# "A" Reorganizations Revisited

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In the February 2005 issue of THE M&A TAX REPORT, I wrote about the temporary and proposed "A" reorganization regulations issued in January 2005 ( "2005 regulations"). [*See* Morris, *Cross-Border Merger Rules,* M&A TAX REPORT, Feb. 2005, at 1). Those regulations came on the heels of similar A reorganization regulations issued in 2000, 2001 and 2003, and are discussed at length in my February 2005 article. They are important, inasmuch as they formally introduce the notion that a foreign merger and consolidation can qualify for tax-free treatment as an A reorganization.

Discarding its complacent image, on January 23, 2006, the IRS finalized the A reorganization regulations, effective for transactions entered into after such date.

Given the quick turnaround, it is not surprising that the newly finalized regulations are substantially similar to the prior regulations. Although this article will focus on the additions in and changes to the final regulations, several questions remain unanswered. The IRS acknowledges this glass half full, and I suspect that will make this a continuing saga for years to come.

## Background

The Code provides for general nonrecognition treatment for reorganizations described in Code Sec. 368. In particular, Code Sec. 368(a)(1)(A) provides that the term "reorganization" includes *a statutory merger or consolidation* (otherwise known as an "A" reorganization). On January 24, 2003, the IRS simultaneously published temporary and proposed regulations ( "2003 regulations") defining a "statutory merger or consolidation" as (1) a transaction effected pursuant to the laws of the United States, a state or the District of Columbia; (2) as a result of the operation of such laws, all of the assets and liabilities of the target corporation are acquired by the acquiring corporation and the target corporation ceases its separate legal existence for all purposes.

A highlight of the 2003 regulations was that the merger of a target corporation into a limited liability company (LLC) that is disregarded as a separate entity from the acquiring corporation can qualify as a statutory merger or consolidation. This was significant, since the statutory merger and consolidation provisions relate to *corporate* reorganizations, and an LLC is obviously not a corporation. In fact, many believed (quite correctly) that this change would portend well for the liberalization of the corporate reorganization rules.

Some practitioners commented that the requirement in the 2003 regulations that the transaction be effected "pursuant to the laws

of the United States, or a State or the District of Columbia" was unnecessarily restrictive. After all, many foreign jurisdictions have merger or consolidation statutes that operate in a fashion similar to the statutes in effect in the states. Evidently, the IRS agreed, and on January 5, 2005, the IRS proposed regulations ( "2005 regulations") containing a revised definition of a statutory merger or consolidation that included transactions effected pursuant to statutes of a foreign jurisdiction or a U.S. possession. Simultaneous with the publication of the 2005 proposed regulations, the IRS published proposed regulations under Code Secs. 358, 367 and 884 ("the foreign regulations") to make corollary adjustments to allow foreign entities and transactions effected under foreign law to qualify as a statutory merger or consolidation.

Generally speaking, the IRS has adopted as final both the 2005 and 2003 regulations (T.D. 9242, Jan. 23, 2006), as well as the foreign regulations (T.D. 9243, Jan. 23, 2006). This deserves our praise. It is not often that the IRS reacts in a manner that is simultaneously quite timely, and that makes so much practical sense. Nonetheless, the IRS did make a few technical changes, which are discussed below.

## State Law Conversions

Under the 2003 regulations, it was uncertain whether all transactions involving a state law conversion of a corporation into a disregarded single-member LLC could qualify as an A reorganization. For example, suppose A, a corporation, acquires all of the stock of T, a corporation, in exchange for equal parts of A voting stock and cash. As part of an integrated transaction, immediately after the stock acquisition, T converts under a state conversion statute to an LLC. 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 simultaneously accomplishes both the transfer of all of the target corporation's assets to the acquiring corporation and the elimination of the target corporation as a corporation.

A similar question arises when the target corporation changes its status through a check-the-box election rather than through a conversion under state law. In such case, no action under state or local law affects the transfer of the target corporation's assets to the acquiring corporation. Nevertheless, the election simultaneously accomplishes both the transfer of all of the target corporation's assets to the acquiring corporation and the elimination of the target corporation as a corporation.

## Qualifying, Not!

These two transactions didn't qualify as an A reorganization under the 2003 regulations. Those regulations provided that a transaction could only qualify as a statutory merger or consolidation if the target corporation ceased its separate legal existence for *all* purposes. Unfortunately, the final regulations retain this requirement. [*See* Reg. §1.368-2(b)(1)(iii), Example 9.] Apparently, the IRS's rationale is that in each scenario the target corporation's separate legal existence doesn't cease under state law, but rather continues in a different legal form. Thus, a stock acquisition of a target corporation followed by either a state law conversion of the target from a corporation to an LLC (which is disregarded for federal income tax purposes) or a check-the-box election to the same effect does not qualify as an A reorganization.

Even though these two transactions do not qualify as A reorganizations, the IRS notes that it plans to further consider this issue, and reserves the right to change its mind. I suppose that's better than nothing. It seems that the IRS is concerned that allowing these two-step transactions to qualify as an A reorganization would upset the balance established by Rev. Rul. 67-274 [1967-2 CB 141] (ruling that an acquisition of stock of a target corporation followed by a liquidation of the target corporation qualified as a reorganization under Code Sec. 368(a)(1)(C)) and Rev. Rul. 72-405 [1972-2 CB 217] (ruling that a forward triangular merger of a subsidiary of an acquiring corporation followed by a liquidation of the subsidiary qualified as a reorganization under Code Sec. 368(a)(1)(C)). Of course, those rulings are in the C reorganization context, not in the context of an A reorganization.

## Disregarded Entities

The 2003 regulations broadened the definition of what constituted a statutory merger or

consolidation, effectively allowing certain transactions with disregarded entities to qualify. In particular, to qualify as an A reorganization, all of the assets and liabilities of each member of the transferor combining unit (*i.e.*, the target group) had to become the assets and liabilities of one or more members of one other combining unit (*i.e.*, the "transferee unit"). A combining unit consists of a combining entity (*i.e.*, a corporation) and all of its disregarded entities. This is the definition that allows for a merger of a corporation into a disregarded entity to qualify as a statutory merger or consolidation.

Under the 2003 regulations, it was clear that the existence and composition of the transferor unit are tested only immediately *before* the transaction, and that the existence and composition of the transferee unit are tested immediately *after* the transaction. However, it was not clear whether the transferee unit should also be tested immediately prior to the transaction. This ambiguity created uncertainty whether certain transactions could qualify as an A reorganization.

Consider the following transaction: A and T, both corporations, together own all of the membership interests in P, an LLC that is treated as a partnership for federal income tax purposes. T merges into P. In the merger, the shareholders of T exchange their T stock for A stock. As a result of the merger, P becomes an entity that is disregarded as an entity separate from A. If the existence and composition of the transferee unit (*i.e.*, A) were tested only after the transaction, the transaction could qualify as a statutory merger or consolidation.

However, if the transferee unit were tested both before and after the transaction, the transaction would not qualify for tax-free treatment. Notably, before the merger, P is not a member of the transferee unit since it is not treated as an entity that is disregarded as an entity separate from A.

## Testing and Qualification

The final regulations clarify that this transaction qualifies as an A reorganization. The regulations contain an example that illustrates that the existence and composition of the transferee unit is not tested immediately prior to the transaction, but only immediately after the transaction. Therefore, the merger of T into P may qualify as a statutory merger or consolidation. [*See* Reg. §1.368-2(b)(1)(iii), Example 11.] Moreover, A would be a party to the reorganization, providing nonrecognition treatment for it as well.

The IRS's largess is quite a surprise, since it also acknowledges that it is not certain what should be the tax consequences to all of the parties to this transaction. To quote a favorite television show of mine—"Whuch you talkin' about Willis?" (Arnold often repeats this rhetorical question in *Different Stokes*.) In fact, the IRS states that treating the merger of T into P as a reorganization raises questions as to the tax consequences of the transaction to the parties, including whether gain or loss should be recognized under the partnership rules of subchapter K as a result of the termination of P.

Similar questions exist in a merger of T directly into A that qualifies as a reorganization where P becomes disregarded as an entity separate from A. The IRS says it is considering the tax consequences in these cases. For example, how do the principles of Rev. Rul. 99-6 [IRB 1999-6, 6] apply? Even though the IRS will continue to study this, for now this should qualify as an A reorganization. This novel approach of tentative acceptance is more lenient than I would have expected.

## Consolidations and Amalgamations

Under the prior regulations, it was unclear how the definition of a statutory merger or consolidation applied to transactions that were effected under state consolidation statutes and foreign amalgamation statutes. In a state law consolidation or a foreign law amalgamation, typically two or more existing corporations combine and continue in a newly created corporation. The problem with consolidation and amalgamation statutes is that they usually provide that the existence of each of the consolidating or amalgamating corporations *continues* in the new corporation. Thus, the requirement that the transferee corporation cease its separate legal existence for all purposes may not be satisfied.

Although the IRS notes that it was its intention to make clear that consolidations and amalgamations qualify under the 2003 regulations, the final regulations firmly

establish this. [*See* Reg. §1.368-2(b)(1)(iii), Examples 12 and 13.] The regulations provide that the continuing existence of the consolidating or amalgamating corporations in the new corporation does not prevent a consolidation from qualifying as a statutory merger or consolidation. The 2003 regulations required that the separate legal existence of the target corporation cease. In a consolidation or an amalgamation, even if the governing law provides that the existence of the consolidating or amalgamating entities continues, according to the IRS, the separate legal existence of the consolidating or amalgamating entities does in fact cease.

Even though the final regulations provide for tax-free treatment for consolidations and amalgamations, they do not clarify the interaction of the A reorganization provisions with the F reorganization provisions. Consider the situation where X and Y, both operating corporations, consolidate pursuant to state law. In the consolidation, X and Y consolidate into Z, a new corporation. The shareholders of X and Y surrender their X and Y stock respectively in exchange for Z stock. Although this qualifies as an A reorganization, it seems that this consolidation could also be viewed as a transfer by X of its assets and liabilities to Z in an F reorganization followed by a merger of Y into Z in an A reorganization (or *vice versa*). The IRS notes that it is studying this interaction and intends to issue more guidance.

## Triangular Consolidations/ Amalgamations

Consolidations and amalgamations involving triangular transactions traditionally presented questions whether such would qualify as an A reorganization. For example, suppose that A seeks to acquire both X and Y, each in exchange for consideration that is 50 percent A voting stock and 50 percent cash. Under state law, X and Y consolidate into Z, a corporation that as a result of the acquisition transaction becomes a wholly owned subsidiary of A. The final regulations test a triangular consolidation or amalgamation as a forward triangular merger of each of the consolidating or amalgamating corporations into a wholly owned subsidiary of the parent corporation. This type of transaction might qualify as a statutory merger or consolidation pursuant to the rules of Code Sec. 368(a)(2)(D).

The IRS notes that in a triangular consolidation or amalgamation, the corporation whose stock is used in the transaction (*i.e.,* A) does not control the acquiring corporation (*i.e.,* Z) immediately before the transaction. Nonetheless, it believes that Code Sec. 368(a)(2)(D) doesn't require the corporation whose stock is used in the transaction to control the acquiring corporation immediately prior to the transaction and that such corporation's control of the acquiring corporation immediately after the transaction is sufficient to satisfy that requirement of Code Sec. 368(a)(2)(D).

Thus, the final regulations provide that the lack of control immediately before the transaction doesn't prevent the transaction from qualifying as an A reorganization. [*See* Reg. §1.368-2(b)(1)(iii), Example 4 and 14.]

## Conclusions

These final regulations have been a long time coming. An iteration of temporary and proposed regulations has appeared annually for several years, creating hope of practical and common sense change. Disregarded entities, which have become as commonplace as Starbucks, have now been included in the A reorganization regime. State law consolidations and foreign law amalgamations have also been included.

Although these changes are well deserved, some issues and questions remain. For example, to obtain tax-free treatment, a target corporation cannot simply convert to an LLC or check the box. It must actually dissolve under state law. Additionally, the interaction between A and F reorganization provisions may create hesitation in some transactions. Granted, more questions may arise over time, but overall, these questions and the issue spotting they will require appear to be manageable.

More importantly, the IRS's generosity seems unparalleled and many practitioners will be thankful for their good and swift judgment. They have allowed transactions to qualify as A reorganizations while reserving judgment on the totality of the effects. Perhaps it is just

me, but I thought that this was the purpose of temporary and proposed regulations. Given that these regulations are comparatively taxpayer friendly, I won't complain one iota.

For the past two holiday seasons now the IRS has issued gifts that should make the lives of considerable numbers of tax and transactional elves happy.