Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–2: Definitions of terms.

T.D. 9038

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Statutory Mergers and Consolidations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations that define the term *statutory merger or consolidation* as that term is used in section 368(a)(1)(A). These regulations affect corporations engaging in statutory mergers and consolidations, and their shareholders. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking (REG–126485–01) on this subject on page 542 of this Bulletin.

DATES: *Effective Date:* These regulations are effective January 24, 2003.

FOR FURTHER INFORMATION CONTACT: Richard M. Heinecke or Reginald Mombrun at (202) 622–7930 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

A. *Section 368(a) Generally*

The Internal Revenue Code of 1986 (Code) provides general nonrecognition treatment for reorganizations specifically described in section 368(a). Section 368(a)(1)(A) provides that the term *reorganization* includes "a statutory merger or consolidation." Section 1.368–2(b)(1) currently provides that a statutory merger or consolidation must be "effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia."

B. *Disregarded Entities Generally*

A business entity (as defined in §301.7701–2(a)) that has only one owner may be disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include a domestic single member limited liability company that does not elect to be classified as a corporation for federal tax purposes, a corporation (as defined in §301.7701–2(b)) that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)) (hereinafter referred to as "QRS"), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)) (hereinafter sometimes referred to as "QSub").

Because a QRS and QSub are corporations under state law, state merger laws generally permit them to merge with other corporations. In addition, many state merger laws permit a limited liability company (LLC) to merge with another LLC or with a corporation.

C. *Previous Proposals of Regulations*

On May 16, 2000, the IRS and Treasury issued a notice of proposed rulemaking (REG–106186–98, 2000–1 C.B. 1226 [65 FR 31115]) (hereinafter referred to as the 2000 proposed regulations) providing that neither the merger of a disregarded entity into a corporation nor the merger of a corporation into a disregarded entity would qualify as a reorganization under section 368(a)(1)(A). While commentators generally agreed that the merger of a disregarded entity into a corporation should not qualify as a reorganization under section 368(a)(1)(A), commentators asserted that the merger of a corporation into a disregarded entity with a corporate owner should be able to qualify as a reorganization under section 368(a)(1)(A).

On November 15, 2001, after consideration of the comments received regarding the 2000 proposed regulations, the IRS and Treasury withdrew the 2000 proposed regulations (REG–106186–98; Announcement 2001–121, 2001–2 C.B. 584 [66 FR 57400]) and issued another notice of proposed rulemaking (REG–126485–01, 2001–2 C.B. 555 [66 FR 57400]) (hereinafter referred to as the 2001 proposed regulations).

The 2001 proposed regulations provide that, for purposes of section 368(a)(1)(A), a statutory merger or consolidation must be effected pursuant to the laws of the United States or a State or the District of Columbia. Pursuant to such laws, the following events must occur simultaneously at the effective time of the transaction: (1) all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) 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 (2) the combining entity of each transferor unit ceases its separate legal existence for all purposes. For this purpose, a combining entity is a business entity that is a corporation (as defined in §301.7701–2(b)) that is not a disregarded entity) and a combining unit is a combining entity and all of its disregarded entities.

The 2001 proposed regulations provide that the merger of a disregarded entity into a corporation will not qualify as a statutory merger or consolidation under section 368(a)(1)(A) because all of the transferor unit's assets may not be transferred to the transferee unit and the separate legal existence of the combining entity of the transferor unit does not terminate as a matter of law. The 2001 proposed regulations, however, generally provide that the merger of a corporation into a disregarded entity will qualify as a statutory merger or consolidation if it satisfies the requirements of the regulations.

No public hearing regarding the 2001 proposed regulations was requested or held. Nonetheless, a number of written comments were received.

Explanation of Provisions

The IRS and Treasury have studied the comments received regarding the 2001 proposed regulations. Although the IRS and Treasury are continuing to study a number of the comments received regarding the proposed regulations, in response to a number of comments requesting immediate guidance in this area upon which taxpayers may rely, the IRS and Treasury are promulgating these regulations as temporary regulations in this Treasury Decision. The temporary regulations retain the general framework of the 2001 proposed regulations, but make certain modifications in response to comments received. The following sections describe a number of the most significant comments and the extent to which they have been incorporated in these temporary regulations. Further changes to the temporary regulations, however, are possible before these regulations are finalized.

A. *Definition of Combining Entity*

As described above, the 2001 proposed regulations define a combining entity as a business entity that is a corporation that is not a disregarded entity. Although the preamble to the 2001 proposed regulations clarifies that, for this purpose, the term corporation is defined as provided in §301.7701–2(b), commentators requested that clarification also be provided in the text of the regulations. In response to these comments, the temporary regulations provide that a combining entity is a corporation (as defined in §301.7701–2(b)) that is not a disregarded entity.

B. *The All of the Assets Requirement*

As stated above, the 2001 proposed regulations require that all of the assets of a transferor unit become the assets of a transferee unit. A number of comments were received regarding this requirement. The following paragraphs describe these comments and the extent to which the temporary regulations reflect them.

One comment suggested that the regulations be amended to clarify that whether the all of the assets requirement is satisfied is determined by reference to the assets of the transferor unit immediately prior to the merger. These temporary regulations add an example that illustrates that a transaction that is preceded by a distribution by the transferor unit to its shareholders may qualify as a statutory merger under these temporary regulations, even if the "substantially all" requirement applicable to certain other types of reorganizations would not be satisfied. The example is provided solely to illustrate the meaning of the all of the assets requirement. No inference is intended regarding the shareholder level and other tax consequences of the transaction described therein.

Another comment stated that the proposed regulations are unclear as to whether a transaction in which an entity that is disregarded as an entity separate from the combining entity of the transferor unit becomes an entity that is disregarded as an entity separate from the combining entity of the transferee unit satisfies the all of the assets requirement. These temporary regulations amend *Example 2* of the 2001 proposed regulations, as described below, to clarify that this transaction may satisfy the all of the assets requirement and, therefore, qualify as a statutory merger or consolidation.

C. *The Cessation of Separate Legal Existence Requirement*

The 2001 proposed regulations require that the combining entity of each transferor unit "ceases its separate legal existence for all purposes." One comment requested that the phrase "for all purposes" be deleted from this requirement. The comment suggested that under some corporate laws a merged corporation may continue its existence for a specified time period and for certain limited purposes, such as bringing and defending against lawsuits. This limited continued existence of a combining entity of a transferor unit, the comment suggested, should not prevent a transaction from being treated as failing to satisfy the requirement that the combining entity of each transferor unit cease its separate legal existence for all purposes.

The IRS and Treasury do not believe that the deletion of "for all purposes" from the regulation will alter the terms of the requirement. Nonetheless, these temporary regulations provide that this requirement will be satisfied even if, pursuant to the laws of the United States or a State or the District of Columbia, 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 all of the assets requirement.

D. *Example 2 of the 2001 Proposed Regulations*

A number of comments were received regarding *Example 2* of the 2001 proposed regulations, which involves the merger of a target corporation into a disregarded entity. The last sentence of the facts of *Example 2* states that, "[p]rior to the transaction, [the combining entity of the transferor unit] is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for federal tax purposes." One commentator indicated that it is not clear why this fact is relevant to the conclusion that the transaction qualifies as a statutory merger or consolidation and suggested either deleting or clarifying this fact.

As described above, in order to qualify as a statutory merger or consolidation, all of the assets of a transferor unit must become assets of the transferee unit. In order to determine whether this requirement has been satisfied, it is necessary to know whether the combining entity of the transferor unit owns the interests of any entity that is disregarded as an entity separate from its owner for federal tax purposes. The last sentence of the facts of *Example 2* was merely intended to convey the fact that the only assets of the transferor unit were those that the combining entity owned directly. To clarify the significance of this fact, the temporary regulations amend the analysis in *Example 2* to indicate that the transaction would still qualify as a statutory merger or consolidation even if the combining entity of the transferor unit were treated as owning assets of an entity that is disregarded as an entity separate from the combining entity of the transferor unit for federal tax purposes, provided that those assets become assets of the transferee unit.

E. *Additional Examples*

One commentator suggested that the scope of the proposed regulations be clarified through additional examples. The following paragraphs describe the suggested examples and the extent to which they have been incorporated in these temporary regulations.

1. *QSub that becomes a C corporation*

A QSub may cease to be a disregarded entity because of an event that renders the subsidiary ineligible for QSub status, such as a merger into an entity owned by a C corporation. For example, suppose Z, an S corporation, owns all of the stock of B, a QSub, and Z merges with and into X, an entity that is disregarded as an entity separate from Y, a C corporation. B's status as a QSub will terminate at the end of the day on which the merger occurs. See Treas. Reg. §1.1361–5(a)(1)(iii). A commentator suggested that, in this case, it is not clear whether B is a member of the transferor unit. If B were treated as a member of the transferor unit, the transaction may not qualify as a statutory merger or consolidation because the assets of B may not become assets of the transferee unit. If, however, B were not treated as a member of the transferor unit, the transaction may qualify as a statutory merger or consolidation. The commentator suggested that B should not be treated as a member of the transferor unit. Alternatively, the commentator suggested that the principles of *Example 9* of §1.1361–5(b)(3) could be applied to this case. In *Example 9* of §1.1361–5(b)(3), the acquisition of the stock of a QSub is treated as a transfer of the QSub's assets followed by the transfer of those assets by the acquirer to a new corporation.

The IRS and Treasury agree with the commentator that the principles illustrated by *Example 9* of §1.1361–5(b)(3) apply to determine whether the merger of Z into X qualifies as a statutory merger or consolidation. In particular, the transaction should be treated as a transfer of B's assets to X followed by a transfer of such assets by X to a new corporation. Accordingly, the transaction may qualify as a statutory merger or consolidation provided that the other requirements of a statutory merger or consolidation are satisfied. These temporary regulations include an example illustrating this result.

2. *Transitory surviving disregarded entity*

One commentator suggested that the 2001 proposed regulations be amended to provide an example in which the surviving disregarded entity in an otherwise qualifying statutory merger or consolidation is transitory. For example, suppose corporation Z merges into X, an entity that is disregarded as separate from corporation Y. In the transaction, the shareholders of Z exchange their Z stock for Y stock. Immediately after the merger of Z into X and as part of a plan that includes that merger, X merges into Y. The commentator noted that, in Rev. Rul. 72–405, 1972–2 C.B. 217, the IRS held that a forward triangular merger of a target corporation into a newly formed controlled corporation of a parent corporation followed by the liquidation of the controlled corporation into the parent corporation would be treated as a reorganization under section 368(a)(1)(C) rather than a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D). The commentator suggested that the principles of Revenue Ruling 72–405 should not be applied to prevent the merger of Z into X from qualifying as a reorganization under section 368(a)(1)(A).

The IRS and Treasury agree that the merger of Z into X followed by the merger of X into Y does not implicate the principles of Revenue Ruling 72–405. Because the merger of X into Y does not alter the identity of the tax owner of the former assets of X, that merger would be disregarded. The IRS and Treasury do not believe that an additional example is necessary to illustrate this result.

F. *The Domestic Entity Requirement*

The 2001 proposed regulations provide that a transaction in which any of the assets and liabilities of a combining entity of a transferor unit become assets and liabilities of one or more disregarded entities of the transferee unit cannot qualify as a statutory merger or consolidation unless such combining entity, the combining entity of the transferee unit, such disregarded entities, and each business entity through which the combining entity of the transferee unit holds its interests in such disregarded entities is organized under the laws of the United States or a State or the District of Columbia. One commentator suggested that where an entity that is disregarded as an entity separate from the combining entity of the transferor unit becomes an entity that is disregarded as an entity separate from the combining entity of the transferee unit, whether such disregarded entity is organized under the laws of the United States or a State or the District of Columbia is not relevant to whether the transaction qualifies as a statutory merger or consolidation. The IRS and Treasury agree and have clarified the domestic entity requirement to exclude such disregarded entities.

Another comment suggested that the domestic entity requirement be eliminated for the disregarded entity into which a target corporation is merged and each business entity through which the combining entity holds its interests in the disregarded entity into which a target corporation is merged. Although these temporary regulations retain that requirement for those entities, as described in the preamble to the 2001 proposed regulations, the IRS and Treasury are continuing to consider further revisions to the regulations under section 368(a)(1)(A) to address statutory mergers and consolidations that involve one or more foreign corporations, including transactions involving a disregarded entity.

Special Analyses

It also has 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 regulation does 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, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Richard M. Heinecke, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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. In §1.368–2, paragraph (b)(1) is revised to read as follows:

§1.368–2 Definition of terms.

* * * * *

(b)(1) For rules regarding statutory mergers or consolidations on or after January 24, 2003, see §1.368–2T(b)(1). For rules regarding statutory mergers or consolidations before January 24, 2003, see §1.368–

2(b)(1) as in effect before January 24, 2003 (See 26 CFR part 1, revised April 1, 2002).

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Par. 3. Section 1.368–2T is added to read as follows:

§1.368–2T Definition of terms (temporary).

(a) [Reserved]. For further guidance, see §1.368–2(a).

(b)(1)(i) *Definitions.* For purposes of this paragraph (b)(1), the following terms shall have the following meanings:

(A) *Disregarded entity.* A disregarded entity is a business entity (as defined in §301.7701–2(a) of this chapter) that is disregarded as an entity separate from its owner for federal tax purposes. Examples of disregarded entities include a domestic single member limited liability company that does not elect to be classified as a corporation for federal tax purposes, a corporation (as defined in §301.7701–2(b) of this chapter) that is a qualified REIT subsidiary (within the meaning of section 856(i)(2)), and a corporation that is a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)).

(B) *Combining entity.* A combining entity is a business entity that is a corporation (as defined in §301.7701–2(b) of this chapter) that is not a disregarded entity.

(C) *Combining unit.* A combining unit is composed solely of a combining entity and all disregarded entities, if any, the assets of which are treated as owned by such combining entity for federal tax purposes.

(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 laws of the United States or a State or the District of Columbia, in which, as a result of the operation of such laws, 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 satisfied or discharged in the transaction) 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, pursuant to the laws of the United States or a State or the District of Columbia, 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.

(iii) *Statutory merger or consolidation involving disregarded entities.* A transaction effected pursuant to the laws of the United States or a State or the District of Columbia in which any of the assets and liabilities of a combining entity of a transferor unit become assets and liabilities of one or more disregarded entities of the transferee unit is not a statutory merger or consolidation within the meaning of section 368(a)(1)(A) and paragraph (b)(1)(ii) of this section unless such combining entity, the combining entity of the transferee unit, such disregarded entities other than entities that were disregarded entities of the transferor unit immediately prior to the transaction, and each business entity through which the combining entity of the transferee unit holds its interests in such disregarded entities is organized under the laws of the United States or a State or the District of Columbia.

(iv) *Examples.* The following examples illustrate the rules of paragraph (b)(1) of this section. In each of the examples, except as otherwise provided, each of V, Y, and Z is a domestic C corporation. X is a domestic limited liability company. Except as otherwise provided, X is wholly owned by Y and is disregarded as an entity separate from Y for federal tax purposes. The examples are as follows:

Example 1. Divisive transaction pursuant to a merger statute. (i) Under State W law, Z transfers some of its assets and liabilities to Y, retains the remainder of its assets and liabilities, and remains in existence following the transaction. The transaction qualifies as a merger under State W corporate law. Prior to the transaction, Y is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for federal tax purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of Y, the combining entity and sole member of the transferee unit. In addition, the transaction does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because the separate legal existence of Z does not cease for all purposes. Accordingly, the transaction does not qualify as a statutory merger or consolidation under section 368(a)(1)(A).

Example 2. Merger of a target corporation into a disregarded entity in exchange for stock of the owner. (i) Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their stock of Z for stock of Y. Prior to the transaction, Z is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for federal tax purposes.

(ii) The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for federal tax purposes, and Z ceases its separate legal existence for all purposes. Paragraph (b)(1)(iii) of this section does not apply to prevent the transaction from qualifying as a statutory merger or consolidation for purposes of section 368(a)(1)(A) because each of Z, Y, and X is a domestic entity. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A). The result would be the same if Z were treated as owning assets of an entity that is disregarded as an entity separate from Z, regardless of whether such disregarded entity became an entity disregarded as an entity separate from Y as a result of the transaction, or merged into X or a domestic entity disregarded as an entity separate from Y.

Example 3. Merger of a target S corporation that owns a QSub into a disregarded entity. (i) The facts are the same as in *Example 2*, except that Z is an S corporation and owns all of the stock of U, a QSub.

(ii) The deemed formation by Z of U pursuant to §1.1361–5(b)(1) (as a consequence of the termination of U's QSub election) is disregarded for federal income tax purposes. The transaction is treated as a transfer of the assets of U to X, followed by X's transfer of these assets to U in exchange for stock of U. See §1.1361–5(b)(3), *Example 9*. The transaction will, therefore, satisfy the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z and U, the sole members of the transferor unit, become the assets and liabilities of one or more members of the transferee unit that is comprised of Y, the combining entity of the transferee unit, and X, a disregarded entity the assets of which Y is treated as owning for federal tax purposes, and Z ceases its separate legal existence for all purposes. Paragraph (b)(1)(iii) of this section does not apply to prevent the transaction from qualifying as a statutory merger or consolidation for purposes of section 368(a)(1)(A) because each of Z, Y, and X is a domestic entity. Moreover, the deemed transfer of the assets of U in exchange for U stock does not cause the transaction to fail to qualify as a statutory merger or consolidation. See §368(a)(2)(C). Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 4. Triangular merger of a target corporation into a disregarded entity. (i) The facts are the same as in *Example 2,* except that V owns 100 percent of the outstanding stock of Y and, in the merger of Z into X, the Z shareholders exchange their stock of Z for stock of V. In the transaction, Z transfers substantially all of its properties to X.

(ii) The transaction is not prevented from qualifying as a statutory merger or consolidation under section 368(a)(1)(A), provided the requirements of section 368(a)(2)(D) are satisfied. Because the assets of X are treated for federal tax purposes as the assets of Y, Y will be treated as acquiring substantially all of the properties of Z in the merger for purposes of determining whether the merger satisfies the requirements of section 368(a)(2)(D). As a result, the Z shareholders that receive stock of V will be treated as receiving stock of a corporation that is in control of Y, the combining entity of the transferee unit that is the acquiring corporation for purposes of section 368(a)(2)(D). Accordingly, the merger will satisfy the requirements of section 368(a)(2)(D).

Example 5. Merger of a target corporation into a disregarded entity owned by a partnership. (i) The facts are the same as in *Example 2,* except that Y is organized as a partnership under the laws of State W and is classified as a partnership for federal tax purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section. All of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit because neither X nor Y qualifies as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 6. Merger of a disregarded entity into a corporation. (i) Under State W law, X merges into Z. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of X (but not the assets and liabilities of Y other than those of X) become the assets and liabilities of Z and X's separate legal existence ceases for all purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because all of the assets and liabilities of a transferor unit do not become the assets and liabilities of one or more members of the transferee unit. The transaction also does not satisfy the requirements of paragraph (b)(1)(ii)(B) of this section because X does not qualify as a combining entity. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 7. Merger of a corporation into a disregarded entity in exchange for interests in the disregarded entity. (i) Under State W law, Z merges into X. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z become the assets and liabilities of X and Z's separate legal existence ceases for all purposes. In the merger of Z into X, the Z shareholders exchange their stock of Z for interests in X so that, immediately after the merger, X is not disregarded as an entity separate from Y for federal tax purposes. Following the merger, pursuant to §301.7701–3(b)(1)(i) of this chapter, X is classified as a partnership for federal tax purposes.

(ii) The transaction does not satisfy the requirements of paragraph (b)(1)(ii)(A) of this section because immediately after the merger X is not disregarded as an entity separate from Y and, consequently, all of the assets and liabilities of Z, the combining entity of the transferor unit, do not become the assets and liabilities of one or more members of a transferee unit. Accordingly, the transaction cannot qualify as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 8. Merger transaction preceded by distribution. (i) Z operates two unrelated businesses, Business P and Business Q, each of which represents 50 percent of the value of the assets of Z. Y desires to acquire and continue operating Business P, but does not want to acquire Business Q. Pursuant to a single plan, Z sells Business Q for cash to parties unrelated to Z and Y in a taxable transaction, and then distributes the proceeds of the sale *pro rata* to its shareholders. Then, pursuant to State W law, Z merges into Y. Pursuant to such law, the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z related to Business P become the assets and liabilities of Y and Z's separate legal existence ceases for all purposes. In the merger, the Z shareholders exchange their Z stock for Y stock. Prior to the transaction, Z is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for federal tax purposes.

(ii) The transaction satisfies the requirements of paragraph (b)(1)(ii) of this section because the transaction is effected pursuant to State W law and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and Z ceases its separate legal existence for all purposes. Paragraph (b)(1)(iii) of this section does not apply to prevent the transaction from qualifying as a statutory merger or consolidation for purposes of section 368(a)(1)(A) because each of Z and Y is a domestic entity. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

(v) *Effective dates.* This paragraph (b)(1) applies to transactions occurring on or after January 24, 2003. Taxpayers, however, may apply these regulations in whole, but not in part, to transactions occurring before January 24, 2003, provided that, if the taxpayer is the acquiring corporation (or a shareholder of the acquiring corporation whose tax treatment of the transaction reflects the tax treatment by the acquiring corporation, such as a shareholder of an acquiring S corporation), the target corporation (and the shareholders of the target corporation whose tax treatment of the transaction reflects the tax treatment by the target corporation) also applies these regulations in whole, but not in part, to the transaction, and if the taxpayer is the target corporation (or a shareholder of the target corporation whose tax treatment of the transaction reflects the tax treatment by the target corporation), the acquiring corporation (and the shareholders of the acquiring corporation whose tax treatment of the transaction reflects the tax treatment by the acquiring corporation) also applies these regulations in whole, but not in part, to the transaction. For all other transactions, see §1.368–2(b)(1) as in effect before January 24, 2003 (See 26 CFR part 1, revised April 1, 2002).

(b)(2) through (k) [Reserved]. For further guidance, see §1.368–2(b)(2) through (k).

David A. Mader,
Assistant Deputy Commissioner of Internal Revenue.

Approved January 17, 2003.

Pamela F. Olson,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on January 23, 2003, 8:45 a.m., and published in the issue of the Federal Register for January 24, 2003, 68 F.R. 3384)