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June 11, 2007

Hon. Kevin Brown
Acting Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Final Regulations Defining the Term “Statutory Merger or Consolidation” (T.D. 9242)

Dear Acting Commissioner Brown:

Enclosed are comments on final regulations defining the term “Statutory Mergers or Consolidation” (T.D. 9242). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Susan P. Serota
Chair, Section of Taxation

Enclosure

- cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
- Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
- Michael J. Desmond, Tax Legislative Counsel, Department of the Treasury
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ABA SECTION OF TAXATION
COMMENTS ON FINAL REGULATIONS DEFINING THE TERM
“STATUTORY MERGER OR CONSOLIDATION”
(T.D. 9242)

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Maury Passman, Eric Sensenbrenner, David Strong, and Lisa Zarlenga. and substantive contributions were made by Julie Divola, Milt Hyman, and Michael Schler, of the Corporate Tax Committee. Substantive contributions were also made, with respect to mergers that cause partnerships to be reclassified as disregarded entities, by Dan Carmody, Adam M. Cohen, Matthew Lay, Eric Sloan (Vice Chair), and James Wreggelsworth (Chair) of the Committee on Partnerships and LLCs. The Comments were reviewed by Karen Sowell, Chair of the Corporate Tax Committee, William M. Richardson of the Section’s Committee on Government Submissions, and Glenn Carrington, Council Director of the Corporate Tax Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, 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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EXECUTIVE SUMMARY

We commend the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) for the final regulations under Reg. § 1.368-2(b)(1)¹(the “Regulations”), which reflect the culmination of a long-term effort to modernize section 368(a)(1)(A). In response to several residual issues raised by Treasury and the Service in the preamble to the Regulations (the “Preamble”), we respectfully submit these Comments.

The Comments are divided into three Parts. Part I contains an introduction; Part II sets forth the scope of our Comments; and Part III contains our detailed Comments. The primary recommendations contained in these Comments can be summarized as follows:

1. **State Law Conversions.** We recommend that a stock acquisition followed by a state law conversion of the target corporation into a disregarded entity should be permitted to qualify as a statutory merger under section 368(a)(1)(A). We believe this recommendation should be implemented by changing the operative language of Reg. § 1.368-2(b)(1)(ii)(B) to state that the combining entity of the transferor unit must cease its separate existence for “*federal income tax*” purposes (rather than for “*all*” purposes).

2. **Entity Classification Elections.** We also recommend that a stock acquisition followed by a “check-the-box” election to change the tax status of the target corporation to a disregarded entity should not be permitted to qualify as a statutory merger under section 368(a)(1)(A). However, in an effort to promote transactional efficiency and other meaningful non-tax objectives, as well as to promote the tax policy objective of providing consistent tax treatment to transactions with similar results, we urge Treasury and the Service to recommend that Congress remove the word “statutory” from section 368(a)(1)(A). We also suggest that Treasury seek a grant of regulatory authority from Congress to interpret and implement section 368(a)(1)(A) in light of this proposed change to the statute.

3. **Mergers that Cause a Partnership to be Reclassified as a Disregarded Entity.** The Regulations conclude that the merger of a corporate partner into the partnership or into its other corporate partner, which results in the former partnership becoming a disregarded entity, should qualify as a statutory merger under section 368(a)(1)(A). We agree with this conclusion. Furthermore, we recommend that in these transactions, the partnership should terminate following the merger. If this construct is adopted, the target corporation would be treated as transferring all of its assets, including the partnership interest, to the acquiring corporation, and the partnership would be deemed to make a liquidating distribution to the acquiring corporation as the sole partner.

¹ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the “Code”), and the Treasury Regulations promulgated thereunder.

COMMENTS

I. INTRODUCTION

A. Background.

On May 16, 2000, Treasury and the Service issued proposed regulations (the “2000 Proposed Regulations”)² which created a new functional definition of a “statutory merger or consolidation” within the meaning of section 368(a)(1)(A) (a “Type A Reorganization”).³ This new functional definition was generally consistent with existing case law⁴ and the holding of Revenue Ruling 2000-5.⁵

The 2000 Proposed Regulations also took the position that the statutory combination of a target corporation with and into a disregarded entity (a “DRE”) could not qualify as a Type A Reorganization because in such a case (the “Target-Into-DRE Case”) the owner of the DRE is not a direct participant in the transaction for non-tax purposes.⁶ In response, commentators criticized the 2000 Proposed Regulations for being inconsistent with the “check-the-box” regulations, which treat a DRE as a division of its owner, and recommended that the Target-Into-DRE Case should be permitted to qualify as a Type A Reorganization.⁷

On November 15, 2001, Treasury and the Service withdrew the 2000 Proposed Regulations and issued new proposed regulations (the “2001 Proposed Regulations”).⁸ The 2001 Proposed Regulations set forth a more detailed functional definition for Type A

² REG-106186-98, 65 Fed. Reg. 31115.

³ See 2000 Prop. Reg. § 1.368-2(b)(1).

⁴ See, e.g., *Cortland Specialty Co. v. Comm’r*, 60 F.2d 937, 939 (2nd Cir. 1932), *cert. denied*, 288 U.S. 599 (1933) (merger ordinarily involves an absorption of assets by the acquiring corporation and merged corporation ceases to exist); *Roebeling v. Comm’r*, 143 F.2d 810, 812 (3rd Cir. 1944), *cert. denied*, 323 U.S. 773 (1944) (literal compliance with corporate law merger statute does not by itself qualify a transaction as a statutory merger under section 368(a)(1)(A)).

⁵ 2000-5 C.B. 436 (divisive transactions qualifying as “mergers” under state corporate law not statutory mergers under section 368(a)(1)(A)).

⁶ See generally preamble to 2000 Proposed Regulations and 2000 Prop. Reg. § 1.368-2(b)(1).

⁷ See, e.g., ABA Section of Taxation, *Comments Concerning Regulations Under Section 368 of the Internal Revenue Code Regarding Mergers Involving Disregarded Entities Proposed May 16, 2000*, reprinted at 2000 TNT 208-19 (hereinafter “2000 Comments”). See also ABA Section of Taxation *Comments on Guidance Needed Concerning the Treatment of Mergers Involving Single Member Entities Owned by Corporations*, reprinted at 98 TNT 151-11 (hereinafter “1998 Comments”); ABA Section of Taxation *Supplemental Comments Concerning Regulations Under Section 368 of the Internal Revenue Code Regarding Mergers Involving Disregarded Entities Proposed May 16, 2000*, reprinted at 2001 TNT 149-27 (hereinafter “2001 Comments”).

⁸ REG-126485-01, 66 Fed. Reg. 57400.

Reorganizations and permitted the Target-Into-DRE Case to qualify as a Type A Reorganization.⁹ On January 24, 2003, Treasury and the Service made certain clarifications to the 2001 Proposed Regulations and issued them as temporary regulations (the “2003 Temporary Regulations”).¹⁰

On January 5, 2005, Treasury and the Service sought to expand the definition of a Type A Reorganization to include transactions effected under the laws of a foreign jurisdiction (the “2005 Proposed Regulations”).¹¹ On January 26, 2006, Treasury and the Service made certain technical changes to the 2005 Proposed Regulations and issued the Regulations.¹²

B. Section Reaction.

We commend Treasury and the Service for adopting a functional approach within the context of section 368(a)(1)(A) that, among other things, permits both the Target-Into-DRE case and certain transactions effected under the laws of a foreign jurisdiction to qualify as Type A Reorganizations. We believe these changes are consistent with the general Congressional intent behind the Type A Reorganization and bring section 368(a)(1)(A) into harmony with the modern transactional landscape. The Regulations also serve to further disconnect the Type A Reorganization from its historical and unstable reliance on the literal requirements of state statutes. This reliance, if left unchecked, had the potential to completely undermine the fundamental purposes of the reorganization provisions.

However, looking ahead, Treasury and the Service have identified several important issues that still remain unresolved within the context of the Type A Reorganization. In an effort to assist Treasury and the Service with some of these residual concerns, and building on our prior comments,¹³ we hereby respectfully submit these Comments. Although we could not reach complete consensus on two of the issues we chose to address (namely, whether a stock acquisition followed by either a pre-planned conversion or a check-the-box election with respect to the target corporation, whereby the target corporation becomes a DRE, should qualify as a Type A Reorganization), our recommendations represent the majority view on those issues. We emphasize that while these Comments do not fully develop the minority view, there are reasonable arguments to potentially support that view. We would, of course, be pleased to more fully discuss these Comments with Treasury and the Service if that would be of further assistance.

⁹ See 2001 Prop. Reg. §§ 1.368-2(b)(1)(i), -2(b)(1)(ii).

¹⁰ T.D. 9038, 68 Fed. Reg. 3384.

¹¹ REG-117969-00, 70 Fed. Reg. 746.

¹² T.D. 9242, 71 Fed. Reg. 4259.

¹³ See generally 1998 Comments; 2000 Comments; 2001 Comments.

II. SCOPE OF COMMENTS

In the Preamble, Treasury and the Service requested comments in two general areas with respect to Type A Reorganizations. First, comments were requested with respect to stock acquisition transactions where, following the initial stock acquisition and as part of an integrated plan, the target corporation either engages in a state law conversion or files an entity classification election and becomes a DRE (the “Conversion Case” and the “Check-the-Box Case,” respectively).¹⁴ In this context, the primary issue under ongoing consideration is whether these transactional patterns should be permitted to qualify as Type A Reorganizations. In addition, Treasury and the Service are considering what implications, if any, a favorable conclusion in this area would have on Revenue Ruling 67-274¹⁵ and Revenue Ruling 72-405.¹⁶

Second, comments were requested with respect to acquisition transactions involving a partnership and its corporate partners where one corporate partner either merges into the partnership or the other corporate partner and, as a result of the transaction, the former partnership becomes a DRE (both cases referred to generally as the “Partnership-to-DRE Case”).¹⁷ Treasury and the Service have already reached the general conclusion that these transactional patterns should be permitted to qualify as Type A Reorganizations.¹⁸ As a result, the primary issues that remain under ongoing consideration in this context relate to the specific tax consequences of the transactions to the parties, including whether gain or loss should be recognized under Subchapter K of the Code, and to what extent the principles of Revenue Ruling 99-6¹⁹ should apply.

Finally, we note that Treasury and the Service intend to devote further study to the issue of whether a consolidation or amalgamation of two operating corporations can involve a reorganization under section 368(a)(1)(F) with respect to one corporation and a Type A Reorganization with respect to the other corporation.²⁰ Although Treasury and the Service did not specifically request comments in this regard in the Preamble, we note that the Section intends to evaluate this issue in separate forthcoming comments that will address reorganizations under section 368(a)(1)(F).

III. DETAILED COMMENTS

¹⁴ See generally Preamble under the heading “Explanation of Provisions – A. State Law Conversions.”

¹⁵ 1967-2 C.B. 141.

¹⁶ 1972-2 C.B. 217.

¹⁷ See generally Preamble under the heading “Explanation of Provisions – B. Existence and Composition of the Transferee Unit.”

¹⁸ See Example 11 of the Regulations.

¹⁹ 1999-1 C.B. 432.

²⁰ See generally Preamble under the heading “Explanation of Provisions – C. Consolidations and Amalgamations.”

The following Comments are divided into four parts. First, to establish the general context for our consideration of the Conversion Case and the Check-the-Box Case, Part III.A recites the current technical requirements for a Type A Reorganization and briefly discusses Revenue Ruling 2001-46.²¹ Parts III.B and III.C then contain our analyses of the Conversion Case and the Check-the-Box Case, respectively. Finally, Part III.D contains our analysis of the Partnership-to-DRE Case.

A. Statutory Overview and Revenue Ruling 2001-46.

1. Reg. § 1.368-2(b)(1)(ii).

The Regulations set forth the functional definition of a Type A Reorganization in Reg. § 1.368-2(b)(1)(ii):

(ii) *Statutory merger or consolidation generally.* For purposes of section 368(a)(1)(A), a statutory merger or consolidation is 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 combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (the transferee unit); and

(B) The combining entity of each transferor unit ceases its separate legal existence for all purposes; provided, however, that this requirement will be satisfied even if, under applicable law, after the effective time of the transaction, the combining entity of the transferor unit (or its officers, directors, or agents) may act or be acted against, or a member of the transferee unit (or its officers, directors, or agents) 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 activities engaged in by such entity, prior to the effective time of the transaction, and such actions are not inconsistent with the requirements of paragraph (b)(1)(ii)(A) of this section.

For purposes of these Comments, we view the above language as being composed of three general requirements and for ease of reference we will refer to each such requirement through the use of a defined term. We refer to the first requirement, the flush language of Reg. § 1.368-2(b)(1)(ii), as the “Statutory Simultaneity Requirement.” This defined term serves as short-hand for the primary requirement that the transaction at issue must be effected pursuant to a statute (or statutes) while, at the same time, the two remaining requirements must be satisfied simultaneously pursuant to the operation of such statute (or statutes). We refer to the second requirement, the language of Reg. §

²¹ 2001-2 C.B. 321.

1.368-2(b)(1)(ii)(A), as the “Absorption Requirement,” and we refer to the third requirement, the language of Reg. § 1.368-2(b)(1)(ii)(B), as the “Cessation Requirement.” As described in more detail in Part III.B below, these two requirements are intended to reflect the general results of a merger or consolidation under state or federal law.

2. Revenue Ruling 2001-46.

In addition to the technical requirements of the Regulations, we note that the general holding of Revenue Ruling 2001-46, and its application of step-transaction principles within the context of the Type A Reorganization, has direct relevance to both the Conversion Case and the Check-the-Box Case.²² Specifically, in order for either the Conversion Case or the Check-the-Box Case to qualify as a Type A Reorganization, the first-step stock acquisition must be disregarded as an intermediate step in an otherwise integrated transaction that is effected pursuant to a common plan. While not a central focus of these Comments, we assume that the principles of Revenue Ruling 2001-46 would apply to both the Conversion Case and the Check-the-Box Case.²³

B. State Law Conversions.

1. Background.

At the present time, it appears that all 50 states and the District of Columbia have adopted some form of a “conversion” statute.²⁴ Although the precise nature and scope of these statutes varies widely from state to state, the common substantive feature is that

²² We also note in passing that any transaction must also satisfy the business purpose, continuity of interest, and continuity of business enterprise requirements. *See generally* Reg. § 1.368-1. We assume that the transactions discussed in these Comments would satisfy all such requirements.

²³ We see no reason why the principles of Revenue Ruling 2001-46 should not apply to effectively disregard a first-step stock acquisition that occurs as part of a larger integrated two-step transaction when, as a result of the second-step, the assets and liabilities of each member of the transferor unit become the assets and liabilities of a DRE that is treated as a division of the combining entity of the transferee unit (the “Stock Acquisition/Target-Into-DRE Case”). We also note that Treasury and the Service appear to agree with this conclusion. *See generally* the Preamble under the heading “Explanation of Provisions – A. State Law Conversions” (noting that the Stock Acquisition/Target-Into-DRE Case may qualify as a statutory merger or consolidation). However, to clearly incorporate this concept into the Regulations, we suggest that Treasury and the Service consider amending the current analysis of Example 2 of the Regulations to state that the result is not altered if, as part of an integrated transaction, Y first acquires the stock of Z and Z then merges into X under State W law.

²⁴ For purposes of these Comments, we conducted our own cursory review of each of the 50 states and the District of Columbia. *See generally* Larry E. Ribstein and Robert R. Keatinge, *Ribstein and Keatinge on Limited Liability Companies*, Vol. 1 at Appendix 11-12 (West 2005 ed.) (identifying 34 states and the District of Columbia as having some form of LLC conversion statute); Paul L. Lion III, “Limited Liability Companies and Cross Entity Merger and Conversion Statutes,” ALI-ABA Video Law Review Study Materials – Choice of Form and Structure for Closely-Held Businesses and Ventures (February 6, 2003).

they enable an entity to readily convert from one state law form of organization to another, such as from a corporation to a limited liability company (“LLC”).²⁵

In general, the reclassification that occurs pursuant to a conversion statute is effective immediately upon the adoption of an appropriate resolution or upon the filing of a certificate of conversion.²⁶ In addition, as a result of the conversion, all of the assets and liabilities of an entity as characterized by its old organizational form are automatically vested within the “same” entity as characterized by its new organizational form.²⁷ In other words, as a technical matter, a conversion statute will typically provide that the state law existence of a converting entity will survive the conversion process, despite the organizational reclassification of the entity. This aspect of a conversion is the key to its general attractiveness, because it means that there is no state law transfer of any of the converting entity’s assets or liabilities.²⁸ As a result, consents for the assumption of loans or other liabilities, and consents for the transfer or assignment of contracts, leases, licenses, permits, or other assets, are generally not required.²⁹

In the Preamble, Treasury and the Service observed that the Conversion Case can have substantive results that are identical to those traditionally associated with a Type A Reorganization.³⁰ However, despite this fact, the Regulations do not currently enable such a transactional pattern to qualify as a Type A Reorganization.³¹ Instead, pending further consideration, the Regulations draw the conclusion that the Conversion Case cannot qualify as a Type A Reorganization because the target corporation does not cease its separate legal existence for all purposes.³²

²⁵ See, e.g., Del. Gen. Corp. Law, § 266(a) (2006). We estimate that approximately 31 states have adopted a conversion statute that allows a corporation to convert to an LLC.

²⁶ See, e.g., Del. Gen. Corp. Law, §§ 266(b), (d) (2006).

²⁷ See, e.g., Del. Gen. Corp. Law, § 266(h) (2006).

²⁸ *Id.*

²⁹ By comparison, if an entity (such as a corporation) effectively reclassified itself by using a state law merger statute to merge with and into a newly-formed shell entity (such as a shell LLC), a state law transfer of assets and liabilities generally would occur and any required consents would need to be obtained.

³⁰ See Preamble under the heading “Explanation of Provisions – A. State Law Conversions” (“Although the conversion does not involve the fusion under state or local law of a target corporation into a pre-existing entity, it is similar to a statutory merger in that it accomplishes simultaneously the 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.”).

³¹ Compare Example 2 of the Regulations (state law merger of target corporation into DRE qualifies as Type A Reorganization) with Example 9 of the Regulations (stock acquisition followed by state law conversion, whereby target corporation becomes a DRE, does not qualify as Type A Reorganization).

³² See analysis relating to Example 9 of the Regulations (“The acquisition by Y of the assets of V does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because V, the combining entity of the transferor unit, does not cease its separate legal existence.”). See also Preamble under the heading

2. Specific Recommendation and Rationale.

We recommend that the Conversion Case should be permitted to qualify as a Type A Reorganization. We believe this recommendation should be implemented by changing the Cessation Requirement to state that the combining entity of the transferor unit must cease its separate existence for federal income tax purposes (rather than for all purposes), and by eliminating the current proviso at the end of the Cessation Requirement. In connection with this recommended change, we also believe that the current analysis of Example 9 to the Regulations should be modified to reach an affirmative result, and that the holdings in Revenue Rulings 67-274 and 72-405 can remain intact without subsequent modification. Our recommendation with respect to the Conversion Case is based on several considerations, which are discussed in detail immediately below.

a. Consistency With Functional Approach of Regulations.

We believe that allowing the Conversion Case to qualify as a Type A Reorganization would be entirely consistent with the overall functional approach of the Regulations, which already permit the Target-Into-DRE Case and the Partnership-to-DRE Case to qualify as Type A Reorganizations.

In particular, assuming the initial stock acquisition that occurs as part of the Conversion Case is ignored as a transitory step in accordance with the principles of Revenue Ruling 2001-46, we believe the Statutory Simultaneity Requirement would be satisfied. We believe this would be the case because the second-step conversion is effected pursuant to a non-tax statute and, as a result of the operation of such statute, the Absorption Requirement and the Cessation Requirement would both be satisfied, if at all, simultaneously upon the effectiveness of the conversion.

Building on this analysis, we also believe the Absorption Requirement would in fact be satisfied in the Conversion Case. We believe this would be the result because all of the assets and liabilities of the sole member of the transferor unit (*i.e.*, the target corporation) become the assets and liabilities of a member of the transferee unit (*i.e.*, a DRE that is treated as a division of the acquiring corporation for federal income tax purposes), as determined immediately after the effective time of the conversion.³³

“Explanation of Provisions – A. State Law Conversions” (“[T]he 2003 temporary regulations provide that a transaction can only qualify as a statutory merger or consolidation if the target corporation ceases its separate legal existence for all purposes. The final regulations retain this requirement. In a conversion, the target corporation’s legal existence does not cease to exist under state law. Its legal existence continues in a different form. Therefore, a stock acquisition of a target corporation followed by the conversion of the target corporation from a corporation to a limited liability company under state law cannot qualify as a statutory merger or consolidation under these final regulations.”).

³³ See generally Example 11 of the Regulations and the Preamble under the heading “Explanation of Provisions – B. Existence and Composition of the Transferee Unit” (“Accordingly, these final regulations include an example that illustrates that the existence and composition of the transferee unit is not tested immediately prior to the transaction but instead is only tested immediately after the transaction.”).

Turning then to the Cessation Requirement, if the only potential reason the Conversion Case cannot technically qualify as a Type A Reorganization is because the target corporation does not cease to exist for all purposes (both tax and non-tax), we believe this technical issue can and should be eliminated on exactly the same basis as the technical section 368(b) “party to the reorganization” issue was eliminated in the course of withdrawing the 2000 Proposed Regulations and issuing the 2001 Proposed Regulations. In the preamble to the 2000 Proposed Regulations, Treasury and the Service made the following statement:

Treasury and the Service believe that it is inappropriate to treat the state or Federal law merger of a target corporation into a Disregarded Entity instead as a statutory merger of the target corporation into the Owner, because the Owner, the only potential party to a reorganization under section 368(b), is not a party to the state or Federal law merger transaction. A reorganization under section 368(a)(1)(A) is a combination of the assets and liabilities of two corporations through a merger under state or Federal law. A merger of a target corporation into a Disregarded Entity differs from a merger of a target corporation into the Owner because 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). (Emphasis added).³⁴

However, after considering the comments received in opposition to the approach of the 2000 Proposed Regulations with respect to the Target-Into-DRE Case, Treasury and the Service decided to withdraw the 2000 Proposed Regulations and made the following statement in issuing the 2001 Proposed Regulations:

Permitting certain transactions involving disregarded entities that have a single corporate owner to qualify as statutory mergers and consolidations for purposes of section 368(a)(1)(A) *is appropriate because it is consistent with the general treatment of a disregarded entity as a division of its owner*. Therefore, under the 2001 proposed regulations, the merger of a target corporation into a disregarded entity may qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A). (Emphasis added).³⁵

Against this historical backdrop, we believe there is no meaningful basis on which to distinguish the rationale that led Treasury and the Service to permit the Target-Into-DRE Case to qualify as a Type A Reorganization from the rationale that would be required to adopt our recommendation with respect to the Conversion Case. Specifically, we see no reason why the Cessation Requirement cannot be modified to operate in a manner that deems the target corporation to cease to exist in the Conversion Case, even though such cessation occurs solely for federal income tax purposes. We believe this

³⁴ See Preamble to 2000 Proposed Regulations under the heading “Explanation of Provisions – The Merger of a Target Corporation Into a Disregarded Entity.”

³⁵ See Preamble to 2001 Proposed Regulations under the heading “Explanation of Provisions – B. Mergers Involving Disregarded Entities.”

conclusion is a clear and logical application of the overall functional approach of the Regulations, which enable the Absorption Requirement to operate in a manner that deems the assets and liabilities of the target corporation to be “absorbed by” the acquiring corporation in the Target-Into-DRE Case, even though such absorption occurs solely for federal income tax purposes.³⁶ We would conclude otherwise if the non-tax survival of the target corporation in the Conversion Case could in some way facilitate a divisive transaction or the avoidance of some other reorganization requirement or policy imperative under section 368(a)(1)(A), but as described in more detail below we do not see how this could occur.

b. Consistency With Legislative History of Section 368(a)(1)(A).

We also believe that allowing the Conversion Case to qualify as a Type A Reorganization would be consistent with the legislative history of section 368(a)(1)(A). We reach this conclusion because in such a case the Statutory Simultaneity Requirement and the Absorption Requirement are satisfied. At the same time, the combining entity of the transferor unit ceases to exist under federal income tax law, and we can find no evidence that Congress intended that a target corporation must strictly cease its existence “for all purposes” in connection with a Type A Reorganization.

The concept of a “statutory” merger or consolidation first appeared in the Revenue Act of 1934.³⁷ Through this new formulation, along with other changes to the reorganization provisions, Congress intended to “stop the known cases of tax avoidance” and at the same time permit “legitimate reorganizations” to continue without the imposition of federal income tax.³⁸ In explaining the nature of the changes, the House Ways and Means Committee stated that “the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law”³⁹

³⁶ Under the same rationale, the fact that the Conversion Case does not result in the “actual fusion” under state or local law of the target corporation into a separate pre-existing entity should be of no consequence because the Conversion Case, as with the Target-Into-DRE Case, results in the “deemed fusion” of the target corporation into the acquiring corporation for federal income tax purposes. We also note that the Partnership-to-DRE Case does not result in the actual fusion under state or local law of the former partnership’s assets and liabilities into a separate pre-existing entity. Instead, the Partnership-to-DRE Case like the Conversion Case causes assets and liabilities of the transferor unit to effectively “become” the assets and liabilities of the transferee unit for federal income tax purposes by reason of an entity being transformed into a DRE. This similarity between the Partnership-to-DRE Case and the Conversion Case would be particularly acute in a situation where the only asset of the target corporation in the Partnership-to-DRE Case was its interest in the former partnership, such that all of the underlying assets and liabilities deemed transferred to the acquiring corporation for federal income tax purposes remain in the “same” entity for purposes of state and local law.

³⁷ See § 112(g)(1)(A) of the Revenue Act of 1934.

³⁸ H.R. Rep. No. 73-704 (1934), at 13-14.

³⁹ *Id.* at 14.

The Senate Finance Committee generally agreed with the approach of the House Committee, but recommended certain modifications to the reorganization definition due to the fact that the state merger statutes then in existence lacked uniformity and, on an even more fundamental level, not all states had yet adopted statutes providing for mergers or consolidations.⁴⁰ The changes recommended by the Senate Finance Committee were ultimately enacted,⁴¹ and stand as the predecessors to the modern Type B and Type C reorganization provisions.

However, despite a clear intent to “*more closely*” conform the reorganization provisions to the “*general requirements*” of corporation law, we can find nothing in the legislative history of the Revenue Act of 1934 that sheds direct light on what Congress thought such general requirements actually were.⁴² Indeed, the precise technical effects of state merger and consolidation statutes in existence in 1934 were far from being well developed or understood,⁴³ and it appears that many transactions conducted pursuant to

⁴⁰ See generally S. Rep. No. 73-558 (1934), at 16-17.

⁴¹ See § 112(g)(1)(B) of the Revenue Act of 1934.

⁴² We note that some contemporaneous commentary suggested that the Type A Reorganization was intended to be solely dependent upon the specific requirements of the statutes in effect in each individual state. See, e.g., Arnold R. Baar & George Maurice Morris, *Hidden Taxes In Corporate Reorganizations* 37, 40-41 (1935) (hereinafter “*Baar & Morris*”); George S. Hills, *Definition – “Reorganization” Under the Revenue Act of 1934*, Taxes, August 1934, at 411, 412, 448. However, whatever force this interpretation may have once had, it has been eviscerated by subsequent cases and administrative authority which have held that compliance with a statute is a necessary but not a sufficient condition for the classification of a transaction as a Type A Reorganization. See, e.g., *Southwest Natural Gas Co. v. Comm’r*, 189 F.2d 332 (5th Cir. 1951), cert. denied, 342 U.S. 860 (1951) (literal compliance with state law merger statute not sufficient to cause transaction to qualify as Type A Reorganization); *Roebbling v. Comm’r*, 143 F.2d 810 (3rd Cir. 1944), cert. denied, 323 U.S. 773 (1944) (same); and Rev. Rul. 2000-5, 2000-1 C.B. 436 (same). We also note that the Regulations eliminate the need for the operative statute to be a corporate law statute, thereby conforming the Regulations to the Service’s long-standing position that a Type A Reorganization can be effected pursuant to non-corporate laws. See Rev. Rul. 84-104, 1984-2 C.B. 94 (Type A Reorganization effected under National Banking Act).

⁴³ See, e.g., Baar & Morris at 36-37 (“Neither state statutes nor the interpretations given them in different states are uniform. A reorganization which constitutes a merger or consolidation in one state may have a contrary result in another. In many states the statutes and decisions of the courts are silent on the subject. A new character of dispute and litigation is in prospect as a result of this express ‘statutory’ restriction on mergers and consolidations.”); Comment, *Statutory Merger and Consolidation of Corporations*, 45 Yale L.J. 105, 106 (1935) (hereinafter “*Yale L.J. Comment*”) (“In some statutes the distinction between [a merger and a consolidation] has been recognized for a comparatively long time, in others it has been made very recently, while in still others the two terms continue to be used loosely and interchangeably.” [Citations omitted]); Steven A. Bank, *Taxing Divisive and Disregarded Mergers*, 34 Ga. L. Rev. 1523, 1569 (2000) (hereinafter “*Bank*”) (“Furthermore, there was no general consensus regarding the appropriate definition of the terms ‘merger’ and ‘consolidation’ that the statutory merger requirement could have implicitly adopted. Although the concepts of merger and consolidation existed under common law, courts and state legislatures often blurred the conceptual meanings, either by design or through inattention to detail.” [Citations omitted]).

such statutes would not have satisfied the strictures of the current formulation of the Cessation Requirement.⁴⁴

Moreover, we note the controversy that was brewing in 1934 with respect to whether the existence of the target corporation had to cease under the merger and consolidation provisions of prior Revenue Acts.⁴⁵ In light of this contemporaneous controversy, and in light of the fact that state merger and consolidation statutes were far from being uniform, it seems that Congress by not expressly mandating a strict cessation requirement within the context of a Type A Reorganization more likely intended that the technical status of the target corporation under state law could remain a somewhat flexible concept as long as the transaction, when viewed as a whole, did not more closely resemble a taxable sale.⁴⁶

As a result, based on our review of the legislative record and given that the current Cessation Requirement does not appear to reflect an unequivocal *general*

⁴⁴ See, e.g., Baar and Morris at 72 (“Dissolution, or other material change in corporate form, may be the effect of the procedure for merger or consolidation required by the statutes of one state, and not be the effect under the laws of another jurisdiction.” [Citations omitted]); Yale L.J. Comment at 127-128 (noting that the statutory consolidation of corporations located in different states often did not result in the creation of a new corporation or the cessation of the separate legal existence of the constituent corporations); Eldon Bisbee, *Consolidation and Merger*, address delivered before the Association of the Bar and of the City of New York on February 7, 1929 reprinted in 6 N.Y.U. L. Rev. 404, 413 (1929) (hereinafter “Bisbee”) (same); Bank at 1569-1570 (same). See also *Commonwealth v. First Nat. Bank & Trust Co. of Easton*, 154 A. 379 (Pa. Sup. Ct. 1931) (state bank remained in existence upon “consolidation” with national bank under federal statute; transaction at issue appears to have been in the nature of a merger rather than a consolidation as all of the assets and property of state bank transferred to national bank); *New York Tel. Co. v. State Board of Taxes and Assessments*, 159 A. 810, 812-813 (N.J. Sup. Ct. 1932) (“The rule that the consolidated corporation is a new and distinct creation does not apply where the constituent corporations owe their existence to different states; for certain purposes, they remain a separate corporation in each state. While there is a union of interest and property, there is said to be no merger of personal or legal identity. For all the purposes of law, our corporations remain corporations of this state.” [Citations omitted]).

⁴⁵ See Baar and Morris at 68-72 (discussing competing judicial views on whether the transferor had to liquidate under the “parenthetical clause” of various Revenue Acts prior to 1934; refers to then pending Supreme Court decision in *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935), which ultimately found that dissolution was not required under Revenue Act of 1928).

⁴⁶ See 2000 Comments under the heading “II. Detailed Comments – D. Statutory Construction and Legislative History” (“Congress, however, did not wish to impede legitimate reorganizations. In addition, Congress desired to preclude taxpayers from claiming a loss in a true reorganization. It was in this context that Congress added the requirement of a ‘statutory’ merger or consolidation. In doing so, Congress was not focused on the precise requirements of state law regarding constituent corporations.” [Citations omitted]); Bank at 1543 (“Furthermore, the notion that the A reorganization contains an explicit liquidation or dissolution requirement is at best controversial and at worst counter to Supreme Court pronouncements on point. Not all states imposed a dissolution requirement on mergers when the statutory merger requirement was first adopted... Moreover, in a series of three cases decided on the same day in 1935 the [Supreme] Court rejected the notion that dissolution is essential for reorganization status... While these cases were decided under the old parenthetical clause, the analysis defies the notion that dissolution constituted a traditional requirement of state corporate law.”) (referring to the decisions in *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *G&K Mfg. Co. v. Helvering*, 296 U.S. 389 (1935)).

requirement of the merger and consolidation statutes that were in effect in 1934,⁴⁷ we believe that Congress more broadly intended that a Type A Reorganization should have the general effect of the target corporation ceasing to exist as a separate entity for all *practical* purposes relevant to the sound administration of the reorganization provisions.⁴⁸

c. Consistency With Case Law and Administrative Authorities Relevant to the Interpretation of Section 368(a)(1)(A).

We also believe that allowing the Conversion Case to qualify as a Type A Reorganization would be consistent with commonly cited case law and administrative authorities that are relevant to the interpretation of section 368(a)(1)(A). In *Cortland Specialty Co. v. Comm’r*,⁴⁹ the Second Circuit Court of Appeals made the following statement in evaluating the concept of a “merger or consolidation” as defined by the Revenue Act of 1926:

A merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corporation alone survives. A consolidation involves a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company. In each case interests of the stockholders and creditors of any company which disappears remain and are retained against the surviving or newly created company. [Citations omitted]. *Undoubtedly such statutes vary in the different states particularly in respect to how far the constituent companies may be deemed to survive the creation of the*

⁴⁷ In this regard, we note that the transferor corporation in a Type C reorganization is not subject to the same rigid standard of cessation as that articulated in the current formulation of the Cessation Requirement. In a Type C reorganization, the transferor corporation need only effectively liquidate for federal income tax purposes and need not liquidate for all purposes under state law. *See generally*, § 368(a)(2)(G); Rev. Proc. 89-50 (1989-2 C.B. 631), *amplifying* Rev. Proc. 77-37 (1977-2 C.B. 568). While we recognize that the requirements for the Type C reorganization and the Type A Reorganization have always diverged, the current dichotomy with respect to the cessation requirement seems highly anomalous and unwarranted given that the Type C reorganization was originally intended to stand as a substitute for a statutory merger or consolidation in those states that did not have a merger or consolidation statute in 1934. *See generally* S. Rep. No. 73-558 (1934), at 16-17.

⁴⁸ *See generally* Bisbee at 405-406 summarizing the uncertain state of merger and consolidation law in 1929 (“Although the text book writers and the most enlightened courts are agreed as to the definition of consolidation and merger, a great deal of statutory confusion persists with respect thereto. During the early days of such unions, the term ‘Merger’ seems to have been employed but little and the word ‘Consolidation’ used to describe them. Although frequently used interchangeably, the obvious meaning of the words clearly suggests their dissimilarity. It is now generally accepted that a consolidation is accomplished when two or more corporations unite to form a new and separate corporation, while a merger takes place when one, or more than one, corporation is absorbed by an existing corporation. The act and fact of consolidation *practically terminate* all of the existing corporations parties thereto and bring into being a new corporation; the act and fact of merger *practically terminate* one, or more than one, but an existing corporation continues; a new corporation results from a consolidation, never from a merger.”) (Emphasis added).

⁴⁹ 60 F.2d 937 (2nd Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

new or modified corporate structure, but we believe that the general purpose of them all has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form. (Emphasis added).⁵⁰

From this passage, as well as the language of other subsequent cases,⁵¹ we believe that relevant judicial authority does not preclude a transaction from qualifying as a Type A Reorganization as long as the target corporation ceases to exist to a degree that is sufficient to carry out the intended purposes of the reorganization provisions.

In support of this conclusion, we also note the analytical underpinnings of Revenue Ruling 84-104⁵² and Revenue Ruling 2000-5.⁵³ In Revenue Ruling 84-104, the substantive results of the transaction at issue were characterized as a “merger” for purposes of sections 368(a)(1)(A) and (a)(2)(E), even though the relevant provision of the National Banking Act was formally labeled a “consolidation” statute.⁵⁴ In addition, under the relevant provision of the National Banking Act, the corporate existence of the merged subsidiary was technically “*merged into and continued*” in the surviving corporation and the surviving corporation was deemed to be the “*same corporation*” as each corporation participating in the merger.⁵⁵ On its face, this result seems potentially at odds with the current formulation of the Cessation Requirement given that the separate corporate (or non-tax) existence of the merged subsidiary did not clearly cease “*for all*

⁵⁰ *Id.* at 939.

⁵¹ *See, e.g., Vulcan Materials Company v. U.S.*, 446 F.2d 690, 694 (5th Cir. 1971) (“In a merger, [the] attributes of corporate life are transferred to the surviving corporation and *are there continued and preserved*. It has been said that ‘all ‘rights, powers, liabilities and assets’ (survive) except the ‘indicia and attributes of a corporate body distinct from that into which it is merged’ [Citation omitted] (Emphasis added); *Argenbright v. Phoenix Finance Co. of Iowa*, 187 A. 124, 126 (Del. Ch. Ct. 1936) (“When a consolidation or merger has taken place under the statute, the *old corporations have their identity absorbed* into that of the new corporation or the one into which they were merged.”) (Emphasis added); *Fidanque v. American Maricao Co.*, 92 A.2d 311, 315-316 (Del. Ch. Ct. 1952) (“Whether a particular transaction is in reality a merger or otherwise depends to a great extent on the circumstances surrounding each particular case and in determining the question all the elements of the transaction must be considered. There is no magic in the words applied to the transaction. *Calling it a merger does not necessarily make it so and giving it another name does not prevent it from being a merger.*”) (Emphasis added).

⁵² 1984-2 C.B. 94.

⁵³ 2000-1 C.B. 436.

⁵⁴ Under the facts of the Ruling, no new corporation was formed and one of the “consolidating” corporations survived. *See* Rev. Rul. 84-104 (1984-2 C.B. 94) (“Although described as a consolidation under the National Banking Act, 12 U.S.C. section 215, the present transaction constitutes a merger since one of the combining corporations (BK) survived the transaction and no new corporation is formed.”).

⁵⁵ *See* 12 U.S.C. § 215(e) (1984) (“The *corporate existence* of each of the consolidating banks or banking associations participating in such consolidation *shall be merged into and continued* in the consolidated national banking association and such consolidated national banking association shall be deemed to be the *same corporation* as each bank or banking association participating in the consolidation.”) (Emphasis added).

purposes” pursuant to the plain language of the relevant statute.⁵⁶ However, despite this fact, the Service concluded that the transaction met all the requirements of section 368(a)(1)(A) and (a)(2)(E) of the Code and the regulations thereunder. Meanwhile, in Revenue Ruling 2000-5, the Service cited *Cortland* as its primary authority in recounting the historical requirements of corporate law merger statutes, thereby at least implicitly adopting the Second Circuit’s recognition of the varying degree to which the target corporation may technically survive.⁵⁷

d. Consistency With Treasury and the Service’s Approach to Similar Issues That Arise In Other Contexts.

As illustrated through our brief historical examination of the Target-Into-DRE Case, the nature of the technical challenges presented by the Conversion Case are not new. Indeed, the advent of the “check-the-box” regulations and the DRE concept constantly require Treasury and the Service to take reasonable measures to account for transactions involving DREs, and we generally believe that practical and sensible approaches have been taken within the bounds of Congressional intent. We believe this to be true, even though such approaches could not have been envisioned by Congress when it enacted the Code provisions that are now set into motion by varying “deemed” transactions that occur solely for federal income tax purposes.⁵⁸ Against this backdrop, we believe the intersection of federal income tax law and non-tax law in the Conversion

⁵⁶ We note the Regulations clarify that the Cessation Requirement is satisfied in the case of certain consolidations and amalgamations, notwithstanding the fact that the precise technical composition of the surviving entity for non-tax purposes includes the consolidating or amalgamating entity, because the consolidating or amalgamating entity ceases to exist as a *separate* corporation. See Example 12 of the Regulations and the Preamble under the heading “Explanation of Provisions – C. Consolidations and Amalgamations” (“In a consolidation or amalgamation, 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 the consolidating or amalgamating entities does in fact cease.”) (Emphasis added). Presumably, this rather pragmatic approach would also apply to the situation at issue in Revenue Ruling 84-104. However, we believe that any potential analytical uncertainty in this regard is entirely unnecessary as long as the transaction, when taken as a whole, cannot lead to a divisive transaction for federal income tax purposes. Consequently, we again point to our recommendation which renders non-tax refinements totally irrelevant in the context of the Cessation Requirement and which simply requires that there be only one surviving combining entity of the transferee unit for federal income tax purposes.

⁵⁷ We further point out that the 2000 Proposed Regulations did not contain an explicit “for all purposes” standard of cessation for the target corporation. Instead, an explicit “for all purposes” standard was first set forth in the 2001 Proposed Regulations. However, the 2001 Proposed Regulations failed to contain a proviso allowing for post-closing actions that relate to the target corporation’s activities prior to the effective time of the transaction. Such a proviso was only first added to the 2003 Temporary Regulations and the same proviso now also appears in the Regulations. In making each of these subtle yet seemingly significant modifications, Treasury and the Service did not provide any legislative, judicial, or administrative authority, or any other analyses of any kind, that might explain or rationalize these changing contours. Therefore, we do not see why the current Cessation Requirement should be considered as reflecting a well-established and deep-rooted principle for Type A Reorganizations. See *generally* Bank at 1568 referring to the analysis of Revenue Ruling 2000-5.

⁵⁸ See *generally* Reg. § 301.7701-3(g)(1) (deemed treatment of elective changes in entity classification).

Case should be fully respected and applied in a pragmatic manner that is seemingly consistent with the general Congressional intent that underlies the Type A Reorganization.

e. Promotion of Transactional Efficiency and Other Meaningful Non-Tax Objectives.

As previously noted in our brief overview of the general effects of conversion statutes, allowing the Conversion Case to qualify as a Type A Reorganization would generally obviate the need to obtain consents for the assumption of the target corporation's loans or other liabilities, or consents for the transfer or assignment of the target corporation's contracts, leases, licenses, permits, or other assets. This would have the desirable effect of creating another efficient transactional pattern, similar to a transaction effected under section 368(a)(2)(E), that would enable the fluid readjustment of capital within the economy under modified corporate forms. We also believe that the emergence of the Conversion Case as a viable method for effecting a Type A Reorganization would not subvert the policy imperatives underlying section 368(a)(2)(E) or otherwise lead to the disappearance of the reverse triangular merger from the transactional landscape. Similar to the concerns that were overcome with respect to the Target-Into-DRE Case and its potential impact on transactions under section 368(a)(2)(D),⁵⁹ we believe that there are clearly meaningful differences between, and valid business purposes for, conducting the ongoing operations of a target corporation as either a DRE or as a separate corporate subsidiary.⁶⁰

Aside from promoting transactional flexibility, we also believe that allowing the Conversion Case to qualify as a Type A Reorganization would have the effect of reducing unnecessary transactional costs and eliminating what now stands as something of a trap for the unwary. In particular, after considering the full implications of the current Cessation Requirement in the context of a Type A Reorganization, we believe such a requirement is fraught with potential uncertainty given its unstable and shifting reliance on the highly technical non-tax effects of a merger or consolidation. While often times non-tax statutes are adequately developed, many times they are not, such that tax practitioners opining on transactions are required either to become experts on non-tax

⁵⁹ See generally 2000 ABA Section of Taxation Comments under the heading "II. Detailed Comments – C. Imposition of Additional Requirements – 1. The 'Substantially All' Requirement – Prevention of Divisive Transactions."

⁶⁰ For example, in the Conversion Case the target shareholders are effectively precluded from retaining any ongoing direct interest in the target as the target must have a single owner in order to qualify as a DRE. In contrast, under the "acquisition of control" requirement of § 368(a)(2)(E)(ii), the target shareholders can potentially maintain a limited continuing interest in the target. This flexibility could be significant in tender offer situations or cases where relevant regulatory or other restrictions require direct ownership by one or more of the historic target shareholders. In addition, insurance companies and banks are generally treated as *per se* corporations for federal income tax purposes and therefore the Conversion Case would not represent a viable option for business combinations within those industries. See Reg. §§ 301.7701-2(b)(4) and -2(b)(5).

matters or otherwise retain the assistance of local counsel.⁶¹ Further, while this requirement may not be particularly burdensome on sophisticated taxpayers with highly capable representation, it places other taxpayers at a distinct disadvantage.

f. Promotion of Tax Policy Objectives.

We believe that allowing the Conversion Case to qualify as a Type A Reorganization would promote the significant tax policy objective of affording the same federal income tax treatment to transactions with similar substantive results. For federal income tax purposes, it is clear that there is no meaningful difference in the net effects of the Conversion Case as compared with the Target-Into-DRE Case. In both cases, the assets and liabilities of the target corporation, “simultaneously” and pursuant to a non-tax statute, become housed in a DRE that is treated as a division of the acquiring corporation.

Furthermore, the net resulting non-tax differences between the Conversion Case and the Target-Into-DRE Case also appear to be relatively minor. This is especially true when, as part of the Target-Into-DRE Case, the target corporation merges into a newly-formed “shell” LLC organized in the same state. As previously noted, in the Conversion Case the identity of the target corporation does not technically change under state law and therefore the target corporation remains the “same” entity with the same assets and liabilities. However, upon the effectiveness of the conversion, the “outward indicia” of the target corporation’s identity do in fact change from that of a corporation to that of an LLC. In addition, the target corporation’s existence and ongoing operation are no longer embodied by and carried out through articles of incorporation and corporate bylaws, but are instead embodied by and carried out through articles of organization and an operating agreement, and the governing law also changes from the law of corporations to the law of limited liability companies. In effect, while the naked core attributes of the target corporation remain intact, the target corporation puts on an entirely new legal “cloak” that fundamentally changes its ongoing legal status and that causes its existence as a corporation to cease.⁶²

⁶¹ As a very simplistic example, consider § 259(a) of the Delaware General Corporation Law which does not, on its face, clearly state that a merged corporation ceases to exist “for all purposes.” See Del. Gen. Corp. Law, § 259(a) (2006). As a result, even in Delaware where corporate statutes are arguably the most developed of any state, a taxpayer must consult case law (and the careful taxpayer would also engage local counsel) to obtain comfort that the target corporation truly ceases to exist “for all purposes” within the apparent meaning of the current Cessation Requirement. See generally *Beals v. Washington International, Inc.*, 386 A.2d 1156, 1161 (Del. Ch. Ct. 1978) (a merged corporation ceases to exist “for all purposes,” including service of process, unless the legislature provides otherwise).

⁶² Some commentators have suggested that the technical cessation of the target corporation’s existence as a corporation and its resulting status as a DRE should be sufficient to cause the Conversion Case to satisfy the current wording of the Cessation Requirement and therefore qualify as a Type A Reorganization. See Los Angeles County Bar Association, Taxation Section, Corporate Tax Committee Report, *Treatment Under Section 368(a)(1)(A) of a Merger or Conversion of the Target Corporation Into a Disregarded Entity Following a Reverse Triangular Corporate Merger*, reprinted at 2004 TNT 97-40 (“Thus, a corporation (T) that is a combining entity ceases its existence as a corporation (and therefore as a combining entity) when it converts to an LLC, just as it does when, instead of a converting, it merges into an LLC.”).

By comparison, in the Target-Into-DRE Case the assets and liabilities of the target corporation are legally transferred to a transferee LLC. However, the transferee LLC has the same outward indicia, can have identical articles of organization and operational provisions, and is subject to the same governing law as the resulting LLC in the Conversion Case. In addition, through the operation of modern merger statutes, the rights, powers, and obligations of the target corporation that relate to the period prior to the effective time of the transaction “survive” for all practical purposes and are continued and preserved in the transferee LLC (a fact recognized by the proviso contained in the second clause of the current Cessation Requirement).⁶³

We believe that all this points to the fact that although the target corporation does not technically cease its separate legal existence in the Conversion Case, the net results of the Conversion Case and the Target-Into-DRE Case are essentially the same for both tax and non-tax purposes. We therefore find it hard to see why the federal income tax treatment of the transactional mechanics associated with each case should differ, particularly when both cases require the invocation of the DRE construct (a purely tax-based notion) in order to reach the conclusion that the target corporation has effectively engaged in a direct statutory merger with the acquiring corporation.

g. Effect of Recommendation on Revenue Rulings 67-274 and 72-405.

In Revenue Ruling 67-274,⁶⁴ corporation Y acquired all of the outstanding stock of corporation X from the shareholders of X in exchange for voting stock of Y and thereafter, and as part of the same plan, Y completely liquidated X. Advice was requested as to whether the first-step stock purchase could be considered independently from the second-step liquidation, such that the first step of the transaction could qualify as a Type B reorganization under the 1954 Code. The Service applied the step-transaction doctrine to integrate the two steps, such that the transaction could not qualify as a Type B reorganization, and held that the transaction instead qualified as a Type C reorganization.

In Revenue Ruling 72-405,⁶⁵ corporation P organized corporation S as a wholly-owned subsidiary and S then acquired all of the assets of corporation T in a statutory merger. Immediately after the merger of T into S, and as part of the same plan, S was completely liquidated into P. Advice was requested as to whether the first-step merger could be considered independently from the second-step liquidation, such that the first step of the transaction could qualify as a forward-triangular merger under section 368(a)(2)(D) of the 1954 Code. The Service applied the step-transaction doctrine to integrate the two steps, such that the transaction could not qualify as a reorganization

⁶³ See, e.g., Del. Gen. Corp. Law § 264(e) and § 259(a) (2006).

⁶⁴ 1967-2 C.B. 141.

⁶⁵ 1972-2 C.B. 217.

under section 368(a)(2)(D), and held that the transaction instead qualified as a Type C reorganization.

If the Conversion Case is allowed to qualify as a Type A Reorganization, we do not believe the holdings of Revenue Rulings 67-274 and 72-405 would need to be modified. We believe these Rulings can be clearly distinguished from the results of the Conversion Case in the same manner that they can be distinguished from the holding of Revenue Ruling 2001-46.

In the Conversion Case (assuming our recommendation is adopted), as well as in each of the two situations in Revenue Ruling 2001-46, the first step is disregarded as transitory and the second step, effected pursuant to a non-tax statute, is treated as a Type A Reorganization of the target corporation with and into the acquiring corporation. As a result, the assets and liabilities of the target corporation are ultimately combined with the acquiring corporation in a manner that is appropriate to support Type A Reorganization treatment (*i.e.*, through a transaction that satisfies each of the Statutory Simultaneity Requirement, the Absorption Requirement, and the Cessation Requirement). In contrast, in Revenue Rulings 67-274 and 72-405, the first step in each of the transactions is also effectively disregarded as transitory, but the assets and liabilities of the target corporation ultimately combine with the acquiring corporation in a manner that is not appropriate to support Type A Reorganization treatment (*i.e.*, through a liquidation proceeding that generally would not satisfy the Statutory Simultaneity Requirement).⁶⁶

h. Arguments Against Permitting the Conversion Case to Qualify as a Type A Reorganization.

As previously noted, there is a minority view that the Conversion Case should not be permitted to qualify as a Type A Reorganization. Those who hold this view recognize that for federal income tax purposes the Conversion Case results in the simultaneous (i) transfer of all of the assets and liabilities of the target corporation to the acquiring corporation and (ii) elimination of the target corporation as a separate entity, which reflect similar consequences to those produced in the Target-Into-DRE Case. However, they remain concerned that in the Conversion Case there is no state law transfer of assets and liabilities to another entity or state law cessation of the target corporation's existence.

In particular, as already discussed in Part III.B.1 of these Comments, in the second step of the Conversion Case the target corporation changes its legal status from a corporation to an LLC pursuant to a state statute. Nevertheless, from a state law standpoint, the converted LLC is generally treated as the "same" entity. Therefore, although a second-step conversion is effected pursuant to state law, no transfer of assets and liabilities to another entity occurs under state law. Similarly, the target corporation is not treated as dissolving or terminating its existence for state law purposes.

⁶⁶ See, e.g., Del. Gen. Corp. Law § 278 (2006) (stating that a corporation shall continue for at least three years following a dissolution for purposes of winding up its affairs).

In light of these facts, the minority view holds that the current wording of section 368(a)(1)(A) does not permit the Conversion Case to qualify as a Type A Reorganization. Holders of this view believe that the plain meaning of the phrase “*statutory merger or consolidation,*” when read in conjunction with the legislative history to the Revenue Act of 1934, must refer to a transaction that involves both a state law transfer of assets and liabilities to another state law entity and the dissolution of the target corporation for all purposes. In addition, they believe that the Target-Into-DRE Case can be effectively distinguished from the Conversion Case because the former case results in the statutory transfer of the target corporation’s assets and liabilities to a DRE, with only the DRE surviving as a separate entity for non-tax purposes.

Finally, holders of the minority view are not convinced by the argument that treating the Conversion Case in the same manner as the Target-Into-DRE Case, as opposed to treating it in the manner discussed below for the Check-the-Box Case, supports the tax policy objective of treating similar transactions in the same way. The Check-the-Box Case is similar to both of these cases, yet the Section feels constrained (correctly in the view of these members) to treat that case in a different manner because of the literal language of the Code. Therefore, whichever way the Conversion Case is treated, it will be treated in the same manner as one transaction similar to it, and in a different manner than another transaction similar to it. Holders of the minority view believe, therefore, that this policy factor is neutral in the analysis and is not a reason to disregard what they believe is the clear literal language of the Code.

C. Entity Classification Elections.

1. Background.

Effective January 1, 1997, Treasury and the Service issued the final entity classification regulations under section 7701 (the “Check-the-Box Regulations”).⁶⁷ Treasury and the Service were prompted to issue the Check-the-Box Regulations because the prior regulatory regime, which was based on the historical differences between corporations and partnerships under local law, was perceived as having become “increasingly formalistic.”⁶⁸ Under the Check-the-Box Regulations, a voluntary election to change the classification of an entity from an association to a DRE is treated as though the association distributed all of its assets and liabilities to its single owner in liquidation of the association.⁶⁹

In the Preamble, Treasury and the Service observed that the Check-The-Box Case can have substantive federal income tax effects that are identical to those traditionally associated with a Type A Reorganization. However, despite this fact, the Regulations do not currently enable such a transactional pattern to qualify as a Type A Reorganization

⁶⁷ T.D. 8697, 61 Fed. Reg. 66584.

⁶⁸ See Preamble to the Check-the-Box Regulations under the heading “Explanation of Provisions.”

⁶⁹ See Reg. § 301.7701-3(g)(1)(iii).

because no action under state law effects the transfer of the assets and liabilities of the target corporation to the acquiring corporation. In addition, as with the Conversion Case, the target corporation does not cease its separate legal existence for all purposes and instead only ceases its separate existence for federal income tax purposes.⁷⁰ As a result, under existing authorities, the Check-the-Box Case must be tested as a Type C, D, or F reorganization, as the case may be, to determine whether it qualifies for non-taxable treatment.

2. Specific Recommendation and Rationale.

Although there is a minority view, we recommend that the Check-the-Box Case should not be permitted to qualify as a Type A Reorganization. We also believe that two other similar transactional patterns should not be permitted to qualify as Type A Reorganizations. Specifically, we believe that a stock acquisition by an S corporation that is followed by a pre-planned qualified Subchapter S subsidiary election with respect to the target corporation (the “Q-Sub Case”), and a stock acquisition by a REIT that results in the automatic conversion of the target corporation into a qualified REIT subsidiary (the “QRS Case”), should not be permitted to qualify as Type A Reorganizations.

Our recommendation with respect to these transactional patterns is based on the belief that the phrase “*statutory merger or consolidation*” as it currently appears in section 368(a)(1)(A), and the corresponding functional definition set forth in Reg. 1.368-2(b)(1)(ii), cannot be interpreted so broadly as to include transactions effected solely pursuant to the operation of federal tax regulations (*i.e.*, Congress intended that the statute at work must be a non-tax statute).⁷¹

However, we note that when the substantive results of the Check-the-Box Case, the Q-Sub Case, and the QRS Case are fully respected for federal income tax purposes, such transactions otherwise satisfy the “simultaneous” element of the Statutory Simultaneity Requirement, and also technically satisfy the Absorption Requirement and

⁷⁰ See generally Preamble under the heading “Explanation of Provisions – A. State Law Conversions” (“A similar question arises when the target corporation is an eligible entity under § 301.7701-3(a), rather than a *per se* corporation, and the status of the target for Federal income tax purposes is changed through an Entity Classification Election under § 301.7701-3 rather than through a conversion under state law. In this case, no action under state or local law effects the transfer of the assets of the target corporation to the acquiring corporation. Nevertheless, the election also accomplishes the simultaneous transfer for Federal income tax purposes of all the assets of the target corporation to the acquiring corporation and the elimination for Federal income purposes of the target corporation as a corporation.”).

⁷¹ In the preamble to the 2005 Proposed Regulations, Treasury and the Service indicated that “the phrase *statute or statutes* is not intended to prevent transactions effected pursuant to legislation from qualifying as mergers or consolidations where such legislation is supplemented by administrative or case law.” Although the use of the term “*legislation*” could potentially be interpreted very broadly to include provisions of the Code and the Regulations issued thereunder, we think such a reading would be somewhat out of step with the legislative history of the Revenue Act of 1934 which clearly contemplates tying the Type A Reorganization to “*state corporation laws*” (which has subsequently been expanded to include other non-tax laws).

the Cessation Requirement. As a result, there does not appear to be any compelling policy rationale for excluding these transactions from qualifying as Type A Reorganizations.

Specifically, as noted above, the Regulations permit the Target-Into-DRE Case to qualify as a Type A Reorganization. Yet, in that case, for all non-federal income tax purposes, the DRE remains a separate legal entity and the DRE rather than its parent is respected as the acquirer of the target's assets and liabilities in the merger. It is only by reason of the Check-the-Box Regulations that the parent is viewed as acquiring the target's assets and liabilities. Admittedly, in the Target-Into-DRE Case the transaction satisfies the Absorption Requirement and the Cessation Requirement pursuant to the operation of a non-tax statute, and the Check-the-Box Regulations only affect the identity of the acquiring entity, whereas in the Check-the-Box Case, the Q-Sub Case, and the QRS Case the transaction satisfying the Absorption Requirement and the Cessation Requirement occurs solely for federal income tax purposes. Notwithstanding this distinction, there does not appear to be any compelling policy reason for treating functionally equivalent transactions differently.

Moreover, permitting the Check-the-Box Case, the Q-Sub Case, and the QRS Case to qualify as statutory mergers or consolidations under Section 368(a)(1)(A) would enhance taxpayer flexibility by facilitating transactions that cannot now be readily structured in a non-taxable manner. This is particularly true in the cross-border and foreign contexts, where local law either does not provide for mergers or equivalent transactions satisfying the requirements of Reg. § 1.368-2(b)(1)(ii), or does not permit such transactions to be effected on a non-taxable basis where stock of a controlling U.S. corporation is issued as consideration. Although the Regulations now permit transactions effected pursuant to the laws of foreign jurisdictions and involving foreign entities to qualify as a "statutory merger or consolidation," as many commentators have noted,⁷² this change is of only limited practical significance until the laws of other jurisdictions develop in a consistent manner. The inability to effect a direct merger, amalgamation or consolidation between a U.S. corporation and a foreign corporation requires that an acquisition of a foreign corporation involving any degree of non-stock consideration often must be structured as an exchange under section 351 or as a Type C asset reorganization in order to qualify for non-taxable treatment. Satisfying the requirements of these sections is often impractical or requires restructuring the transaction in ways that alter the underlying business transaction.

⁷² See, e.g., Bernard T. Bress, *The Cross-Border 'A' Final Regulations*, 17 J. Int'l Tax'n 18 (August 2006) ("These Regulations will certainly facilitate same-country asset acquisitions. At the present time, however, cross-border statutory mergers/consolidations are literally non-existent – this includes acquisitions among companies organized in EU member countries."); Bernard T. Bress, *The New Cross-Border 'A' Regulations*, 16 J. Int'l Tax'n 14, 16 (June 2005) ("Theoretically, these Regulations provide for a variety of cross-border merger transactions that may not have been possible before – U.S.-to-foreign, foreign-to-foreign, and foreign-to-U.S. asset acquisitions. So what does all this mean in the real world? In the short run, it surely is a positive development that these rules have been promulgated but after they are finalized, they will have only a limited sphere of application until other jurisdictions enact legislation that is compatible with these rules.").

Consequently, given that the results of the Check-the-Box Case, the Q-Sub Case, and the QRS Case are substantively the same as a Type A Reorganization, but for the fact that a purely tax-based regulation is at work rather than a non-tax statute, we urge Treasury and the Service to recommend that Congress remove the word “statutory” from section 368(a)(1)(A). We also suggest that Treasury seek a grant of regulatory authority from Congress to interpret and implement section 368(a)(1)(A) in light of this change to the statute. We believe such a change to the statute and related grant of regulatory authority would, at long last, appropriately disconnect Type A Reorganizations from an exclusive and unstable reliance on non-tax statutes and promote significant tax and non-tax objectives.⁷³ We further believe, for reasons previously discussed, that such a change would not undermine the current requirements for Type C reorganizations and somehow enable taxpayers to engage in divisive transactions for federal income tax purposes.

D. Mergers That Cause a Partnership to be Reclassified as a DRE.

1. Background.

Treasury and the Service have already reached the general conclusion that the Partnership-to-DRE Case should be permitted to qualify as a Type A Reorganization. As a result, the primary issues that remain under ongoing consideration in this context relate to the specific tax consequences to the parties, including whether gain or loss should be recognized under Subchapter K of the Code, and to what extent the principles of Revenue Ruling 99-6 should apply.

2. Specific Recommendation and Rationale.

The following discussion proceeds by first providing an overview of the rules under the Regulations that relate to the appropriate time for testing the transferee unit. The discussion then summarizes relevant provisions under Subchapter K, describes three separate modes of analysis that could potentially be applied to the Partnership-to-DRE Case, and concludes by recommending that the first suggested mode of analysis should be adopted. If our recommendation is adopted, the target corporation would be treated as transferring all of its assets, including the partnership interest, to the acquiring corporation, and the partnership would be deemed to make a liquidating distribution to the acquiring corporation as the partnership’s only partner.

a. Time for Testing the Transferee Unit.

The Regulations address the timing for testing the existence and composition of the transferee unit. Example 7 of the Regulations, which was included in the 2003 Temporary Regulations, concludes that the merger of a corporation into a DRE in exchange for interests in the DRE does not qualify as a Type A Reorganization, because the DRE becomes a partnership by default immediately after the merger and, therefore,

⁷³ The effect of this change would be similar to the changes brought about by the Check-the-Box Regulations which rely on non-tax law to some degree while also providing an elective regime that has effect solely for federal income tax purposes. *See generally* Reg. §§ 301.7701-2 and -3.

cannot be a member of the transferee unit. Thus, the existence and composition of the transferee unit is tested immediately after the merger. The Preamble states that one commentator noted that it is not clear whether the existence and composition of the transferee unit are also tested immediately prior to the merger. The Regulations clarify that the existence and composition of the transferee unit is not tested immediately before the merger, but is only tested immediately after the merger. The Regulations added Example 11 to illustrate this point:

A and T own 60 percent and 40 percent, respectively, of the capital and profits interest in P, an entity classified as a partnership for federal income tax purposes. Under state law, T merges into P. Pursuant to such law, the following events occur simultaneously at the effective time of the merger: all of the assets and liabilities of T become the assets and liabilities of P, and T ceases its separate legal existence for all purposes. As a result of the merger, P becomes a DRE.

Example 11 of the Regulations concludes that the transaction satisfies the requirements for a Type A Reorganization, because all of the assets and liabilities of T, the combining entity and sole member of the transferor unit, become the assets and liabilities of one or more members of the transferee unit comprised of A, the combining entity of the transferee unit, and P, a DRE owned by A immediately after the transaction, and T ceases its separate legal existence for all purposes. Although we believe that the timing for testing the transferee unit is appropriate under these circumstances, treating the merger of T into P as a Type A Reorganization raises other issues that need to be addressed; namely, whether gain or loss should be recognized under Subchapter K of the Code, and to what extent the principles of Revenue Ruling 99-6 should apply. The same issues arise if T merges into the other partner, A, instead of P.

b. Subchapter K Partnership Termination Rules.

Under section 708(b)(1)(A), a partnership terminates if no part of its business continues to be carried on by any of its partners in a partnership. Thus, a partnership terminates when only one partner remains.⁷⁴ The tax consequences of a partnership liquidation are generally as follows: (i) under section 731(a)(1), a partner recognizes taxable gain only to the extent that money (including marketable securities) distributed⁷⁵ exceeds the partner's basis in his partnership interest; (ii) under section 731(a)(2), a partner recognizes a loss if he receives only cash, unrealized receivables, and inventory, and the adjusted basis of his partnership interest exceeds the amount of cash and the partnership's basis in such distributed assets; (iii) under section 731(b), the liquidating partnership recognizes no gain or loss; (iv) under section 732(b), the basis of property received by the partner generally is the same as the basis of his partnership interest, reduced by any money distributed in the liquidation; and (v) under section 735(b), the

⁷⁴ See Rev. Rul. 99-6 (discussed below).

⁷⁵ In general, any decrease in the partner's share of partnership liabilities is treated as a distribution of money. Section 752(b).

partner's holding period in the assets received in the liquidation includes the partnership's holding period as determined under section 1223.

In addition to these normal "operating" rules, Subchapter K contains a number of rules that can produce very different results (so-called "anti-deferral" rules). For example, under section 751(b), the distribution of partnership property is treated, in part, as a sale or exchange of hot assets (*i.e.*, unrealized receivables and appreciated inventory) for other assets between the distributee partner and the partnership to the extent the distributee partner gives up or receives more or less than his share of hot assets in exchange for other assets, with the balance of the distribution being treated under the rules described in the preceding paragraph.⁷⁶

Most notably, perhaps, it is also possible for a partnership liquidation to trigger the application of the so-called anti-mixing bowl provisions of sections 704(c)(1)(B) and 737. Under section 704(c)(1)(B), if a partner contributes built-in gain or built-in loss property to a partnership, and the partnership distributes the property to another partner within seven years of the contribution to the partnership, the contributing partner recognizes any remaining pre-contribution gain or loss at the time of the distribution. Conversely, under section 737, if a partner contributes built-in gain property to a partnership, and, within seven years of the contribution, the partnership distributes other property to the contributing partner, the contributing partner is required to recognize gain to the extent of the lesser of (i) the net pre-contribution gain on property contributed by such partner to the partnership (*i.e.*, the amount of gain the partner would recognize under section 704(c)(1)(B) if the property the partner contributed were distributed to another partner), or (ii) the excess of the value of the distributed property over such partner's adjusted basis in its partnership interest. Although there are certain, limited exceptions,⁷⁷ these rules generally apply in connection with the liquidation of a partnership. Consider the following example:

Example 1. A and T form P, with A contributing nondepreciable Asset 1 with a fair market value of \$100 and a basis of \$10, and T contributing nondepreciable Asset 2 with a fair market value of \$100 and a basis of \$90. A has a basis in its P interest of \$10, and T has a basis in its P interest of \$90. P has a basis in Asset 1 of \$10 and a basis in Asset 2 of \$90. P liquidates within seven years of its formation, distributing its assets pro rata to its partners. Absent an exception, the anti-mixing bowl rules would cause both A and T to recognize gain.

If the anti-mixing bowl rules did not apply because the distribution occurred more than seven years after the contribution of the assets, A would hold a 50-percent interest in Asset 1 with a \$5 basis, and a 50-percent interest in Asset 2 with a \$5 basis. Significantly, T would hold a 50-percent interest in Asset 1 with a \$45 basis, and a 50 percent interest in Asset 2 with a \$45 basis. Thus, basis would have been shifted, free of tax, from Asset 2 to Asset 1.

⁷⁶ Reg. § 1.751-1(b)(1).

⁷⁷ See Reg. § 1.704-4(c)(2)-(6) and Reg. § 1.737-2.

c. Treatment of P's Liquidation.

If, in the Partnership-to-DRE Case, the merger of T into P causes a liquidation of P, it is not entirely clear how the transaction should be characterized. There appear to be three options:

- A transfer of T's assets, including its interest in P, to A, followed by a liquidating distribution of all partnership assets to A as a 100-percent partner ("Option 1");
- An asymmetrical transaction that is treated as a merger as to T and a partnership liquidation as to A consistent with Revenue Rulings 84-111 and 99-6 ("Option 2"); or
- The liquidation of P, followed by the merger of T into a DRE owned by A ("Option 3").

(1) Option 1 – Merger Followed by Partnership Liquidation.

The first option combines Subchapter K and Subchapter C rules by deeming there to be a liquidation of P following the merger of T into P. This construct would be an exception to the rules of Revenue Rulings 84-111 and 99-6.⁷⁸ Although this construct would result in a transitory one-person partnership, as discussed below, it would not be the only circumstance in which Treasury and the Service have allowed a one-person partnership to be recognized. Option 1 may be illustrated by the following example:

Example 2. A and T form P, with A contributing nondepreciable Asset 1 with a fair market value of \$100 and a basis of \$10, and T contributing nondepreciable Asset 2 with a fair market value of \$100 and a basis of \$90. A has a basis in its P interest of \$10, and T has a basis in its P interest of \$90. T also owns nondepreciable Asset 3 with a basis of \$20 and a value of \$200. P has a basis in Asset 1 of \$10 and a basis in Asset 2 of \$90. T merges into P within seven years of P's formation, with the shareholders of T receiving only A stock in consideration for their stock in T. P terminates under section 708(b)(1)(A). Because P is a DRE immediately after the transaction, the transaction qualifies as an A Reorganization into a division of A.

Under Option 1, T is viewed as transferring all of its assets, including its interest in P, to A, the combining entity of the transferee unit, in the merger. Thus, A would receive a carryover basis in all of T's assets under section 362(b). As a result, A's basis in its 100-percent interest in P would be \$100 -- the sum of the basis in its original

⁷⁸ Prior to the issuance of Rev. Rul. 99-6, members of the Tax Section recommended that this approach be applied to all transfers that cause a partnership to become a DRE. See "No Special Rules for Classification Changes Resulting from Numerical Changes, ABA Members Urge," 98 TNT 204-28 (October 22, 1998).

interest, plus a carryover basis of \$90 in the interest received from T⁷⁹-- and A would take a carryover basis of \$20 in Asset 3. T's shareholders should have a basis in the A stock equal to their basis in the T stock and a holding period that includes the period during which they held the T stock under section 1223(1). Immediately after the merger, P would be treated as distributing all of its assets to A in liquidation of A's interest. Under section 732(c), A would allocate its basis in P between Assets 1 and 2, so that A would have a \$10 basis in Asset 1, and a \$90 basis in Asset 2. In addition, A would take a holding period in the assets that includes P's holding period under section 735(b).

Option 1 thus preserves tax-free treatment to T. Because all partnership assets are distributed to one partner, A, Option 1 is less likely than Options 2 and 3 to result in the shifting of basis among partnership assets when the assets are distributed from the partnership. For the same reason, Option 1 is less likely than Options 2 and 3 to result in the recognition of gain or loss under section 731. In addition, only the assets originally held by P would have a substituted basis in A's hands; T's other assets would have a carryover basis in A's hands. If the consideration received by the shareholders of T included a combination of A stock and taxable boot, A's basis in the assets received from T, including T's interest in P, would not be affected.⁸⁰ Finally, the anti-mixing bowl rules should not apply, because A would be treated as having contributed all of the property contributed by T.⁸¹

Treasury and the Service have previously recognized transitory one-person partnerships. For example, final regulations published in 1997 recognize the creation of a one-person partnership in the context of "technical terminations" resulting from the sale or exchange of 50 percent or more of the interests in partnership capital and profits within a 12-month period under section 708(b)(1)(B).⁸² These regulations provide that a terminating partnership is deemed to contribute all of its assets and liabilities to a new partnership in exchange for an interest in the new partnership, and the terminating partnership is then deemed to make a liquidating distribution of the interests in the new partnership to the purchasing partner and remaining partners.⁸³

Similarly, Treasury and the Service also published regulations in 2001 recognizing the creation of a one-person partnership in the context of partnership divisive reorganizations (or "divisions").⁸⁴ The construct of these rules is similar to the technical

⁷⁹ See Rev. Rul. 84-53, 1984-1 C.B. 159 and Rev. Rul. 84-52, 1984-1 C.B. 157 (a partner has a single basis in a partnership interest, even if such partner is both a general partner and a limited partner of the same partnership).

⁸⁰ § 361(b)(1)(A).

⁸¹ Reg. §§ 1.704-4(d)(2) and 1.737-1(c)(2)(iii).

⁸² T.D. 8717, May 8, 1997.

⁸³ Reg. § 1.708-1(b)(4).

⁸⁴ T.D. 8925, Jan. 3, 2001 (corrected Sept. 9, 2002).

termination provisions discussed above. Thus, very generally, these regulations provide that, in an “assets-over” partnership division where at least one resulting partnership is a “continuation” of the prior partnership, the dividing partnership is treated as contributing a portion of its assets and liabilities to a new partnership in exchange for interests in the new partnership, with the dividing partnership then distributing the interests in the new partnership to some or all of its partners.⁸⁵ If no resulting partnership is treated as a “continuation” of the prior partnership under the division rules, the prior partnership is treated as contributing all of its assets and liabilities to new partnerships in exchange for interests in the resulting partnerships, and then making liquidating distributions of the interests in the resulting partnerships to its partners.⁸⁶

We believe that Option 1’s characterization of the Partnership-to-DRE Case is more consistent with these transitory one-person partnerships in the section 708 regulations than it is with the asymmetrical approach of Revenue Ruling 99-6 (which addresses a taxable purchase of one partner’s partnership interest by the other partner), in that the former involve transactions that are generally not taxable. The *McCauslen* case, upon which Revenue Ruling 99-6 is based, was a holding period case. In a nonrecognition transfer such as a statutory merger, the acquiring partner will have the same holding period in the distributed assets whether those assets are first deemed to be distributed to the disposing partner, or are treated as distributed to the acquiring partner as the partnership’s sole owner. Thus, it has been argued that the asymmetrical transaction described in Revenue Ruling 99-6 should not be applied to such transfers.⁸⁷

If Treasury and the Service adopt Option 1 in the case of statutory mergers, it would be useful for future guidance to elaborate on the scope of the rule adopted for statutory mergers. That is, should the same rule apply to other nonrecognition transfers, such as the partnership incorporation described in situation 3 of Rev. Rul. 84-111? If so, then Rev. Rul. 84-111 would need to be modified on a prospective basis.

In addition, if Treasury and the Service adopt Option 1, certain ancillary matters may need to be addressed. In some cases, the partnership may have a section 754 election in effect or may have a substantial built-in loss within the meaning of section 743(d). In these events, a basis adjustment under section 743(b) arguably would be required. Also, in some cases the transfer of T’s interest may result in sales or exchanges of more than 50 percent of the capital and profits of the partnership within the 12-months preceding the transfer. Since the partnership’s business no longer is conducted in partnership form after the merger, it would be helpful for future guidance to clarify that,

⁸⁵ Reg. § 1.708-1(d)(3)(i)(A).

⁸⁶ Reg. § 1.708-1(d)(3)(i)(B).

⁸⁷ See “KPMG Recommends Changes to Proposed Regs on Partnership Mergers and Divisions,” 2000 TNT 223-25 (November 17, 2000).

even in these cases, the partnership terminates under section 708(b)(1)(A), rather than terminating under section 708(b)(1)(B).⁸⁸

(2) Option 2 – Merger Followed by Partnership Liquidation (Asymmetrical Approach).

Option 2 would apply the principles of Revenue Rulings 84-111 and 99-6 in the Partnership-to-DRE Case. The merger of T into P results in A being the only remaining partner of the partnership, which causes P to terminate under section 708(b)(1)(A). Thus, this option is similar to Situation 3 in Revenue Ruling 84-111.⁸⁹ In that situation, the partners of Z transferred their partnership interests in Z to a newly formed corporation, T, in exchange for all of the stock of T in a section 351 transaction. The exchange terminated Z, and all of its assets and liabilities became assets and liabilities of T. The Service applied the approach of *McCauslen v. Commissioner*⁹⁰ and respected the partners' transfer of their partnership interests in exchange for T stock, but treated T as receiving the partnership's assets. Thus, the partners received a basis in the stock received under section 358(a) equal to that of their partnership interests and could tack the holding periods of their partnership interests, but T received a basis in Z's assets under section 732(c) equal to the partners' bases in their partnership interests and could tack Z's holding period in its assets.⁹¹

A similar approach was applied in Revenue Ruling 99-6. In situation 1 of Revenue Ruling 99-6, A and B were equal partners in an LLC classified as a partnership for federal tax purposes. A sold its entire interest in the LLC to B for \$10,000. After the transaction, LLC was wholly owned by B and treated as a disregarded entity by default under the Check-the-Box Regulations. The ruling concluded that the partnership

⁸⁸ This would be consistent with Rev. Rul. 99-6. Whether a partnership terminates under section 708(b)(1)(A) or (B) will affect the partnership's recovery period for depreciable property. In a termination under section 708(b)(1)(B), the partnership's recovery period for depreciable property is restarted. See § 168(i)(7) (flush language).

⁸⁹ 1984-2 C.B. 88.

⁹⁰ 45 T.C. 588 (1966) (partner who purchased deceased partner's interest in a two-person partnership was not entitled to tacked holding period under section 735(b) with respect to the assets attributable to the deceased partner's interest).

⁹¹ Not all practitioners understood Rev. Rul. 84-111 to require an asymmetrical approach when the ruling originally was issued. Treasury and the Service later clarified Rev. Rul. 84-111 in the preamble to proposed partnership mergers and divisions regulations in 2000, which included the following language: "In the context of partnership incorporations, Rev. Rul. 84-111 distinguishes among all three forms of incorporation. However, with respect to the Interest-Over Form, the revenue ruling respects only the transferors' conveyances of partnership interests, while treating the receipt of the partnership interests by the transferee corporation as the receipt of the partnership's assets (*i.e.*, the Assets-Up Form). The theory for this result, based largely on *McCauslen v. Commissioner*, 45 T.C. 588 (1966), is that the transferee corporation can only receive assets since it is not possible, as a sole member, for it to receive and hold interests in a partnership (*i.e.*, a partnership cannot have only one member; so, the entity is never a partnership in the hands of the transferee corporation)." REG-111119-99, 65 F.R. 1572-1580 (January 11, 2000).

terminated under section 708(b)(1)(A) when B purchased A's interests in LLC. As a result, A was required to treat the transaction as a sale of the partnership interest and report gain or loss on the sale of such interest under section 741. For purposes of determining the tax treatment to B, the Service applied the principles of *McCauslen* and Revenue Ruling 67-65⁹² (both of which considered the purchase of a deceased partner's interest by the remaining partner) and treated the LLC as having made a liquidating distribution to A and B, followed by an acquisition by B of the assets deemed distributed to A in liquidation of A's interest in LLC. Thus, B was required to recognize any gain or loss to the extent required by section 731(a) with respect to the deemed distributions to B; B's basis in the assets received in the deemed liquidation was equal to B's basis in its partnership interest, reduced by any money distributed under section 732(b); and B's holding period for the assets attributable to its interest in the partnership included the partnership's holding period under section 735(b).⁹³ As discussed below, because Revenue Ruling 99-6 only addressed the application of section 731(a) and certain holding period and basis issues, the ruling did not resolve many ambiguities that exist with regard to the tax consequences of such partnership termination transactions.

Applying the approach of Revenue Rulings 84-111 and 99-6 to the facts of Example 2, above, the transaction would be treated the same with respect to T. Thus, T would be viewed as transferring all of its assets, including its interest in P, to A in a Type A Reorganization, with T's shareholders receiving A stock.⁹⁴ A would be treated as receiving the assets of P after the assets have been deemed distributed to A and T in liquidation of P. As a result, similar to Example 2, T would recognize no gain or loss under section 361(a), but A could recognize gain or loss to the extent required by section 731(a) only with respect to those P assets deemed distributed to A.⁹⁵

⁹² 1967-1 C.B. 168.

⁹³ Similarly, in Situation 2 of Revenue Ruling 99-6, C and D, equal partners of the LLC, sold their entire interests to E, an unrelated person, for cash. After the sale, LLC was wholly owned by E and thus disregarded. The Service ruled that C and D must report their gain or loss on the sale of the partnership interests in the LLC, and E is deemed to acquire the assets of the LLC that were deemed distributed to C and D.

⁹⁴ T's shareholders should have a basis in the A stock equal to their basis in the T stock and a holding period that includes the period during which they held the T stock under section 1223(1). Query whether it is appropriate to view T as transferring its partnership interest rather than assets for purposes of allocating boot. Cf. Reg. § 1.1060-1(b)(4).

⁹⁵ Similar to Example 2, the other normal operating rules of subchapter K would also apply with respect to this deemed distribution. Thus, A's share of the P assets should have a basis equal to A's basis in its partnership interest under section 732(b) and a holding period that includes P's holding period under section 735(b). T's share of the P assets should have a basis equal to T's basis in its partnership interest under sections 732(b) and 362(b) and a holding period that includes P's holding period under sections 735(b) and 1223(2). Under Option 2, even if the partners' aggregate basis in their partnership interests (outside basis) equals the partnership's aggregate basis in its assets (inside basis), in some cases basis could be shifted from one asset to another. Whether or not basis will be shifted depends on A's outside basis, T's outside basis, and which assets are treated as being distributed to T and A, respectively.

Option 2, dependent as it is on Revenue Ruling 99-6, however, raises the difficult question of how the Subchapter K partnership termination rules should be harmonized with the Subchapter C merger rules. This is because while Revenue Ruling 99-6 expressly stated that section 731(a) would apply to the acquiring partner to the extent cash deemed distributed to it exceeded the basis in its partnership interest, the Ruling did not address many other issues that arise in the case of such an asymmetrical approach. For example:

- In what manner should the assets of the partnership be deemed to be distributed to the partners? That is, the ruling provided that the assets “attributable to” each partner’s interest would be distributed to that partner, but did not specify how to determine which assets should be attributable to a partnership interest. As a result, it is far from clear whether the deemed distribution should always be deemed to be pro rata, whether the partnership should be deemed to distribute its assets to the partners that contributed the assets (to the extent possible), or whether some other construct should be applied.⁹⁶
- The manner in which the assets are deemed distributed will have significant tax consequences with respect to potential gain recognition under section 731(a), the anti-mixing bowl rules of sections 704(c)(1)(B) and 737, section 751(b), and other provisions.
- Should the marketable securities rules of section 731(c) apply?
- Should section 732(f) apply to these types of transactions? If not, then cash could indirectly be distributed to A without gain recognition by means of the distribution of a corporation that holds cash.
- Should section 751(b) apply?
- What is the impact on the manner in which property is deemed distributed if the partnership has liabilities that are allocated other than pro rata to the partners?

⁹⁶ Compare Rev. Rul. 99-5, 1999-1 C.B. 434, which provides that if the sole owner of a disregarded entity sells a portion of its interest in the entity, the owner is treated as selling a pro rata share of each asset in the entity. The omission of similar language in Rev. Rul. 99-6 suggests that each partner’s share of partnership assets may be determined in other ways. For example, the partners’ shares of partnership assets could be determined based on the assets that actually would be distributed to them under the terms of the partnership agreement upon an actual liquidation of the partnership. In the alternative, a partner with section 704(c) gain or loss in a particular asset arguably should be deemed to carry out that gain or loss in a deemed liquidating distribution.

- How should liabilities be treated as being assumed or taken subject to? The answer to this question would implicate section 752. In particular, there would be deemed contributions and distributions under sections 752(a) and (b) in the context of a merger of a partner into the partnership or the other partner unless, from the acquiring partner's perspective, the share of assets deemed distributed out to each of the partners carries with it that partner's share of the partnership debt that was included in its basis in the partnership interest.
- Should the anti-mixing bowl rules of sections 704(c)(1)(B) and 737 apply?⁹⁷

Although the Partnership-to-DRE Case highlights these issues, some or all of these issues are present in every transaction governed by Revenue Ruling 99-6. Thus, we believe that it is important that these issues be studied in greater detail and be the subject of a separate guidance project.⁹⁸ Nevertheless, we recommend that, in the interests of the sound administration of the tax laws, if Option 2 is adopted, the various subchapter K anti-deferral rules generally not be applied in the context of the Partnership-to-DRE Case. The corporate reorganization provisions are intended to permit the tax-deferred transfer of assets provided that the detailed rules governing such transactions are complied with. One fundamental premise underlying the reorganization provisions is that reorganizations represent little more than a reconstitution of the same businesses in modified corporate form. In the context of a Partnership-to-DRE Case, all of the assets of the former partnership end up in one entity, clearly distinguishing such cases from the much-discussed (if seldom implemented) "mixing bowl partnerships" that are intended to utilize the partnership rules to effectuate an otherwise non-qualifying tax-deferred exchange of property. Thus, in the Partnership-to-DRE Case, we recommend that the anti-deferral rules of subchapter K (including the anti-mixing bowl rules) not apply, unless the transaction is undertaken with a principal purpose of increasing the basis of

⁹⁷ The possibility that the anti-mixing bowl rules could apply in the context of transactions governed by Revenue Ruling 99-6 has been recognized by practitioners for many years and has been addressed by commentators. *See, e.g.*, Jackel, "New Rulings Address One-to-Two and Two-to-One Entity Conversions," 1999 TNT 34-111 (Nov. 22, 1999). Members of the ABA Section of Taxation and members of the American Institute of Certified Public Accountants have requested guidance on the potential application of the anti-mixing bowl rules to the deemed liquidations in Rev. Rul. 99-6 transactions. *See, e.g.*, "ABA Tax Section Members Recommend Projects for 2006-2007 Guidance Priority Plan," 2006 TNT 126-14 (June 30, 2006); "AICPA Recommends Items for Guidance Priority List," 2006 TNT 107-84 (May 31, 2006).

⁹⁸ In connection with such a guidance project, it would be appropriate to consider deeming liquidating distributions under Revenue Ruling 99-6 to be made in a manner that limits gain recognition under section 731(a) (and section 732(f)). *See* note 99, *infra*. In addition, because all of the "hot" and "cold" assets of the partnership will, after the deemed liquidation, reside with the same person, it might well be appropriate to make section 751(b) inapplicable to such deemed liquidations, again subject to an appropriate anti-abuse rule.

assets that will be sold within a relatively short period of time (perhaps 2 years) of the transaction.⁹⁹

(3) Option 3 – Partnership Liquidation Followed by Merger.

The third option combines Subchapter K and Subchapter C rules by deeming there to be a liquidation of P prior to the merger of T into P. As discussed below, the application of both Subchapters is inconsistent with the reorganization provisions as they relate to T.

This option would treat P as terminating, distributing its assets and liabilities to A and T. Upon the liquidation of P, A and T would recognize gain to the extent that the money (including, in certain circumstances, marketable securities) distributed exceeds their basis in their P interests (and possibly under the anti-mixing bowl provisions).¹⁰⁰ The assets distributed in the liquidation would be received by A and T with bases equal to their basis in their partnership interests (reduced by any money distributed in the liquidation) and a tacked holding period.¹⁰¹ Upon the merger of T into P (now a DRE owned by A), T would recognize no gain or loss on the transfer of its assets and the P assets deemed received in the liquidation;¹⁰² A (through its ownership of P) would take a carryover basis in the assets transferred by T,¹⁰³ and receive a tacked holding period;¹⁰⁴ and T's shareholders would take a basis in the A stock equal to their basis in the T stock, and their holding period should include the period during which they held their T stock.¹⁰⁵

We believe that Option 3 is inferior to Options 1 and 2 for two principal reasons. First, under Option 3, T could recognize gain, which is inconsistent with subchapter C principles. Second, Option 3 needlessly departs from long-standing subchapter K

⁹⁹ An alternative to such an anti-abuse rule would be to provide that the partnership in any deemed liquidation in the Partnership-to-DRE Case is, to the extent possible given relative values and relative capital account balances, deemed to distribute the contributed property to the partner that contributed that property, to distribute any cash in the partnership to the partners with remaining basis to the extent of that basis and then to distribute the remaining properties in the partnership to the partners *pro rata* in accordance with their remaining positive capital account balances. Due to the variety of difficult issues arising from this alternative approach, we recommend the adoption of an anti-abuse rule.

¹⁰⁰ *Id.*

¹⁰¹ Under Option 3, as in Option 2, even if the partners' aggregate outside basis equals the partnership's aggregate inside basis, in some cases basis could be shifted from one asset to another. *See* note 95, *supra*.

¹⁰² § 361(a).

¹⁰³ § 362(b).

¹⁰⁴ § 1223(2).

¹⁰⁵ § 1223(1).

principles applied to similar transfers in *McCauslen* and Revenue Rulings 84-111 and 99-6.

If Option 3 is selected, we would nevertheless suggest that the anti-deferral rules of subchapter K not apply to the deemed liquidating distributions made by P, again subject to the application of an appropriate anti-abuse rule.

d. Suggested Approach.

On balance, we believe that Option 1 would preserve tax-free treatment to T in a manner that is most consistent with Subchapter C principles. Option 1 also avoids issues involving the interplay of the anti-mixing bowl regulations and the deemed distributions in Revenue Ruling 99-6. Moreover, Option 1 does not apply precedent developed to address taxable transactions (*McCauslen* and Revenue Ruling 99-6) to otherwise nontaxable transactions, where there is no policy reason for doing so. Accordingly, we recommend that Option 1 be adopted in the Partnership-to-DRE Case.