Notice of Proposed Rulemaking and Notice of Public Hearing

Certain Corporate Reorganizations Involving Disregarded Entities

REG–106186–98

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance to corporations and their shareholders about whether certain transactions qualify as corporate reorganizations. The proposed regulations apply to certain mergers under state or Federal law between two entities, one of which is a corporation and the other of which, for Federal tax purposes, is disregarded as an entity separate from its owner (for example, a qualified REIT subsidiary, a qualified subchapter S subsidiary, or a limited liability company with a single corporate owner that does not elect to be treated as a separate corporation). This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 14, 2000. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for August 8, 2000, must be received by July 18, 2000.

ADDRESSES: Send submissions to CC:DOM:CORP:R (REG–106186–98), room 5226, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 am and 5 pm to: CC:DOM:CORP:R (REG–106186–98), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20044. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/reglist.html. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Reginald Mombrun, (202) 622-7750, concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) that provide guidance as to whether certain mergers under state or Federal law between two entities, one of which is a corporation and the other of which, for Federal tax purposes, is disregarded as an entity separate from its owner can be statutory mergers qualifying as reorganizations under section 368(a)(1)(A) of the Internal Revenue Code of 1986 (Code). The Code provides general nonrecognition treatment for reorganizations specifically described in section 368(a). Section 368(a)(1)(A) provides that the term *reorganization* means "a statutory merger or consolidation." Section 1.368–2(b)(1) provides that a statutory merger must be accomplished under the "corporation laws of the United States or a State or territory or the District of Columbia." In addition to meeting the requirements of section 368(a), a merger transaction must meet other reorganization requirements such as the requirement that the persons engaged in the transaction each qualify as "a party to a reorganization" under section 368(b), the continuity of interest requirement of §1.368–1(e), and the continuity of business enterprise requirement of §1.368–1(d).

Certain entities that are respected under state law are disregarded for Federal tax purposes. These entities include a qualified REIT subsidiary, a qualified subchapter S subsidiary (QSub), and an entity that is disregarded under §301.7701–3 as an entity separate from its owner. Section 856(i)(2) provides that a corporation that is wholly owned by a real estate investment trust (REIT) is a qualified REIT subsidiary. Section 1361(b)(3)(B) provides that a QSub is an eligible domestic corporation, wholly owned by an S corporation, for which the S corporation makes a QSub election. Under §301.7701–3, a business entity that is not classified as a corporation per se (see §301.7701–2(b)((1), (3), (4), (5), (6), (7) or (8); for example, a limited liability company) can elect to be treated as a corporation or, if it has a single owner, can choose to be disregarded. (These entities hereinafter are collectively referred to as Disregarded Entities, and the corporation that owns the Disregarded Entity is referred to as the Owner.) For Federal tax purposes, all of the assets, liabilities, and items of income, deduction, and credit of a Disregarded Entity are treated as those of its Owner.

Because qualified REIT subsidiaries and QSubs are corporations under state law, state merger laws generally permit them to merge with other corporations. In addition, many state merger laws permit mergers between limited liability companies and corporations.

Commentators have raised questions as to whether the merger under state or Federal law of a Disregarded Entity into an acquiring corporation or of a target corporation into a Disregarded Entity can qualify as a reorganization under section 368(a)(1)(A). These regulations address this issue.

Explanation of Provisions

The proposed regulations provide guidance on the tax treatment of the following two transactions: (1) the merger of a Disregarded Entity into an acquiring corporation, and (2) the merger of a target corporation into a Disregarded Entity. Under the Federal tax laws, the merger under state or Federal law of a Disregarded Entity into an acquiring corporation in which the Owner exchanges its interest in the Disregarded Entity for stock in the acquiring corporation and the Disregarded Entity ceases to exist as a result of the transaction by operation of the state or Federal merger law (hereinafter, the merger of a Disregarded Entity into an acquiring corporation) is treated as if the Owner transferred the assets of the Disregarded Entity to the acquiring corporation. Conversely, the merger under state or Federal law of a target corporation into a Disregarded Entity in which the shareholders of the target corporation exchange their target corporation stock for stock in the Owner and the Disregarded Entity does not lose its status as a Disregarded Entity as a result of the transaction (hereinafter, the merger of a target corporation into a Disregarded Entity) is treated as if the Owner acquired all of the assets of the target corporation.

The proposed regulations reflect Treasury's and the IRS' view that neither merger is a statutory merger qualifying as a reorganization under section 368(a)(1)(A). Compliance with a corporate law merger statute does not by itself qualify a transaction as a "statutory merger" for purposes of section 368(a)(1)(A). See *Roebling v. Commissioner*, 143 F.2d 810, 812 (3d Cir. 1944), *cert. denied*, 323 U.S. 773 (1944). The proposed regulations contain the requirements that must be satisfied for a state or Federal law merger or consolidation to qualify as a reorganization under section 368(a)(1)(A). In addition, the proposed regulations remove the word "corporation" from the requirement that, in order to qualify as a reorganization under section 368(a)(1)(A), a merger or consolidation must be effected pursuant to the corporation law of the relevant jurisdiction. This change is necessary to conform the regulations to the IRS' long-standing position that a merger or consolidation may qualify as a reorganization under section 368(a)(1)(A) even if it is undertaken pursuant to laws other than the corporation law of the relevant jurisdiction. See Rev. Rul. 84-104 (1984–2 C.B. 94) (a "consolidation" pursuant to the National Banking Act, 12 U.S.C. 215, is treated as a merger for Federal tax purposes).

The Merger of a Disregarded Entity into an Acquiring Corporation

Consistent with the views of all the commentators, Treasury and the IRS believe that the merger of a Disregarded Entity into an acquiring corporation is not a statutory merger qualifying as a reorganization under section 368(a)(1)(A) because the Owner's assets (other than those held in the Disregarded Entity) are not transferred to the acquiring corporation and the Owner does not cease to exist as a result of the state or Federal law merger transaction. "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." *Cortland Specialty Co. v. Commissioner of Internal Revenue*, 60 F. 2d 937, 939 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933). The merger of a Disregarded Entity into an acquiring corporation, in which the Owner's assets and liabilities are divided between the Owner and the acquiring corporation after the transaction, is a divisive transaction, not a transaction in which the assets of the Owner and the acquiring corporation are combined. Congress intended that section 355 be the sole means under which divisive transactions will be afforded tax-free status and, thus, specifically required the liquidation of the acquired corporation in reorganizations under both sections 368(a)(1)(C) and 368(a)(1)(D) in order to prevent these reorganizations from being used in divisive transactions that did not satisfy section 355. See S. Rep. No. 1622, 83rd Cong., 2d Sess. 274 (1954); S. Rpt. No. 169, 98th Cong., 2d Sess. 204 (1984) and Rev. Rul. 2000–5 (2000–5 I.R.B. 436).

Accordingly, consistent with existing law, the proposed regulations provide that for a merger to qualify as a reorganization under section 368(a)(1)(A), it must, by operation of the merger statute of the relevant jurisdiction, result in one corporation acquiring the assets of the merging corporation and the merging corporation ceasing to exist. Thus, the merger of a Disregarded Entity into an acquiring corporation cannot qualify as a reorganization under section 368(a)(1)(A). However, the transaction may be treated as a reorganization under section 368(a)(1)(C), (D), or (F) if all applicable requirements are met (including the liquidation of the Owner). The transaction also may be described in section 351.

The Merger of a Target Corporation into a Disregarded Entity

There has been a split in views as to whether the merger of a target corporation into a Disregarded Entity is a statutory merger qualifying as a reorganization under section 368(a)(1)(A). Some commentators argue that, because the Disregarded Entity is disregarded for Federal tax purposes, the transaction should be treated for Federal tax purposes as a merger into the Owner. Thus, they argue, as long as the Owner is a corporation, all other relevant reorganization requirements are satisfied, and the target corporation could have merged into the Owner in a transaction that qualifies as a reorganization under section 368(a)(1)(A), the merger should qualify as a reorganization under section 368(a)(1)(A). According to these commentators, treating such a merger as a statutory merger into the Owner qualifying as a reorganization under section 368(a)(1)(A) does not inappropriately facilitate avoidance of any reorganization requirement under section 368. Accordingly, the commentators argue there is no sound policy for not permitting the merger of a target corporation into a Disregarded Entity to be treated as a statutory merger into the Owner qualifying as a reorganization under section 368(a)(1)(A).

Other commentators argue that, as a technical matter, the better interpretation of the applicable provisions of the Code and regulations is that the merger of a target corporation into a Disregarded Entity is not a statutory merger of the target corporation into the Owner qualifying as a reorganization under section 368(a)(1)(A). Congress added the word "statutory" in 1934 so that the definition "will conform more closely to the general requirements of [state or Federal] corporation law." See H.R. Rep. No. 704, 73rd Cong., 2nd Sess. 14 (1934). Treasury and the IRS 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).

Accordingly, the proposed regulations provide that the merger of a target corporation into a Disregarded Entity is not a statutory merger of the target corporation into the Owner qualifying as a reorganization under section 368(a)(1)(A). Such a transaction may qualify as a reorganization under section 368(a)(1)(C), section 368(a)(1)(D), or section 368(a)(1)(F) if all relevant requirements are met. Such a transaction also may qualify for nonrecognition of gain under section 351.

Proposed Effective Date

These regulations as proposed apply to any transaction occurring on or after the date these regulations are published as final regulations in the **Federal Register**.

Comments Requested

Several states permit the merger of a domestic corporation into a foreign corporation under state law. Treasury and the IRS are studying whether this transaction qualifies as a reorganization under section 368(a)(1)(A) and request comments on this issue.

Special Analysis

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight copies) that are submitted timely to the IRS. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the “Tax Regs” option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/reglist.html. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 8, 2000, beginning at 10:00 AM in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “For Further Information Contact” portion of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by July 18, 2000. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for reviewing outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Reginald Mombrun of the office of the Assistant Chief Counsel (Corporate), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

PART 1— INCOME TAXES

Paragraph 1**.** The authority citation for part 1 continues to read in part as follows:

Authority**:** 26 U.S.C. 7805 * * *

Par. 2. Section 1.368–2 is amended by revising paragraph (b)(1) to read as follows:

§1.368–2 Definition of terms.

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(b) (1) In order to qualify as a reorganization under section 368(a)(1)(A), the transaction must be a merger or consolidation involving two corporations effected pursuant to the laws of the United States or a State or territory, or the District of Columbia. In addition, by operation of such a merger law, the transaction must result in one corporation acquiring the assets of the merging corporation and the merging corporation ceasing to exist. Similarly, by operation of such a consolidation law, the transaction must result in one newly formed corporation acquiring the assets of both consolidating corporations, and both consolidating corporations ceasing to exist. Thus, the merger under state or Federal law of an entity that is disregarded as an entity separate from its owner for Federal tax purposes into an acquiring corporation in which the owner exchanges its interest in the disregarded entity for stock in the acquiring corporation and the disregarded entity ceases to exist as a result of the transaction by operation of the state or Federal merger law is not a statutory merger qualifying as a reorganization under section 368(a)(1)(A). Moreover, the merger of a target corporation into an entity that is disregarded as an entity separate from its owner for Federal tax purposes that does not lose its status as a disregarded entity as a result of the transaction is not a statutory merger qualifying as a reorganization under section 368(a)(1)(A). Examples of entities that are disregarded as entities separate from their owners include a qualified REIT subsidiary (within the meaning of section 856(i)(2)), a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)), and a business entity that is not classified as a corporation and that has a single owner (as provided in §301.7701–2(c)(2) of this chapter). The preceding five sentences apply to any transaction occurring on or after [*Date These Regulations Are Published As Final Regulations In The Federal Register*].

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Robert E. Wenzel,
Deputy Commissioner
Internal Revenue.

(Filed by the Office of the Federal Register on May 11, 2000, 2:30 p.m., and published in the issue of the Federal Register for May 16, 2000, 65 F.R. 31115)