Amendment of Previously Proposed Regulations and Notice of Public Hearing

Statutory Mergers and Consolidations

REG–117969–00

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Amendment of previously proposed regulations and notice of public hearing.

SUMMARY: This document amends previously proposed regulations published in the **Federal Register** on January 24, 2003 (REG–126485–01, 2003–1 C.B. 542, 68 FR 3477) by cross-reference to temporary regulations. Those regulations define the term *statutory merger or consolidation* as that term is used in section 368(a)(1)(A). This notice of proposed rulemaking affects corporations engaging in mergers and consolidations and their shareholders. It is being issued concurrently with proposed regulations under sections 358, 367, and 884. (See REG–125628–01 in this issue of the Bulletin).

DATES: Written and electronic comments and requests to speak and outlines of topics to be discussed at the public hearing scheduled for May 19, 2005, to be held in the IRS Auditorium (7th Floor) must be received by April 28, 2005.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG–117969–00), Room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG–117969–00), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically, via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov* (IRS-REG–117969–00). The public hearing will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Vincent Daly, (202) 622–7770; concerning submissions, the hearing, or placement on the building access list to attend the hearing, Robin Jones, (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

Before 1934, the term *merger*, as used in the reorganization provisions, included statutory mergers as well as other combinations of corporate entities. In 1934, Congress amended the definition of a reorganization to provide separately for *statutory mergers or consolidations* and for the other types of transactions previously included in the definition of a *merger*. There is no indication in the legislative history of the 1934 changes to the definition of a reorganization that Congress intended to exclude transactions effected under foreign law.

In 1935, Treasury regulations interpreted the term *statutory merger* under the revised provision to mean a merger or consolidation effected pursuant to the corporation laws of a State or Territory or the District of Columbia. The requirement that the transaction be effected under domestic law remains in place, with minor variations. The Treasury Department and IRS believe that this interpretation is reasonable; nevertheless, the Treasury Department and IRS believe that a reexamination is warranted in light of the purposes of the statute and changes in domestic and foreign law since 1935.

The states have revised their laws to offer a greater variety of business entities and greater flexibility in effecting business combinations. Accordingly, the Treasury Department and IRS thought it advisable to define a merger or consolidation functionally, to supplement the reference to state law. Accordingly, the Treasury Department and IRS developed and proposed such a functional definition in 2003. See Notice of Proposed Rulemaking (REG–126485–01, 2003–1 C.B. 542 [68 FR 3477]), cross-referencing temporary regulations (T.D. 9038, 2003–1, C.B. 524 [68 FR 3384]) (January 24, 2003).

Many foreign jurisdictions now have merger or consolidation statutes that operate in material respects like those of the states, *i.e.*, all assets and liabilities move by operation of law. The Treasury Department and IRS believe that transactions effected pursuant to these statutes should be treated as reorganizations if they satisfy the functional criteria applicable to transactions under domestic statutes.

This document proposes a revised definition of a statutory merger or consolidation. The previously proposed definition of a statutory merger required that it be a transaction effected "pursuant to the laws of the United States or a State or the District of Columbia." See REG–126485–01 (2003–1 C.B. 542 [68 FR 3477]). The new proposed definition contained in this document replaces the quoted language with "pursuant to the statute or statutes necessary to effect the merger or consolidation." This proposed change would allow a transaction effected pursuant to the statutes of a foreign jurisdiction or of a United States possession to qualify as a statutory merger or consolidation under section 368(a)(1)(A), provided it otherwise qualifies as a reorganization. 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.

This notice of proposed rulemaking also proposes to remove §1.368–2(b)(1)(iii) of the previously proposed regulations. That section imposes limitations on the use of disregarded entities in statutory mergers or consolidations when certain entities are not organized under the laws of the United States or a State or the District of Columbia.

Although this document revises the terms of the proposed definition of a statutory merger or consolidation for purposes of section 368, the provisions of the temporary regulations will remain in effect until this proposal is incorporated in temporary or final regulations after notice and comment.

Section 1.368–2(b)(1)(B)(iv), *Examples 1* and *2* in the previously proposed regulations each specified that one of the parties to the transaction described in the example "is not treated as owning any assets of an entity that is disregarded as an entity separate from its owner for Federal tax purposes." The results in those examples would be the same in each case whether or not a party to the transaction held such assets. See §1.368–2(b)(1)(B)(iv), *Example 3* in the previously proposed regulations. To avoid any possible implication to the contrary, the Treasury Department and IRS propose removal of the sentence specifying that condition from each example. The Treasury Department and IRS are continuing to study other comments received on the earlier proposed regulations.

A notice of proposed rulemaking proposing amendments to the regulations under sections 358, 367, and 884 (including special rules for determining basis and holding period in certain transactions involving one or more foreign corporations) is being published simultaneously with the publication of this notice of proposed rulemaking. See REG–125628–01 in this issue of the Bulletin.

Proposed Effective Date

These regulations are proposed to apply to transactions occurring after the date final regulations are published in the **Federal Register**.

Special Analyses

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 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. 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 Internal Revenue 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 (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and on 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 May 19, 2005, beginning at 10 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. 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 30 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 or electronic 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 April 28, 2005. 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 receiving 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 Vincent Daly, Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and 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. Paragraph (b)(1) of §1.368–2 as proposed on January 24, 2003, at 68 FR 3477, is proposed to be revised to read as follows:

§1.368–2 Definition of terms.

* * * * *

(b)(1)(i) *Definitions*. The following definitions apply for purposes of this paragraph (b)(1):

(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 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 satisfied or dis-

charged 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, 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.

(iii) *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 C corporation. X is a 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.

(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.

(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. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

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. 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 section 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.

(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. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

Example 9. Transaction effected pursuant to foreign statutes. (i) Z and Y are entities organized under the laws of Country Q and classified as corporations for Federal tax purposes. Z and Y combine. Pursuant to statutes of Country Q the following events occur simultaneously: all of the assets and liabilities of Z become the assets and liabilities of Y and Z's separate legal existence ceases for all purposes.

(ii) The transaction satisfies the requirements of paragraphs (b)(1)(ii) of this section because the transaction is effected pursuant to statutes of Country Q and the following events occur simultaneously at the effective time of the transaction: all of the assets and liabilities of Z, the combining entity 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. Accordingly, the transaction qualifies as a statutory merger or consolidation for purposes of section 368(a)(1)(A).

(iv) *Effective dates.* This paragraph (b)(1) applies to transactions occurring after the date these regulations are published as final regulations in the **Federal Register**. For rules regarding statutory mergers or consolidations on or after January 24, 2003, and before these regulations are published as final regulations in the **Federal Register**, see §1.368–2T(b)(1). For rules regarding statutory mergers or consolidations before January 24, 2003, see §1.368–2(b)(1) as it applies before January 24, 2003 (see 26 CFR part 1, revised April 1, 2002).

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Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on January 4, 2005, 8:45 a.m., and published in the issue of the Federal Register for January 5, 2005, 70 F.R. 746)