

**SUPPLEMENTAL COMMENTS CONCERNING REGULATIONS
UNDER SECTION 368 OF THE INTERNAL REVENUE CODE
REGARDING MERGERS INVOLVING DISREGARDED ENTITIES
PROPOSED MAY 16, 2000 (REG-106186-98)**

The following comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

The comments were prepared by members of the Committee on Corporate Tax of the Section of Taxation. Principal responsibility was exercised by Benjamin G. Wells. Substantive comments were made by Kevin D. Anderson, Eric M. Elfman, Terrill A. Hyde, Stuart J. Offer, R. David Wheat, and Robert G. Woodward. The comments were reviewed by John P. Barrie of the Section's Committee on Government Submissions and by Joseph M. Pari, Council Director for the Corporate Tax Committee.

Although the members of the Section of Taxation who participated in preparing these Comments may have clients who would be affected by the federal income tax principles addressed by these Comments, or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: July 23, 2001

By letter dated October 13, 2000, the Committee on Corporate Tax of the ABA Tax Section (the "Committee" or "we") submitted comments (the "Prior Comments") on the proposed changes to Reg. §1.368-2(b)(1) which were published on May 16, 2000 (REG-106186-98) and which relate to mergers involving disregarded entities. In the Prior Comments, the Committee expressed the view that the merger of a corporation into a disregarded entity should be permitted to qualify as a statutory merger under section 368(a)(1)(A).¹

This report will supplement the Prior Comments on one question: to what extent is it relevant whether the target corporation could have merged into the corporation (the "owner corporation") that owns the disregarded entity? This question was discussed at section II.E.1 (pp. 13-15) of the Prior Comments, but we will here expand upon that discussion.

One fundamental question is whether a merger into a disregarded entity should be permitted when the owner corporation is a foreign corporation. In this context, the "could have merged" question raises the broader question whether cross-border or foreign-to-foreign mergers should be permitted.

That question is beyond the scope of this letter. Therefore, without intending to express any view on the matter, we assume in the remainder of this letter that the owner corporation is a U.S. corporation. On this assumption, we suggest that the category of permissible transactions should not be restricted by any "could have merged" requirement, apart from the general requirements applicable to any reorganization.

Section 368(a)(2)(D)(ii) sets forth a statutory "could have merged" requirement for (a)(2)(D) mergers. Reg. §1.368-2(b)(2) provides that this requirement refers to the general requirements for a reorganization and not to whether the merger could have been accomplished under state or federal corporation law.

When it enacted section 368(a)(2)(D), Congress fully considered this question and concluded that there was no reason to examine whether the target could have merged into the parent under the applicable corporate law. The Senate Finance Committee Report indicates that it is sufficient that "the merger *insofar as the tax laws are concerned* would have qualified as a type A reorganization had the merger been made into the parent corporation instead of into the subsidiary" (emphasis added). S. Rep. No. 1653, 90th Cong., 2d Sess. (1968), 1968-2 C.B. 849, 851. See also Rev. Rul. 74-297, 1974-1 C.B. 84 (relying on legislative history to permit a U.S.-to-U.S. merger for stock of a foreign parent).

Moreover, section 368(a)(2)(E) was intended to function in parity with section 368(a)(2)(D). See S. Rep. No. 91-1533, 91st Cong., 2d Sess. (1970), 1971-1 C.B. 622, 623. Section 368(a)(2)(E), however, contains no statutory "could have merged" requirement at all.

Thus, Congress evidently concluded that the requirement of a statutory merger does not necessitate an inquiry into a hypothetical transaction which does not, in fact, take place.

¹ Hereafter, for convenience, terms such as "permitted" and "qualify" are sometimes used to refer to qualification of the transaction as a statutory merger under section 368(a)(1)(A). Of course, the transaction might in any event qualify as another type of reorganization.

The only requirement which is specifically imposed by section 368(a)(1)(A) is that the actual merger be a statutory merger.

There is no apparent reason for a different result in a merger of a corporation into a disregarded entity. In this respect, such a merger should be on a parity with a triangular merger.² The key consideration is the provisions of the merger law under which the transaction occurs, not some other law which would have applied to a different transaction.

Other mechanisms are already in place to ensure that the merger satisfies the underlying assumptions of section 368(a)(1)(A). Thus, Rev. Rul. 2000-5, 2000-5 I.R.B. 436, holds that the substance of the state law, and not just its nomenclature, must be examined. Similarly, Rev. Rul. 84-104, 1984-2 C.B. 94 held that a transaction described under applicable banking law as a "consolidation" nevertheless constituted a merger under section 368(a)(2)(E).

In addition, the owner of the disregarded entity must be a corporation. Otherwise, the consideration delivered in the merger would necessarily be taxable boot. See section 354(a)(1) (exchange must be for stock of a corporation which is a party to the reorganization).

A hypothetical inquiry into a transaction other than the actual transaction would serve no useful purpose but would merely create the potential for confusion. In the actual transaction, the corporate attorneys must be satisfied that the merger satisfies the statutory requirements, and so must the Secretary of State. This would not be the case for a shadow transaction important only under the tax laws.

In addition, as pointed out in the Prior Comments, a restrictive "could have merged" requirement would operate unfavorably against banks. This would be contrary to the direction taken by the amendments to subchapter S in 1996, which extended the S corporation form to banks.

Having said all of the foregoing, if the final regulation permits a merger of a target corporation into a disregarded entity, it might be appropriate to include "could have merged" language like that which is already found in Reg. §1.368-2(b)(2). This would merely confirm what was probably obvious under section 368(a)(2)(D) and should be obvious here, i.e., that the merger must satisfy the general requirements of a reorganization.

Attached are proposed amendments to Prop. Reg. §1.368-2(b)(1), incorporating the changes which we suggest, along with a blacklined version showing the changes. That language, by use of brackets, leaves open the question whether cross-border or foreign-to-foreign mergers should be permitted. If we can be of further help on this project, please let us know.

² We draw the analogy to section 368(a)(2)(D) on the "could have merged" question because the policy considerations would seem to be similar to those applicable to a merger of a disregarded entity. However, for the reasons expressed in the Prior Comments at section II.C.1 (pp. 9-10), we recommend that no "substantially all" requirement be imposed on a merger into a disregarded entity.

SUGGESTED REVISED LANGUAGE OF PROP. REG. § 1.368-2(B)(1)

§ 1.368-2 -- Definition of terms.

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(b)(1) In order to qualify as a reorganization under section 368(a)(1)(A), the transaction must be a merger or consolidation involving two corporations effected pursuant to the laws of [the United States or a State or territory, or the District of Columbia]. In addition, by operation of such a merger law, the transaction must result in one corporation acquiring the assets of the merging corporation and the merging corporation ceasing to exist. Similarly, by operation of such a consolidation law, the transaction must result in one newly formed corporation acquiring the assets of both consolidating corporations, and both consolidating corporations ceasing to exist. Thus, the merger under [state or Federal] law of an entity that is disregarded as an entity separate from its owner for Federal tax purposes into an acquiring corporation in which the owner exchanges its interest in the disregarded entity for stock in the acquiring corporation and the disregarded entity ceases to exist as a result of the transaction by operation of the [state or Federal] merger law is not a statutory merger qualifying as a reorganization under section 368(a)(1)(A) because, in such a merger, the acquiring corporation does not acquire the assets of another corporation nor does any other corporation cease to exist. However, the merger of a target corporation into an entity that is disregarded as an entity separate from its owner for Federal tax purposes is a statutory merger qualifying as a reorganization under section 368(a)(1)(A) if the owner of the disregarded entity is itself a [domestic] corporation (the owner corporation) and if the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the owner corporation because, in such a merger, one corporation, the owner corporation, acquires the assets of the merging corporation and the merging corporation ceases to exist. The foregoing test of whether the transaction would have qualified under section 368(a)(1)(A) if the merger had been into the owner corporation means that the general requirements of a reorganization under section 368(a)(1)(A) (such as a business purpose, continuity of business enterprise, and continuity of interest) must be met. Under this test, it is not relevant whether the merger into the owner corporation could have been effected pursuant to [State or Federal] corporation law. Examples of entities that are disregarded as entities separate from their owners include a qualified REIT subsidiary (within the meaning of section 856(i)(2)), a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)), and a business entity that is not classified as a corporation and that has a single owner (as provided in § 301.7701-2(c)(2) of this chapter). The preceding eight sentences apply to any transaction occurring on or after [Date These Regulations Are Published As Final Regulations In The Federal Register].

SUGGESTED REVISED LANGUAGE OF PROP. REG. § 1.368-2(B)(1)

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