001 Proposed Regulations"). *See* REG-126485-01, 2001-2 C.B. 542.

[5] *See* T.D. 9242, 2006-7 I.R.B. 422. This letter assumes that the second-step Tax Liquidation or actual liquidation, as the case may be, would be integrated with the relevant stock acquisition under the step transaction doctrine.

For convenience, this letter refers to the resulting entity following a Conversion as an LLC. However, the same analysis would apply in determining whether A reorganization treatment is appropriate after a second-step foreign law Conversion in which an entity changes its legal status to that of an entity which is

A substantial majority of our Executive Committee believes that the statutory language of section 368(a)(1)(A) does not support A reorganization treatment for a stock acquisition followed by a related CTB Election of the target corporation (a "Stock Acquisition/CTB Election") or for a stock acquisition followed by the target's actual liquidation (a "Stock Acquisition/Actual Liquidation"), because these integrated transactions lack the necessary predicate of a statutory merger or consolidation (the "statutory merger requirement"). A majority of our Executive Committee believes that the statutory language also does not support A reorganization treatment for a stock acquisition followed by a related Conversion of the target, though a significant minority believes that section 368(a)(1)(A) is adequate to support such treatment, because the Conversion occurs pursuant to a state statute. Notwithstanding the limiting statutory language, we believe there are reasonable policy arguments for treating a Stock Acquisition followed by a related Conversion (a "Stock Acquisition/Conversion"), a Stock Acquisition/CTB Election (together with a Stock Acquisition/Conversion, a "Stock Acquisition/Tax Liquidation"), and a Stock Acquisition/Actual Liquidation as an A reorganization. If Treasury reaches similar conclusions, it might seek from Congress the necessary statutory authority to allow for such an interpretation of section 368(a)(1)(A).[6]

Background

The corporate reorganization provisions exempt from the general rule of gain recognition certain non-divisive transactions that are merely readjustments of continuing interests in property under modified corporate forms.[7] Section 368, which describes seven forms of a reorganization and sets forth the requirements for each, defines an A reorganization as a "statutory merger or consolidation".[8] The Final Regulations adopt the definition of a "statutory merger" espoused in Revenue Ruling 2000-5, which held that "a transaction effected under a corporate law merger statute must have the result that one corporation acquires the assets of the target corporation by operation of the corporate law merger statute and the target corporation ceases to exist".[9] Section 368 also permits a statutory consolidation to qualify as an

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eligible to be treated as a disregarded entity. *See* Treas. Reg. § 301.7701-3(a) (eligible entity with a single member can elect to be treated as either a corporation or a disregarded entity for Federal income tax purposes); Treas. Reg. § 301.7701-2(b)(8) (listing foreign entities that are treated as "per se" corporations for Federal income tax purposes).

6 Such statutory authority might extend beyond the specific issues considered in this letter and grant Treasury the authority to broadly interpret section 368 in its entirety to take into account changes in both tax and corporate laws since Congress enacted the predecessor to section 368 over eighty years ago.

7 *See* Treas. Reg. § 1.368-1(b).

8 *See* I.R.C. § 368(a)(1)(A). In addition, reorganizations generally must satisfy the business purpose, continuity of interest and continuity of business enterprise requirements contained in the regulations (the "judicial requirements"). *See* Treas. Reg. § 1.368-1. We assume that the transactions discussed in this letter would comply with all the judicial requirements.

9 Rev. Rul. 2000-5, 2000-1 C.B. 436. Of course, satisfaction of this definition does not guarantee A reorganization treatment when a merger statute would produce a divisive transaction. The Service concluded in Revenue Ruling 2000-5 that state law mergers in which the target corporation transfers only certain assets and liabilities and remains in existence, or transfers a portion of its assets and liabilities to

A reorganization. This term historically has represented "a dissolution of the companies consolidating and a transfer of corporate assets" to another corporation.[10]

Final Disregarded Entity Merger Regulations

The Final Regulations define the parties to an A reorganization as "combining units," which each consist of a "combining entity that must be taxed as a corporation, and any disregarded entities whose assets the combining entity is treated as directly owning for Federal income tax purposes".[11] The Final Regulations also add the following functional definition of a "statutory merger or consolidation", which supplements the statutory reference to state law:

> a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation, in which transaction, as a result of the operation of such statute or statutes, the following events occur simultaneously at the effective time of the transaction—
>
> (A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more transferor combining units (each, a transferor unit) become the assets and liabilities of one or more members of another combining unit (*i.e.*, the transferee unit); and
>
> (B) The combining entity of each transferor unit generally ceases its separate legal existence for all purposes.[12]

Under this standard, a target corporation's merger into the acquiring corporation's disregarded entity may qualify as an A reorganization (a "Disregarded Entity Merger").[13]

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each of two separate acquiring corporations, do not qualify as A reorganizations. In addition, a transaction effected under a state merger or consolidation statute will not qualify as an A reorganization if the transaction does not satisfy the judicial requirements. *See, e.g.*, *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Roebling v. Commissioner*, 143 F.2d 810 (3d Cir.), *cert. denied*, 323 U.S. 773 (1944).

[10] *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933); *see* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 12.

[11] Treas. Reg. § 1.368-2(b)(1)(ii).

[12] Treas. Reg. § 1.368-2(b)(1)(ii); *see* REG-117969-00, 2005-1 C.B. 533 (preamble to 2005 proposed section 368(a) regulations). The latter requirement is satisfied even if, after the effective time of the transaction, the combining entity of the transferor unit, a member of the transferee unit, or the officers, directors or agents of either entity may act (or be acted against) in the name of the combining entity of the transferor unit, provided that such actions relate to assets or obligations of the combining entity of the transferor unit that arose, or relate to the combining entity's activities, prior to the effective time of the transaction. *See* Treas. Reg. § 1.368-2(b)(1)(ii).

The Final Regulations contain an example of a Stock Acquisition/Conversion. The example concludes that the integrated transaction did not qualify as an A reorganization because the target corporation did not cease its separate legal existence for all purposes; although the target was a disregarded entity for Federal income tax purposes after the Conversion, the target continued to exist as a "juridical entity".[14] The Preamble notes, however, that second-step Conversions and CTB Elections are similar to a statutory merger because each "accomplishes the simultaneous transfer for Federal income tax purposes of all of the assets of the target corporation to the acquiring corporation and the elimination for Federal income tax purposes of the target corporation as a corporation."[15]

In light of these similarities, the Preamble explains that the government is considering whether a Stock Acquisition/Tax Liquidation should be permitted to qualify as an A reorganization, and seeks input on that issue and the effect, if any, that such a change would have on prior step transaction guidance contained in Revenue Ruling 67-274[16] and Revenue Ruling 72-405.[17] As discussed below, these rulings test similar two-step transactions as section 368(a)(1)(C) reorganizations (each, a "C reorganization").[18]

Integration of Two-Step Transactions

The government and the courts have utilized the step transaction doctrine to integrate two-step acquisitions into a single transaction qualifying as an asset reorganization under Section 368(a).[19] Revenue Ruling 67-274 was one of the government's earliest applications of the step transaction doctrine. In the ruling, a corporation acquired all the target corporation's stock solely in exchange for acquirer voting stock, and then liquidated the target as part of the same plan. The Service held that the stock acquisition and the liquidation were part of an overall plan of reorganization and could not be considered independently of each other. Accordingly, the Service tested the integrated transaction as a C reorganization, rather than as a

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[13] *See* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 2.

[14] *See* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 9. The same issue arises in a Stock Acquisition/CTB Election.

[15] T.D. 9242, 2006-7 I.R.B. 422.

[16] 1967-2 C.B. 141.

[17] 1972-2 C.B. 217.

[18] In order to qualify as a C reorganization, although there is no statutory merger requirement, a transaction must satisfy requirements that are generally much stricter than those for an A reorganization. An acquiring corporation must acquire substantially all the assets of the target corporation solely in exchange for its voting stock (or voting stock of its immediate controlling parent corporation), or in exchange for such voting stock and a limited amount of other property. *See* I.R.C. §§ 368(a)(1)(C), (a)(2)(B).

[19] *See, e.g., King Enters. Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969) (treating an integrated stock acquisition and upstream merger as an A reorganization); Rev. Rul. 2001-26, 2001-1 C.B. 1297 (treating an integrated tender offer and second-step reverse subsidiary merger as a section 368(a)(2)(E) reorganization).

section 368(a)(1)(B) reorganization (a "B reorganization") followed by a section 332 liquidation of the newly acquired target. Similarly, in Revenue Ruling 72-405, a merger subsidiary acquired all the target corporation's assets solely in exchange for stock of the subsidiary's parent corporation and then liquidated into the parent. The Service concluded that the acquisition and the liquidation were part of an overall plan for the parent to acquire the target's assets and rejected the "transitory passage" of the target's assets through the merger subsidiary. Therefore, the Service treated the integrated transaction as a C reorganization, rather than as a section 368(a)(2)(D) reorganization followed by a section 332 liquidation of the merger subsidiary.

More recently, in Revenue Ruling 2001-46,[20] the Service examined a two-step transaction involving a first-step stock acquisition and a second-step upstream merger of the acquired target directly into the parent corporation (a "Stock Acquisition/Upstream Merger").[21] After considering whether to reject the step transaction doctrine based on section 338 policy, the ruling ultimately applied the doctrine to hold that the integrated transaction qualified as an A reorganization.[22] The Service concluded that applying the step transaction doctrine would not contravene the Congressional mandate that section 338 constitute the sole means of recharacterizing a stock purchase as an asset purchase, because that mandate was limited to taxable transactions and integrating the two steps as an A reorganization would not produce a cost basis in the target's assets.[23]

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[20] 2001-2 C.B. 321.

[21] We previously submitted a report supporting the result in Revenue Ruling 2001-46. *See* NYSBA Tax Section, "Report Responding to Rev. Rul. 2001-46, Dealing With Multi-Step Acquisitions", *reprinted at* 2002 TNT 142-18 (the "NYSBA 2001-46 Report").

[22] In the ruling, a parent corporation acquired all the target corporation's stock in a first-step reverse subsidiary merger in which the consideration received by the target shareholders was 70 percent parent voting stock and 30 percent cash. In the second step, the target merged directly into the parent in a state law merger. The stock acquisition viewed alone was a qualified stock purchase (a "QSP"), *i.e.*, a "purchase" of at least 80 percent (by vote and value) of a target corporation's stock by another corporation within a 12-month period, which is a prerequisite to the application of section 338. *See* I.R.C. § 338(d)(3); Rev. Rul. 90-95, 1990-2 C.B. 67 (taxable stock acquisition of target corporation treated separately from target's related section 332 liquidation). Where the step transaction doctrine does not apply to integrate steps, U.S. tax law generally treats a reverse subsidiary merger as a stock acquisition and treats an upstream merger of a wholly owned subsidiary into its parent corporation as a section 332 liquidation. *See, e.g.*, Treas. Reg. § 1.332-2(d), (e) (upstream merger directly into acquirer); Rev. Rul. 74-565, 1974-2 C.B. 125; Rev. Rul. 74-564, 1974-2 C.B. 124 (B reorganizations effected through transitory mergers).

[23] *See* Rev. Rul. 2001-46, 2001-2 C.B. 321; Treas. Reg. § 1.338(h)(10)-1(c)(2) and (e), Ex. 11-13; NYSBA 2001-46 Report, *supra*. In response to the concern that Revenue Ruling 2001-46's integration of a QSP and related upstream merger or liquidation could preclude a section 338(h)(10) election because the first-step QSP would be disregarded once the two steps are integrated, the government amended the section 338 regulations in 2003 to permit taxpayers to elect the application of section 338(h)(10) in this situation. *See* T.D. 9071, 2003-2 C.B. 560. If the election is made, the second-step merger or liquidation, as the case may be, generally is treated as a separate transaction. *See* Treas. Reg. § 1.338(h)(10)-1(c)(2) and (e), Ex. 12.

Discussion

Stock Acquisition/Disregarded Entity Mergers

Although similar to a Stock Acquisition/Upstream Merger, neither Revenue Ruling 2001-46 nor the Final Regulations explicitly address an integrated transaction in which the acquisition of the target's stock is followed by the target's merger into the acquiring corporation's disregarded entity (a "Stock Acquisition/Disregarded Entity Merger"). However, the Preamble suggests that such an integrated transaction should qualify as an A reorganization.[24] Because a disregarded entity is treated as a branch of its owner for all Federal income tax purposes, the second-step state law merger in a Stock Acquisition/Disregarded Entity Merger is equivalent to the second-step state law merger of the target directly into the acquiring corporation in Revenue Ruling 2001-46.[25] Accordingly, we recommend that the government confirm that a Stock Acquisition/Disregarded Entity Merger does, in fact, qualify as an A reorganization.[26]

Statutory Merger Requirement and Tax Liquidations

Assuming a Stock Acquisition/Disregarded Entity Merger can qualify as an A reorganization, the Final Regulations distinguish between a Stock Acquisition/Disregarded Entity Merger and a Stock Acquisition/Tax Liquidation in applying the statutory merger requirement. As discussed below, a plain reading of the statutory merger requirement in section 368(a)(1)(A) precludes the treatment of a Stock Acquisition/Tax Liquidation as a statutory merger or consolidation.

Congress adopted the statutory merger requirement in 1934 as part of its effort to "conform" the definition of a reorganization "more closely to the general requirements of

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[24] *See* T.D. 9242, 2006-7 I.R.B. 422 (Stock Acquisition/Conversion is like a Stock Acquisition/Disregarded Entity Merger; "[i]n the latter case, the overall transaction may qualify as a statutory merger or consolidation of T into A under the 2003 temporary regulations.").

[25] Both transactions generally are treated on a stand-alone basis as complete liquidations into the acquiring corporation under section 332. *See, e.g.*, Treas. Reg. § 1.332-2(d), (e) (upstream merger directly into acquirer); Priv. Ltr. Rul. 200310005 (Mar. 7, 2003); Priv. Ltr. Rul. 200239022 (Sept. 27, 2002) (merger into disregarded entity of acquirer).

[26] The preamble to the 2003 Temporary Regulations (the "2003 Preamble") also supports A reorganization treatment for a Stock Acquisition/Disregarded Entity Merger. As described therein, a commentator inquired as to whether Revenue Ruling 72-405 requires the merger of a target into an acquirer disregarded entity in an otherwise qualifying A reorganization to be tested under the more restrictive C reorganization rules if the acquirer's disregarded entity immediately merges directly into the acquirer in a second-step transaction. The 2003 Preamble confirmed that the second-step merger would be disregarded because it did not "alter the tax identity of the tax owner of the former [target's] assets", and concluded that the integrated transaction did not "implicate" the principles of Revenue Ruling 72-405. *See* T.D. 9038, 2003-1 C.B. 524. Like the treatment of a single-step Disregarded Entity Merger as a merger directly into the acquirer, this analysis employs the Final Regulations' combining unit concept to treat the acquirer and its disregarded entities as a single unit for A reorganization purposes.

corporation law".[27] Congress enacted several reorganization-related amendments that year to "remove the danger that taxable sales can be cast in the form of a reorganization. . . ."[28] Historically, state corporate laws imposed significant restrictions on statutory mergers, including that the parties engage in similar businesses, the target corporation's shareholders receive an equity interest in the acquiring corporation, and the target dissolve after completion of the merger.[29] While some merger statutes had departed from these historic requirements in 1934, Congress concluded that the statutory merger requirement—including the accompanying requirements of a formal plan of merger, shareholder vote, dissenters' rights and assumption of liability for the target corporation's legal obligations—was sufficient to distinguish transactions that appropriately qualified for reorganization treatment from disguised sales.[30] Following the adoption of the statutory merger requirement, Treasury issued regulations in 1935 providing that a statutory merger or consolidation had to be "effected in pursuance of the corporation laws of the United States or of a State or territory or the District of Columbia".[31] The regulations remained essentially unchanged until the recent amendments addressing Disregarded Entity Mergers.

Based on the plain language of section 368(a)(1)(A) and our review of the history of the statutory merger requirement, we conclude that, as a predicate to A reorganization treatment, the transaction must result in the combination of the target and acquiring corporations pursuant to a statute, with the target entity going out of existence. Congress expressed its clear intent in the 1934 Tax Act to condition qualification as an A reorganization on the occurrence of a statutory merger or consolidation. We recognize that a Stock Acquisition/Tax Liquidation accomplishes for Federal income tax purposes (i) the simultaneous transfer of the target corporation's assets and liabilities to the acquiring corporation, and (ii) the target's elimination as a corporation, which are similar consequences to those produced in a statutory merger or consolidation such as a Stock Acquisition/Disregarded Entity Merger. However, we remain concerned that the acquiring corporation in a Stock Acquisition/Tax Liquidation is not a party to a statutory merger or consolidation, and the target does not cease its separate legal existence

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[27] H.R. Rep. No. 704, 73d Cong., 2d Sess. 14 (1934) (the "1934 Tax Act"); *see* NYSBA 2000 Report, *supra*. *See generally* Randolph E. Paul, *Studies in Federal Taxation* 36-41 (3d ed. 1940) (discussing the purposes of the 1934 Tax Act) [hereinafter, "Paul"].

[28] *See* H.R. Rep. No. 704, 73d Cong., 2d Sess. 14 (1934).

[29] *See* David S. Miller, "Devolution & Inevitable Extinction of the Continuity of Interest Doctrine," 3 *Fla. Tax Rev.* 187, 192 (1996) [hereinafter, "Miller"].

[30] *See* Miller, *supra*, at 200-01.

[31] Reg. 86, Art. 112(g)-2 (1935).

under state law.[32] Thus, we are concerned that section 368(a)(1)(A) as currently drafted does not permit the treatment of these transactions as A reorganizations.[33]

In a second-step Conversion, a target corporation changes its legal entity status from a corporation to an LLC in accordance with state law. From a state law standpoint, the converted LLC generally is treated as the same entity as the prior corporation.[34] Therefore, although a Conversion is effected pursuant to state law, no transfer or assumption of assets or liabilities to a new entity is deemed to occur as a state law matter. Similarly, the corporation is not treated as dissolving and terminating its existence for state law purposes.[35] As the Preamble explains, A reorganization treatment requires a fusion pursuant to state law of the target corporation into a second, pre-existing entity.[36]

We believe that the case for A reorganization treatment is even weaker after a second-step CTB Election than a Conversion. It is axiomatic that a CTB Election and the corresponding deemed asset transfer and corporate dissolution only have effect for Federal income tax purposes. No action occurs, or is treated as occurring, under state law to effect the transfer of assets from the target corporation to the acquirer.[37]

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[32] We note that, after a Stock Acquisition/Disregarded Entity Merger, there is a continuing legal entity that owns all the assets and liabilities of the target corporation. This legal entity, however, is not the same legal entity as the former target corporation, although the entity is disregarded for Federal income tax purposes.

[33] As discussed above, in Revenue Ruling 2001-46, the government integrated and treated as an A reorganization a first-step stock acquisition effected pursuant to a reverse subsidiary merger and a second-step upstream merger of the target corporation into the acquiring corporation. *See* Rev. Rul. 2001-46, 2001-2 C.B. 321. In contrast to a Stock Acquisition/Tax Liquidation, the integrated transaction in the Revenue Ruling consisted of two statutory mergers, and the acquirer was a party to the second merger.

[34] *See, e.g.*, Del. Gen. Corp. Law, § 266(h) (2006) ("When a corporation has been converted to another entity or business form pursuant to this section, the other entity or business form shall, for all purposes of the laws of the State of Delaware, be deemed to be the same entity as the corporation."); Ore. Bus. Corp. Act, § 60.478(i)(a) (2006) ("When a conversion to or from a corporation . . . takes effect . . . the business entity continues its existence despite the conversion. . . ."). Indeed, the continued existence of the converted entity is one of the principal benefits of a Conversion; the statute allows a change in legal status without requiring compliance with consent and other burdensome state law approval requirements.

[35] *See* Del. Gen. Corp. Law, § 266(f) (2006) ("Unless otherwise provided in a resolution of conversion adopted in accordance with this section, . . . the conversion shall not constitute a dissolution of [the applicable] corporation.").

[36] *See* T.D. 9242, 2006-7 I.R.B. 422. As noted earlier, a significant minority of our members believes that a Stock Acquisition/Conversion could appropriately be treated as an A reorganization, because the target corporation ceases its corporate existence pursuant to a statutory event that may qualify as a consolidation. *See Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933) (noting that state laws historically permitted some degree of survival for the constituent corporations in a consolidation).

[37] *See* T.D. 9242, 2006-7 I.R.B. 422.

Possible Amendment of Section 368

As evidenced by the recent expansion of the A reorganization rules to include mergers involving disregarded and foreign entities, the government has interpreted the 1934 statutory definition of A reorganizations to include transactions that Congress could not have foreseen when the statute was enacted. Treasury has concluded, and we agree, that section 368(a) properly allows Disregarded Entity Mergers and mergers involving foreign entities to be treated as A reorganizations.[38] However, because the current statutory language does not support A reorganization treatment for transactions that do not satisfy the statutory merger requirement, we question whether there is authority to issue an interpretive regulation permitting a Stock Acquisition/Tax Liquidation to qualify as an A reorganization.

Based on the evolution of the law regarding reorganizations and entity classifications as well as the creation of complex, multi-national corporate structures, it may be appropriate to seek expanded legislative authority to reflect these practical and legal changes in section 368, including authority to treat integrated transactions such as those discussed in this letter as satisfying the statutory merger requirement in section 368(a)(1)(A). Because technical problems exist in other subsections of section 368, this could be part of a larger request for legislative authority to broadly construe section 368 in its entirety (such authority, "Section 368 Interpretive Authority").[39] Indeed, Treasury recognized the need for similar authority more than seventy years ago.[40] If Treasury were to obtain Section 368 Interpretive Authority, we would

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[38] For example, in a prior report, we explained that neither the text of section 368(a) nor the legislative history specified that the "statutory" basis for a merger or consolidation had to be domestic rather than foreign, and we noted the possibility that Congress did not even contemplate foreign mergers when it enacted the 1934 Tax Act. *See* NYSBA 2000 Report, *supra*.

[39] One issue Treasury might address with Section 368 Interpretive Authority would be to permit the parent corporation in a triangular C reorganization to assume the target corporation's liabilities (in particular, the target's employee stock option liabilities) without violating the modified "solely for voting stock" requirement applicable to C reorganizations. Current law, which predates the promulgation of the triangular C reorganization rules, permits only the acquirer (which would be the acquiring subsidiary in a triangular C reorganization) to assume the target's liabilities without the liabilities being treated as boot. *See* Rev. Rul. 70-107, 1970-1 C.B. 78. We would be happy to discuss with the government additional issues that Treasury might address with Section 368 Interpretive Authority.

[40] In 1933, Treasury recommended that it receive general interpretive authority with respect to the predecessor to section 368. In response to a House Ways and Means Committee report proposing the elimination of the reorganization rules, Treasury proposed redrafting the rules to "express in the statute as simply as possible the general plan for dealing with [transactions structured to qualify as reorganizations], leaving to [Treasury] as in other cases the power to make rules and regulations to carry out the congressional intent." Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcomm. of the House Comm. on Ways and Means Relative to Methods of Preventing the Avoidance and Evasion of the Internal Revenue Laws Together with Suggestions for the Simplification and Improvement Thereof, 73d Cong., 2d Sess., at 10 (Comm. Print 1933); *see* Paul, *supra*, at 37-38.

The amendment of section 1502 in the American Jobs Creation of 2004 ("AJCA") provides a recent example of a grant of such interpretive authority. In *Rite Aid Corporation v. United States*, 255 F.3d 1357 (Fed. Cir. 2001), *reh'g denied*, 2001 U.S. App. LEXIS 23207 (Oct. 23, 2001), the Federal Circuit

support regulations permitting Stock Acquisition/Tax Liquidations to qualify as A reorganizations. The discussion below assumes that Treasury receives Section 368 Interpretive Authority.[41]

In light of the evolution of the A and C reorganizations[42], we believe that A reorganization treatment for a Stock Acquisition/Tax Liquidation would be consistent with general reorganization policy and also with the Final Regulations' acknowledgment that disregarded entities have no tax effect. In addition, we believe that there is significant merit to consistent treatment for transactions that produce the same tax result.[43] As discussed below, we believe that Treasury should use Section 368 Interpretive Authority to test as an A reorganization an integrated transaction that results for Federal income tax purposes in the (i) transfer of all the target corporation's assets and liabilities to the acquiring corporation, and (ii) the target's elimination or its treatment as a disregarded entity owned by the acquiring corporation.

Treatment of a Stock Acquisition/Tax Liquidation as an A reorganization would produce substantial legitimate benefits. In particular, A reorganization treatment would enable several common foreign acquisition structures to qualify as A reorganizations, and thus avoid the need of having to run the gamut of the C reorganization rules. In addition, unlike the United States, many foreign countries are only now beginning to adopt merger statutes. Under this approach, taxpayers that may not be able to effect foreign law mergers could effect an integrated transaction such as a Stock Acquisition/Tax Liquidation in order to obtain A reorganization treatment.

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invalidated a portion of the former consolidated return loss disallowance regulations and noted that the regulations produced a different result than would have applied if the relevant corporations filed separate tax returns rather than a consolidated return. In the AJCA, Congress amended section 1502 and expressly granted Treasury general authorization to promulgate regulations under the consolidated return rules that change the application of a particular Code provision in the case of transactions between members of the same affiliated group. *See* Pub. L. No. 108-357, 118 Stat. 1418, § 844(a).

[41] As explained below, a separate statutory amendment may be necessary to address issues involving the appropriate Federal income tax treatment of a target corporation's actual transfer of all its assets and liabilities to an acquiring corporation followed by the target's liquidation into its shareholder(s).

[42] In 1921, Congress defined a "reorganization" to include "a merger or consolidation (including the acquisition by one corporation . . . of substantially all the properties of another corporation). . . ." Revenue Act of 1921, § 202(c)(2), 42 Stat. 227, 230. In the 1934 Tax Act, Congress separated this rule into two distinct provisions which were the predecessors to the modern A and C reorganizations. *See* Revenue Act of 1934, ch. 277, 48 Stat. 680 § 112(g)(1). However, at that time, not all states had yet adopted merger statutes. As a result, in order to permit reorganization treatment where a state law merger was unavailable, Congress enacted the predecessor C reorganization statute. The legislative history indicates that Congress considered such transactions to be tantamount to statutory mergers. *See* S. Rep. No. 73-558, at 17 (1934) ("The committee believes that these transactions . . . are sufficiently similar to mergers and consolidations as to be entitled to similar treatment."). Similarly, the Service has described the C reorganization as a "practical merger". Rev. Rul. 56-345, 1956-2 C.B. 206.

[43] *See Superior Coach of Fla. v. Commissioner*, 80 T.C. 895, 905 (1983) ("[It is a] general tax law principle that purely formal distinctions cannot obscure the substance of the transaction.").

The Final Regulations appropriately treat a Disregarded Entity Merger as an A reorganization. A Stock Acquisition/Tax Liquidation achieves the same Federal income tax result as a Disregarded Entity Merger, *i.e.*, the acquiring corporation holds the target's assets and liabilities through a disregarded entity, and the target ceases to exist for Federal income tax purposes. Thus, the acquirer holds the target's assets for all Federal income tax purposes. Consequently, no tax policy would be advanced by denying A reorganization treatment for a Stock Acquisition/Tax Liquidation, which we note could otherwise be achieved by having (1) the target merge upstream directly into the acquiring corporation (in an integrated A reorganization), and (2) the acquiring corporation then contribute the target's assets to a disregarded entity. We believe, where possible, similar transactions should be treated the same to avoid traps for the unwary and advance reorganization policies.

A second-step Tax Liquidation consolidates the assets of the target and the acquirer.[44] By permitting, since the 2001 Proposed Regulations, a Disregarded Entity Merger to qualify as an A reorganization, the government has already concluded, appropriately we believe, that A reorganization treatment does not require that the target's assets and liabilities become the direct assets and liabilities of the acquiring corporation via a state law merger or combination.[45] Permitting a Stock Acquisition/Tax Liquidation to qualify as an A reorganization would be a natural extension of the combining unit principle employed in the Final Regulations.[46] Moreover, this treatment would be consistent with both the fundamental nature of mergers and consolidations and Treasury's early understanding of reorganizations.[47] As we have previously observed, the Treasury regulations at one point defined a "reorganization" as a transaction in which "two (or more) corporations unite their properties", and this standard is certainly satisfied in the case of a Stock Acquisition/Tax Liquidation.[48] In the second-step Tax Liquidation, all the assets and liabilities of the target immediately prior to the stock acquisition are consolidated with

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[44] *See* T.D. 9242, 2006-7 I.R.B. 422.

[45] Although a Disregarded Entity Merger does include a statutory merger of the target, the target does not merge into the acquiring corporation. The preamble to the 2000 Proposed Regulations (the "2000 Preamble"), which declined to treat such a merger as an A reorganization, explained that it was "inappropriate" to treat a Disregarded Entity Merger as a statutory merger of the target corporation into the acquiring corporation, because the acquiring corporation was not a party to the state law merger transaction. The 2000 Preamble concluded that "the target corporation and the Owner have combined their assets and liabilities only under the Federal tax rules concerning Disregarded Entities, and not under state or Federal merger law, the law on which Congress relied in enacting section 368(a)(1)(A)." REG-106186-98, 2000-1 C.B. 1226. The 2001 Proposed Regulations concluded that the presence of a statutory merger of the target, plus the combination of the assets and liabilities of the target and acquiring corporations for Federal income tax purposes, were sufficient to treat a Disregarded Entity Merger as an A reorganization, despite the foregoing technical issue.

[46] *See* NYSBA 1998 Report, *supra* (advocating adoption of a combining unit concept).

[47] *See, e.g.*, *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933) (describing a merger as "an absorption by one corporation of the properties . . . of another" and a consolidation as "a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company.").

[48] *See* NYSBA 2000 Report, *supra*, *citing* Reg. 45, Art. 1567 (1921).

(and become) the assets and liabilities of the acquiring corporation, and the target ceases to exist, for Federal income tax purposes.

We recognize that the target corporation does not cease its separate legal existence after a Tax Liquidation.[49] However, we do not view this fact as necessary to the determination of whether a transaction can qualify as an A reorganization. Because reorganization qualification is a creature of the tax law, the only relevant issue should be whether the target corporation ceases its existence for Federal income tax purposes. As discussed above, in their deliberations on the issues now reflected in the Final Regulations, the government concluded that U.S. tax principles should govern the determination of whether a Disregarded Entity Merger qualifies as an A reorganization and so adopted the combining unit concept, which is based exclusively on a disregarded entity's U.S. tax status. It is consistent with the Final Regulations to focus exclusively on the Federal income tax treatment of the relevant entities.

We also note that, in the context of consolidation and amalgamation transactions in which two or more corporations combine and continue in the resulting entity, commentators questioned whether such a transaction could satisfy the requirement that the transferee corporation cease its separate legal existence for all purposes. In concluding that such a transaction could qualify as an A reorganization, the government explained that, even if the governing law provides that the existence of the consolidating (or amalgamating) entities continues in the resulting corporation, the separate legal existence of those regarded entities ceases.[50] For tax purposes, the continued existence of the combined entities as divisions was disregarded, in effect treating these entities as part of the resulting corporation's combining unit.

Like a statutory merger, a Stock Acquisition/Tax Liquidation accomplishes the simultaneous (i) transfer of all the target's assets to the acquirer, and (ii) elimination of the target as a corporation for Federal income tax purposes. Significantly, a Stock Acquisition/Tax Liquidation does not raise the issues highlighted in the examples in the Final Regulations of transactions that do not qualify as A reorganizations because (i) the target corporation transferred less than all its assets and liabilities in a state law merger[51], (ii) the disregarded entity transferred assets and liabilities which represented a portion of the assets and liabilities of its parent corporation in a state law merger[52], or (iii) the target corporation merged into a disregarded entity in exchange for interests in the disregarded entity (which converted the entity into a partnership for Federal income tax purposes).[53] Each of these transactions failed to accomplish from a Federal income tax standpoint either (i) the transfer of all the target's assets and liabilities to the acquiring corporation or (ii) the termination of the target's existence as a corporation and

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49 The target corporation in a Conversion ceases its separate corporate legal existence pursuant to operation of state law, and a target ceases to exist as a tax matter after making a CTB Election.

50 *See* T.D. 9242, 2006-7 I.R.B. 422.

51 Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 1; *see* Rev. Rul. 2000-5, 2000-1 C.B. 436.

52 Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 6.

53 Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 7.

conversion to a disregarded entity of the acquiring corporation, which materially distinguishes these non-qualifying transactions from a Stock Acquisition/Tax Liquidation.

The Preamble also requested comments regarding the impact of the foregoing modifications, if implemented, on Revenue Ruling 67-274 and Revenue Ruling 72-405. If Treasury receives the requisite Section 368 Interpretive Authority, we believe that the government could either publish additional guidance clarifying that Stock Acquisition/Tax Liquidations qualify as A reorganizations and distinguish the Revenue Rulings, or retain the Revenue Rulings and provide that the transactions described therein qualified as both A and C reorganizations.[54] Although the transactions in the Revenue Rulings satisfied the strict C reorganization requirements, many integrated transactions cannot do so, including the transaction in Example 9 of the Final Regulations. In the example, however, the acquiring corporation transferred consideration that could qualify under more lenient A reorganization rules. Thus, the government's confirmation of this result would be particularly helpful for integrated transactions of this type in which the target corporation's shareholders receive a mix of cash and equity consideration that would not satisfy the C reorganization rules.

Congress originally enacted C reorganizations to permit asset transfers effected in states without merger laws to qualify for reorganization treatment, concluding that these acquisitions were tantamount to the statutory mergers effected in other states. We believe the judicial requirements for all reorganizations, which have evolved since Congress enacted the C reorganization statute, now adequately address the concerns relevant to a Stock Acquisition/Tax Liquidation. Accordingly, it seems unnecessary for the C reorganization's "substantially all" and "solely for voting stock" requirements to be applied to these transactions to further reorganization policy.

Actual Liquidations and Asset Transfers

While the Preamble did not request comments on the appropriate treatment of a stock acquisition followed by an actual liquidation of the target corporation (a Stock Acquisition/Actual Liquidation), we believe that such a transaction must be considered in connection with the above described policy deliberations as it is substantially similar to a Stock Acquisition/Disregarded Entity Merger, a Stock Acquisition/Tax Liquidation, and especially a Stock Acquisition/Upstream Merger of the type endorsed by Revenue Ruling 2001-46. That is, regulations provide specifically that a CTB Election is treated as though the entity distributes all

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[54] By contrast to other types of reorganizations, there is no overlap rule addressing transactions that qualify as both an A and a C reorganization. *Cf.* I.R.C. § 368(a)(2)(A) (transaction described in both section 368(a)(1)(C) and (D) generally is treated as a section 368(a)(1)(D) reorganization (a "D reorganization"); Rev. Rul. 75-161, 1975-1 C.B. 114 (transaction qualifying as an A or a D reorganization is treated as a D reorganization for purposes of section 357(c)). Revenue Ruling 75-161 predated the amendment to section 357(c) in the AJCA, which effectively obsoleted the government's position in the overlap ruling by restricting the application of section 357(c) to divisive D reorganizations in which the transferee corporation's stock is distributed pursuant to section 355. *See* Pub. L. No. 108-357, 118 Stat. 1418, § 898(b).

its assets and liabilities to its single owner in liquidation[55], and both a stand-alone Conversion as well as a corporation's merger into a disregarded entity of its parent corporation result in a deemed liquidation of the target entity.[56] We recognize that Treasury's exercise of Section 368 Interpretive Authority to accord A reorganization treatment to Stock Acquisition/Actual Liquidations would represent a significant departure from current law. However, as discussed above, we do not believe that the protection of reorganization policy requires Stock Acquisition/Actual Liquidations to satisfy the heightened requirements of C reorganizations. Moreover, drawing the line at Stock Acquisition/Upstream Mergers, Conversions or CTB Elections, as the case may be, would create a system that provides disparate treatment for substantially similar transactions which, in turn, could create traps for the unwary and unintended planning alternatives for taxpayers.

Example 10 of the Final Regulations concludes that a Stock Acquisition/Actual Liquidation does not constitute an A reorganization because the acquiring corporation does not acquire all the target corporation's assets either by filing a certificate of dissolution or simultaneously with the cessation of the target's separate legal status. We note that the example explains that the target must first transfer its assets to its creditors to satisfy liabilities and can then transfer its remaining assets to the acquiring corporation. However, in our experience, there are commercial alternatives available that would permit the liquidating subsidiary to distribute its assets directly to its shareholder. For example, notes and indentures often permit corporate borrowers to transfer their assets to affiliates in a merger or liquidation, provided the successor assumes the borrower's liabilities. Thus, while it is true that provision must be made for liabilities in the case of an actual liquidation, we do not believe that this requirement alone should justify the exclusion of a Stock Acquisition/Actual Liquidation from A reorganization treatment as a policy matter.[57] The tax consequences of a target's actual liquidation are, of course, the same as those discussed above with respect to Tax Liquidations, and, on balance, we believe that the same analysis should be considered to test an integrated Stock Acquisition/Actual Liquidation as an A reorganization.

Finally, we have considered whether, as a policy matter, a stand-alone transaction in which a target corporation transfers all its assets and liabilities to an acquiring corporation and then distributes the stock consideration received to its shareholder(s) in liquidation should be treated as an A reorganization (an "<u>Actual Asset Transfer</u>"). A reorganization treatment for Actual Asset Transfers would present issues that are not raised by two-step transactions such as a Stock Acquisition/Tax Liquidation or a Stock Acquisition/Actual Liquidation. As Revenue Ruling 67-274 indicates, the government already recasts these transactions. The sole question, therefore, is whether the appropriate recast is as an A or a C reorganization. By contrast, an

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[55] Treas. Reg. § 301.7701-3(g)(1)(iii); *see Dover v. Commissioner*, 122 T.C. 324 (2004).

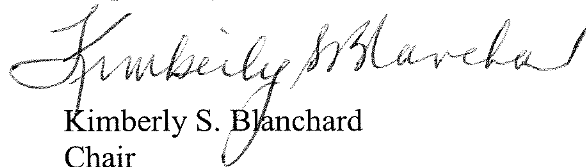
[56] *See, e.g.*, Priv. Ltr. Rul. 200505009 (Feb. 4, 2005) (Conversion); Priv. Ltr. Rul. 200310005 (Mar. 7, 2003) (merger into parent corporation's disregarded entity).

[57] In addition, the Final Regulations contemplate that a target corporation may satisfy or discharge its liabilities as part of the statutory merger or consolidation, thus avoiding the need for an initial transfer of assets to the target's creditors. *See* Treas. Reg. § 1.368-2(b)(1)(ii)(A).

Actual Asset Transfer does not involve such a recast. Accordingly, treating Actual Asset Transfers as A Reorganizations may require a separate statutory amendment.

We appreciate your consideration of our comments and would be pleased to provide further comments or assistance regarding this matter.

Respectfully submitted,



Kimberly S. Blanchard
Chair

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
William D. Alexander, Associate Chief Counsel (Corporate), Internal Revenue Service
Marc A. Countryman, Attorney Advisor, Treasury Department