BIG A, LITTLE C: BABY STEPS TOWARD MODERNIZING REORGANIZATIONS©

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Since 1934, a tax-free reorganization has included a statutory merger or consolidation (an "A reorganization").[1] However, the words "statutory merger or consolidation" have meant many things. Today, a statutory merger or consolidation includes transactions that Congress could not have conceived of in 1934. As the contours of state statutes have shifted, the Treasury Department ("Treasury") and the Internal Revenue Service ("IRS" and with Treasury, collectively, the "Government") have embraced an increasingly functional interpretation of the "statutory merger or consolidation" requirement that now encompasses state law mergers into disregarded entities and mergers and consolidations effected under foreign law.[2]

Against this backdrop, the Government requested comments on whether A reorganization treatment should extend to an acquisition by an acquiring corporation (the "Acquirer") of all of Target's stock followed by Target's related conversion under state law into a limited liability company ("LLC" and such transaction, a "Stock Acquisition/Conversion"[3]) or an acquisition

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* We are grateful for the insightful comments of our partner, David Miller, and the assistance of our colleague, Ken Baker.

We published a substantially similar version of this article with Tax Notes on July 15, 2013, and presented an earlier version of this article to The Tax Club in New York City on April 29, 2013; we appreciate the members' feedback, particularly the comments we received from Barney Phillips, Mike Schler, Bill Burke and Peter Faber.

1 I.R.C. § 368(a)(1)(A). Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury Regulations promulgated thereunder.

2 *See* Treas. Reg. § 1.368-2.

3 Although this article generally contemplates a U.S. corporation's conversion to an LLC, the same analysis generally applies in analyzing whether A reorganization treatment is appropriate after a second-step, foreign law conversion in which an entity changes its legal status from that of an entity treated as a corporation for U.S. tax purposes to that of an entity eligible to be treated as a disregarded

of all of Target's outstanding equity interests followed by a related election to change Target's U.S. tax entity classification from a corporation to a disregarded entity pursuant to Treasury Regulation section 301.7701-3 (such transaction, a "Stock Acquisition/CTB Election"[4] and together with a Stock Acquisition/Conversion, "Functional Mergers").[5] Neither transaction can qualify as an A reorganization under the current Treasury Regulations, and an example in the regulations specifically concludes that a Stock Acquisition/Conversion was not an A reorganization because Target continued to exist as a "juridical entity" after the second-step conversion.[6] Consequently, Functional Mergers must satisfy the more demanding statutory requirements of section 368(a)(1)(C) (a "C reorganization") or section 368(a)(1)(D) (a "D reorganization") for tax-free treatment, which may not be possible in some cases. However, as the preamble to the Treasury Regulations recognizes, each form of Functional Merger is similar to a technical merger insofar as such transaction accomplishes the simultaneous transfer of Target's assets to Acquirer, and Target's elimination as a corporation, for U.S. tax purposes.[7]

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entity. *See* Treas. Reg. § 301.7701-3(a) (eligible entity with a single member can elect to be treated either as a corporation or a disregarded entity for U.S. federal income tax ("U.S. tax") tax purposes); Treas. Reg. § 301.7701-2(b)(8) (listing foreign entities that are treated as *per se* corporations for U.S. tax purposes). Putative reorganizations involving foreign corporations generally must also satisfy section 367 and the Treasury Regulations promulgated thereunder. Those issues are beyond the scope of this article.

4 Although this article generally contemplates an entity's election to be treated as a disregarded entity, the same analysis generally should apply in analyzing, where applicable, whether A reorganization treatment is appropriate after Target's related second-step election to be treated as a qualified subchapter S subsidiary under section 1361(b)(3)(B) or Target's related conversion into a qualified REIT subsidiary as defined in section 856(*i*)(2). *See* Treas. Reg. § 1.368-2(b)(1)(i)(A) (defining "disregarded entity" for purposes of A reorganization regulatory definition).

5 References in this article to "Target" mean the entity whose stock or assets are acquired, including pursuant to a Functional Merger.

6 *See* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 9.

7 *See* T.D. 9242, 2006-1 C.B. 422, 423. For commentary addressing Functional Mergers, see ABA Section of Tax'n, *Comments on Final*

This article considers whether it is appropriate to extend A reorganization treatment to Functional Mergers that satisfy the business purpose, continuity of interest ("COI") and continuity of business enterprise ("COBE") requirements in Treasury Regulation section 1.368-1. We acknowledge that a literal interpretation of section 368(a)(1)(A) would limit A reorganizations to acquisitions effected pursuant to a technical merger or consolidation effected under applicable law; however, we note that section 368 does not define a "statutory merger or consolidation." In addition, Congress obviously did not foresee the advent of disregarded entities, which make Functional Mergers possible, when it created A reorganizations in 1934. Disregarded entities are unique in that they are separate legal entities but, absent an election to the contrary, a division of the entity's owner for U.S. tax purposes.[8] Today, an Acquirer can use a disregarded entity to acquire Target's assets for tax purposes without participating in the acquisition transaction for corporate law purposes. The question is whether transactions involving this unique entity warrant a unique definition of a "statutory merger or consolidation."

Significantly, the Government already has appropriately recognized that A reorganization treatment does not require that Target's assets and liabilities become the direct assets and liabilities of Acquirer pursuant to a statutory mechanic. The Government's extension of the Treasury Regulations to permit Target's merger into Acquirer's disregarded entity to qualify as an A reorganization is a particularly compelling example of this type of logical extension, as these transactions now qualify as A reorganizations even though Acquirer and Target do not merge under state law, and the acquiring disregarded entity—the only Acquirer group party to the merger—is not a party to a reorganization under section 368(b).[9] Likewise, we seek to establish that the absence of a technical merger under applicable

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Regulations Defining the Term "Statutory Merger or Consolidation," 2007 TNT 113-21 (June 11, 2007) (hereinafter, the "ABA 2007 Report") and Letter from New York State Bar Assn. Section on Tax'n, *Section 368(a)(1)(A) Regulations Defining a "Statutory Merger or Consolidation,"* 2006 TNT 200-17 (Oct. 13, 2006) (hereinafter, the "NYSBA 2006 Letter").

8 *See* Treas. Reg. § 301.7701-2(a).

9 *See* 66 Fed. Reg. 57400 (Nov. 15, 2001), 2001-2 C.B. 555.

law does not preclude a Functional Merger's treatment as an A reorganization.

As discussed below, compelling policy reasons support the treatment of Functional Mergers as A reorganizations, notwithstanding the absence of a technical merger or consolidation under current law. Functional Mergers are substantially equivalent to technical mergers under state law; as such, amending the regulations to conform the treatment of Functional Mergers to those substantially equivalent transactions would continue the Government's logical and measured pattern of broadening the regulations to address modern commercial realities.[10] Moreover, treating Functional Mergers as A reorganizations would not contravene Congress's intent in promulgating A reorganizations, which was to preserve COI by Target shareholders. Finally, the Government has ample authority under *Chevron U.S.A. Inc. v. Natural Resources Defense Council*, *Inc.*[11] and its progeny to adopt our proposed regulatory changes.[12]

This article has four parts: (i) a discussion of the current requirements for A, C and D reorganizations, the U.S. tax consequences of a corporation's state law conversion to an LLC or an eligible entity's election to change its entity classification from a corporation to a disregarded entity, and the application of the step transaction doctrine to recast two-step acquisitions as tax-free reorganizations, (ii) a discussion of the history of section 368(a)(1)(A) and its predecessors, along with an explanation of

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[10] The state and local income tax consequences of Functional Mergers and technical mergers may differ. Those consequences are beyond the scope of this article.

[11] 467 U.S. 837 (1984).

[12] Although this article recommends that the Government modify Treasury Regulation section 1.368-2(b)(1) to permit Functional Mergers to qualify as A reorganizations, the same reasons we advocate would also support a legislative clarification by Congress confirming this result. While a regulatory amendment is perhaps a more achievable goal, removing the word "statutory" from the A reorganization definition, coupled with a broad grant of authority to Treasury to promulgate implementing regulations, would be an ideal alternative. Others have made similar suggestions. *See* ABA 2007 Report, *supra* n. 7, at 24; NYSBA 2006 Letter, *supra* n. 7, at 10.

why preserving COI by Target shareholders was Congress's principal focus in adopting the reorganization provision in 1934, (iii) an analysis of the policies supporting the treatment of Functional Mergers as A reorganizations and (iv) an explanation of why regulations authorizing A reorganization treatment would be valid under *Chevron* and its progeny.[13]

I. BACKGROUND

A. Section 368

The tax-free reorganization rules under section 368(a) exempt from gain recognition certain corporate combinations that "effect only a readjustment of continuing interest in property under modified corporate forms."[14] An A reorganization is a statutory merger or consolidation.[15] A C reorganization generally is an

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[13] As discussed in Part III.C below, substantially similar reasoning would also support extending A reorganization treatment under certain circumstances to a wholly owned tax corporation's standalone (i) local law conversion to an LLC or other entity eligible to be treated as a disregarded entity or (ii) election to change its U.S. tax classification to a disregarded entity, in each case, where the entity's owner for U.S. tax purposes is a tax corporation.

[14] Treas. Reg. § 1.368-1(b).

[15] I.R.C. § 368(a)(1)(A). A reorganization treatment also applies to certain triangular acquisitions. A forward triangular merger generally consists of Target's merger into a corporate merger subsidiary with the merger subsidiary surviving, if the merger subsidiary acquires substantially all of Target's properties partly or entirely in exchange for stock of the merger subsidiary's immediate parent corporation which owns stock representing section 368(c) control of the merger subsidiary, the acquisition would satisfy section 368(a)(1)(A) if the Target merged directly into the parent corporation and no stock of the merger subsidiary is used in the transaction. I.R.C. § 368(a)(2)(D); Treas. Reg. § 1.368-2(b)(2). A reverse triangular merger generally consists of a corporate merger subsidiary's merger into Target with Target surviving, if the merger subsidiary's immediate parent corporation owns stock representing section 368(c) control of the merger subsidiary before the merger, Target's shareholders surrender, in the transaction, stock representing section 368(c) control of Target in exchange for parent corporation voting stock and, immediately after the merger, Target holds substantially all of its and the merger subsidiary's properties.

acquisition of substantially all of Target's properties[16] solely in exchange for voting stock of Acquirer (or its immediate controlling parent corporation) or in exchange for such voting stock and a limited amount of money and/or other property[17] if Target makes a liquidating distribution of the stock received and any other assets (with limited exceptions) to Target shareholders.[18] A D reorganization generally includes Target's transfer of part or all of its assets to Acquirer if, immediately after the transfer, Target (or one or more of its shareholders) controls[19] Acquirer, and Acquirer

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I.R.C. § 368(a)(2)(E); Treas. Reg. § 1.368-2(j)(3). For section 368(c) purposes, "control" means the ownership of at least 80 percent of the total voting power, and at least 80 percent of the total number of shares of each class of nonvoting stock, of the applicable corporation.

16 IRS advance ruling guidelines provide a strict safe harbor under which the "substantially all of the properties" requirement is satisfied only if Target's assets represent at least 90 percent of the fair market value of the net assets, and at least 70 percent of the fair market value of the gross assets, held by Target immediately prior to the acquisition. *See* Rev. Proc. 77-37, 1977-2 C.B. 568, *amplified by* Rev. Proc. 86-42, 1986-2 C.B. 722. Notably, this requirement treats any Target assets distributed as part of the plan of reorganization as assets that were held by Target immediately before, but were not acquired in, the acquisition. *See id.* Therefore, an acquisition may fail to qualify as a C reorganization if Target distributes a portion of its assets shortly before the acquisition. *See, e.g.*, *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir. 1937), *cert. denied*, 305 U.S. 605 (1938) (Target's distribution of a portion of its assets to shareholders prevented the subsequent acquisition of Target from qualifying as a reorganization under the predecessor to section 368(a)(1)(C)).

17 *See* I.R.C. § 356(a)(1)(B).

18 I.R.C. § 368(a)(1)(C), (2)(B), (2)(G). To qualify as a C reorganization, the sum of any boot paid (or deemed paid for U.S. tax purposes), plus any liabilities of Target assumed by Acquirer and the fair market value of any Target assets that are not transferred to Acquirer cannot exceed 20 percent of the fair market value of Target's assets. I.R.C. § 368(a)(2)(B). In other words, voting stock of Acquirer (or its immediate controlling parent corporation) must represent at least 80 percent of the fair market value of Target's total assets.

19 "Control" in this context means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of

stock or securities are distributed in a transaction qualifying under section 354 or 356.[20]

In addition to the applicable statutory requirements, an acquisitive reorganization must satisfy the business purpose, COI and COBE requirements in Treasury Regulation section 1.368-1. First, a reorganization requires a valid corporate business purpose,[21] such as the synergistic benefits that Acquirer expects to realize from the combination of Acquirer's and Target's respective businesses.[22] Second, to prevent transactions that are, in

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stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock of the corporation (after application of attribution rules). *See* I.R.C. § 368(a)(2)(H) (adopting the control standard in section 304(c)).

[20] I.R.C. § 368(a)(1)(D), (a)(2)(H). To satisfy section 354, Acquirer must acquire substantially all of Target's assets, and Target must distribute the stock, securities and other property received in the acquisition, as well as any other property of Target, pursuant to the plan of reorganization. I.R.C. § 354(a)-(b). Section 368 also treats certain divisive transactions and single-company restructurings as a tax-free reorganization. These reorganizations generally are beyond the scope of this article. *See* I.R.C. §§ 355; 368(a)(1)(D), (E) and (F).

[21] Treas. Reg. § 1.368-1(c). This requirement is a regulatory adoption of the Supreme Court's decision in *Gregory v. Helvering*, 293 U.S. 465 (1935). In *Gregory*, the taxpayer was the sole shareholder of United Mortgage Corporation ("United Mortgage"), which itself owned Monitor Securities Corporation ("Monitor"). In an effort to avoid incurring tax, the taxpayer formed Averill Corporation, and then caused United Mortgage to contribute its Monitor stock to Averill. Averill then distributed the Monitor stock to the taxpayer in a complete liquidation. The shareholder structured the transaction "for the sole purpose" of reducing her taxes by avoiding dividend treatment on the distribution of Monitor stock. *Id.* at 467. The Supreme Court stated that Averill's formation and liquidation lacked a business purpose and instead constituted "an elaborate and devious form of conveyance masquerading as a corporate reorganization." *Id.* at 470. Accordingly, the Court held that the transaction "upon its face [lay] outside the plain intent of the statute." *Id.* at 469-70.

[22] *See, e.g.*, *Am. Bronze Corp. v. Comm'r*, 64 T.C. 1111, 1124-25 (1975) (the reduction of administrative costs resulting from more streamlined corporate structure was a valid business purpose for reorganization); *Wortham Mach. Co. v. United States*, 375 F. Supp. 835, 838 (D. Wyo. 1974), *aff'd*, 521 F.2d 160 (10th Cir. 1975) (a

substance, taxable sales from qualifying as reorganizations, the COI test generally requires that Acquirer stock represent at least 40 percent of the aggregate consideration delivered to Target shareholders.[23] Third, the qualified group must satisfy the COBE test by either continuing Target's historic, *i.e.*, most recently conducted, business or using a significant portion of Target's historic business assets in the qualified group's business.[24]

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reorganization must include a reformation or a reshaping of existing corporate business for the purpose of continuing the business in the new and changed corporate form).

23 Treas. Reg. § 1.368-1(e)(1)(i); *see also Helvering v. Minn. Tea Co.*, 296 U.S. 378, 385 (1935) ("[T]his interest must be definite and material; it must represent a substantial part of the value of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation."). To this end, the Supreme Court has held that an acquisition satisfied the COI test where Target shareholders received Acquirer stock equal to approximately 38.5 percent of the aggregate consideration delivered, and the COI regulations include an example in which Acquirer stock represented 40 percent of the aggregate consideration received by Target shareholders in a reorganization. *See John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); Treas. Reg. § 1.368-1(e)(2)(v), Ex. 1.

24 Treas. Reg. § 1.368-1(d)(1) ("The policy underlying [COBE] . . . is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form. . . ."); *see also* H.R. Rep. No. 83-1337, at A134 (1954) (a corporation may not acquire assets with the intention of transferring them to a "stranger"). A "qualified group" generally includes the issuing corporation, one or more corporations with respect to which the issuing corporation directly owns stock representing section 368(c) control, and any other corporations in which group members' aggregate ownership constitutes section 368(c) control directly or through certain partnerships. Treas. Reg. § 1.368-1(d)(4)(ii). An "issuing corporation" is generally Acquirer or its immediate parent corporation in the case of a triangular reorganization. Treas. Reg. § 1.368-1(b). If Target has more than one line of business, the business continuity test requires only that the qualified group continue a significant line of business. Treas. Reg. § 1.368-1(d)(2)(ii).

B. Section 368(a)(1)(A) Treasury Regulations

For approximately 65 years after the 1934 adoption of the statutory merger or consolidation provision, the Treasury Regulations generally defined the term "statutory merger or consolidation" simply as a merger or consolidation effected pursuant to the corporation laws of the United States, a state or territory thereof or the District of Columbia.[25] Two events prompted the Government's development of a new regulatory definition beginning in 2000: (i) the adoption of the check-the-box regulations under section 7701 (the "CTB Regulations") and (ii) the release of Revenue Ruling 2000-5.[26]

In 1997, the Government released final regulations adopting the CTB Regulations,[27] which generally treat an unincorporated entity that has a single owner as a disregarded entity for U.S. tax purposes, unless the entity affirmatively elects

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[25] *See* T.D. 4585, 14-2 C.B. 55; *see also* Thomas W. Avent, *The Evolution of the A Reorganization*, 138 Corporate Tax Practice Series, at 9-11 (2009) (providing longstanding regulatory definition of statutory merger or consolidation in effect prior to 2003 temporary regulations).

[26] 2000-1 C.B. 436.

[27] *See* Treas. Reg. § 301.7701-1(f). The Government first announced consideration of an elective entity classification scheme in 1995. *See* Notice 95-14, 1995-1 C.B. 297. Initially, the Supreme Court determined that corporate classification generally depended on the existence of six factors: (i) associates, (ii) a business objective and intent to divide profits, (iii) perpetual life of the organization, (iv) centralized management, (v) freely transferable ownership interests and (vi) limited liability. *Morrissey v. Comm'r*, 296 U.S. 344, 359-60 (1935). In 1960, the Government issued regulations based on the last four factors (the "Kintner Regulations"). Under the Kintner Regulations, an unincorporated entity that exhibited at least two of the listed factors generally was taxable as a corporation; if the entity possessed two or fewer of these characteristics, the entity generally was taxable as a partnership. Former Treas. Reg. § 301.7701-2(a)(1)-(2) (1960). Over time, the Kintner Regulations became difficult to administer, principally because of the emergence of hybrid entities such as LLCs which could usually achieve their desired tax classification with proper planning.

to be taxable as a corporation.[28] A disregarded entity, in turn, generally is treated for U.S. tax purposes as a branch or division of the disregarded entity's owner.[29] Accordingly, for U.S. tax purposes, a disregarded entity's assets, liabilities and items of income, loss and credit generally constitute assets, liabilities and such items of the disregarded entity's owner.[30]

Initially, it was uncertain whether mergers involving disregarded entities could qualify as A reorganizations. In May 2000, the Government issued proposed regulations (the "2000 Proposed Regulations") that did not allow either the merger of Target into a disregarded entity (a "DRE Merger") or a merger of a disregarded entity into Target to qualify as an A reorganization.[31] The Government withdrew the 2000 Proposed Regulations and issued new proposed regulations in November 2001 (the "2001 Proposed Regulations"), which allowed DRE Mergers to qualify as A reorganizations, reasoning that this result was consistent with a disregarded entity's status as a division of its owner.[32] In January 2003, the Government promulgated temporary regulations adopting this position (the "2003 Regulations").[33]

The 2003 Regulations adopted a detailed definition of a statutory merger or consolidation that was also generally consistent with Revenue Ruling 2000-5, which addressed the tax treatment of two divisive transactions that qualified as "mergers" under

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[28] Treas. Reg. § 301.7701-3(b).

[29] Treas. Reg. § 301.7701-2(a).

[30] *Id.*; *see* Chief Counsel Adv. 2002-35-023 (Aug. 30, 2002) ("When the single member owner is the taxpayer, the Service may recover the tax liability [resulting from the operations of a single member LLC that is a disregarded entity] from the property and rights to property of the single member owner, but the single member owner under state law has no interest in the assets of the LLC. In short, the Service may not look to the LLC's assets to satisfy the tax liability of the single member owner.").

[31] Prop. Treas. Reg. § 1.368-2(b)(1), 2000-1 C.B. 98.

[32] 66 Fed. Reg. 57400 (Nov. 15, 2001), 2001-2 C.B. 555 at 556.

[33] *See* T.D. 9038, 2003-1 C.B. 524. Part III below discusses in detail the Government's reasoning in the 2000 Proposed Regulations and the 2001 Proposed Regulations.

applicable state law: (i) Target transferred some, but not all, of its assets in exchange for Acquirer stock and retained the remainder of its assets and remained in existence, and (ii) Target transferred all of its assets to two corporations in exchange for stock of both corporations and then liquidated. Revenue Ruling 2000-5 concluded that neither transaction qualified as an A reorganization. The first transaction was not an A reorganization because Acquirer did not acquire all of Target's assets and Target did not go out of existence, while the second transaction failed to qualify as an A reorganization because two corporations, rather than one, acquired Target's assets and liabilities in exchange for their stock.[34]

In response to these developments, the current Treasury Regulations defined the parties to an A reorganization in terms of "combining units," which each consist of a "combining entity"–a corporation for U.S. tax purposes–and any disregarded entities owned by the combining entity.[35] The Treasury Regulations provide the following functional definition of a "statutory merger or consolidation":

> 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—

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[34] Rev. Rul. 2000-5, 2000-1 C.B. at 437. The IRS emphasized that divisive transactions generally must satisfy all of the requirements of section 355 to qualify as a reorganization. *Id.* The IRS likely issued Revenue Ruling 2000-5 in response to the enactment of the Texas Business Corporation Act (the "TBCA") in 1998, which permitted divisive transactions to qualify as mergers under Texas law. *See* Tex. Bus. Corp. Act. Ann. art. 1.02(A)(18) (2000) (defining a merger to include "[t]he division of a domestic corporation into two or more new domestic corporations or into a surviving corporation and one or more new domestic or foreign corporations or other entities…."); *see also* Avent, *supra* n. 25, at 14 (discussing TBCA).

[35] Treas. Reg. § 1.368-2(b)(1)(i)(C).

(A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent such liabilities are satisfied or discharged in the transaction or are nonrecourse liabilities to which assets distributed in the transaction are subject) of each member of one or more transferor combining units (each, a transferor unit) become the assets and liabilities of one or more members of another combining unit (*i.e.*, 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 (A) immediately above.[36]

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[36] Treas. Reg. § 1.368-2(b)(1)(ii).

These regulations essentially impose three requirements. First, Acquirer must effect the merger or consolidation pursuant to a statute or statutes under which the events described immediately below occur simultaneously at the effective time (the "Simultaneity Test").[37] Second, the assets and liabilities of Target and its disregarded entities generally must "become" the assets and liabilities of the transferee unit (the "Combination Test").[38] Third, Target must cease its separate legal existence for all purposes (the "Dissolution Test").[39]

C. Application of Step Transaction Doctrine

Current law provides two paths for effectively combining entities without a technical merger or liquidation: a Stock Acquisition/Conversion and a Stock Acquisition/CTB Election.

Most states now permit a corporation organized in the applicable jurisdiction to convert to an LLC.[40] While the precise statutory requirements may vary, in most states compliance with applicable formalities (*e.g.*, filings) automatically vests the assets of the "former" corporation with the "new" LLC. The converting entity's state law existence survives the conversion, notwithstanding the change in legal classification. Because no assets are transferred for state law purposes, no consent is required for the LLC's "acquisition" and "assumption" of the former corporation's assets and liabilities, as it would be if a parent corporation causes its corporate subsidiary to merge into the parent's wholly owned LLC.[41] A corporate subsidiary's conversion to a disregarded LLC wholly owned by its parent

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[37] *See* Treas. Reg. § 1.368-2(b)(1)(ii) (flush language).

[38] *See* Treas. Reg. § 1.368-2(b)(1)(ii)(A).

[39] *See* Treas. Reg. § 1.368-2(b)(1)(ii)(B).

[40] *See*, *e.g.*, Del. Code Ann. tit. 8 § 266 (2013); N.J. Rev. Stat. § 42:2C-78 (2013); Cal. Corp. Code § 1151; Tex. Bus. Orgs. Code Ann. § 10.101 (2013); Mass. Gen. Laws ch. 156D, § 9.50 (2013); Fla. Stat. § 607.1112 (2013).

[41] *See* ABA 2007 Letter, *supra* n. 7, at 8; NYSBA 2006 Letter, *supra* n. 7, at 9.

corporation, standing alone, generally constitutes a complete liquidation of the subsidiary under section 332.[42]

In addition, as discussed above, unincorporated U.S. entities and eligible foreign entities with a single owner generally can elect to be treated for U.S. tax purposes as a corporation or disregarded entity.[43] Subject to certain limits, the CTB Regulations permit eligible entities to change their entity classification status for U.S. tax purposes.[44] If an eligible entity classified as a corporation elects to be treated as a disregarded entity, the corporation is deemed to distribute all of its assets and liabilities to the corporation's single owner in a section 332 liquidation.[45]

The step transaction doctrine is a judicially developed variation of the "substance over form" rule articulated by the Supreme Court in *Gregory v. Helvering*,[46] which treats a series of separate steps as a single transaction if the substance of the steps is integrated, interdependent and focused toward a particular end result.[47] The Supreme Court has explained that "[t]ransitory phases of an arrangement frequently are disregarded under these

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42 *See*, *e.g.*, Priv. Ltr. Rul. 2012-52-014 (Dec. 28, 2012); Priv. Ltr. Rul. 2012-13-018 (Mar. 30, 2012); Priv. Ltr. Rul. 2011-07-003 (Jan. 18, 2011).

43 Treas. Reg. § 301.7701-3(a).

44 Treas. Reg. § 301.7701-3(c)(1).

45 Treas. Reg. § 301.7701-3(g)(1)(iii); *see*, *e.g.*, *Dover v. Comm'r*, 122 T.C. 324, 347 (2004) ("[The IRS] specifically acknowledges that, for tax purposes, [the corporation's disregarded entity election] constituted a deemed section 332 liquidation . . . and states that there is no difference between [such election] and an actual section 332 liquidation."); Priv. Ltr. Rul. 2007-09-013 (Mar. 2, 2007); Priv. Ltr. Rul. 2002-06-051 (Feb. 8, 2002) (entity classification change from corporation to disregarded entity was treated as a section 332 liquidation of the corporation).

46 293 U.S. 465 (1935).

47 *See*, *e.g.*, 1 Boris I. Bittker & James S. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 12.61[3], at 12-252 to 12-255 (7th ed. 2002); Seymour S. Mintz & William T. Plumb, Jr., "Step Transactions in Corporate Reorganizations," in 12 *N.Y.U. Inst. on Fed. Tax'n* 247 (1954).

sections of the revenue acts where they add nothing of substance to the completed affair."[48]

The Tax Court has described the step transaction doctrine as a "particular manifestation of the more general tax law principle that purely formal distinctions cannot obscure the substance of the transaction."[49] A substantial body of case law and revenue rulings apply the step transaction doctrine to integrate a first-step stock acquisition and second-step asset acquisition and then test the integrated transaction for reorganization qualification.

King Enterprises, Inc. v. United States[50] and *J.E. Seagram Corp. v. Commissioner*[51] are two examples of judicial application of the step transaction doctrine in this context. In *King Enterprises* and *J.E. Seagram*, the courts integrated an acquisition of all of Target's stock and related state law merger of Target into Acquirer (and, in *J.E. Seagram*, Acquirer's merger subsidiary) and treated the integrated transaction as an A reorganization (and, in *J.E. Seagram*, as a section 368(a)(2)(D) reorganization).[52]

More recently, in Revenue Ruling 2001-46,[53] the IRS examined a two-step transaction similar to those executed in *King*

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[48] *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 184-85 (1942).

[49] *Superior Coach of Fl. v. Comm'r*, 80 T.C. 895, 905 (1983).

[50] 418 F.2d 511 (Ct. Cl. 1969).

[51] 104 T.C. 75 (1995).

[52] *J.E. Seagram Corp. v. Comm'r*, 104 T.C. 75, 104-05 (1995); *King Enters, Inc. v. United States*, 418 F.2d 511, 519 (Ct. Cl. 1969); *see also* Rev. Rul. 72-405, 1972-2 C.B. 217 (a corporate merger subsidiary acquired all of Target's assets solely in exchange for stock of the merger subsidiary's immediate parent corporation and then liquidated into the parent; the IRS rejected the "transitory passage" of Target's assets through the merger subsidiary, integrated the asset acquisition and liquidation and treated the integrated transaction as a C reorganization); Rev. Rul. 67-274, 1967-2 C.B. 141(Acquirer acquired all of Target's stock solely in exchange for Acquirer voting stock, and then liquidated Target pursuant to the same plan; the IRS integrated the stock acquisition and the liquidation and treated the integrated transaction as a C reorganization).

[53] 2001-2 C.B. 321.

Enterprises and *J.E. Seagram*. After considering whether applying the step transaction doctrine would contravene section 338 policy, the revenue ruling ultimately applied the doctrine and treated the integrated stock acquisition and merger as an A reorganization.[54] The IRS concluded that the congressional mandate that section 338 constitute the sole means of recharacterizing a stock purchase as an asset purchase applied only to taxable transactions, and integrating the two steps in the revenue ruling as an A reorganization was permissible because doing so would not produce a cost basis in Target's assets.[55]

Functional Mergers typically occur pursuant to a written plan in effect at the time of the first-step acquisition of Target stock, and the step transaction doctrine generally should integrate the two steps of a Functional Merger and test such steps for qualification as an asset reorganization.

II. HISTORY OF REORGANIZATION PROVISIONS

Ample authority to amend the current Treasury Regulations to allow Functional Mergers to qualify as A reorganizations exists in the legislative history of section 368 and the relevant case law. This section of the article demonstrates that, in adopting the reorganization definition in 1934 (including the statutory merger or consolidation provision), Congress intended to prohibit transactions resembling sales from qualifying as reorganizations by limiting reorganization treatment to transactions that preserved continuity. We believe that Congress viewed the technical merger

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54 The stock acquisition viewed alone was a qualified stock purchase, *i.e.*, a "purchase" of at least 80 percent (by vote and value) of Target's stock by another corporation within a 12-month period, which is a prerequisite to section 338's application. *See* I.R.C. § 338(d)(3); *see also* Rev. Rul. 2008-25, 2008-1 C.B. 986; Rev. Rul. 90-95, 1990-2 C.B. 67 (taxable stock acquisition of Target treated separately from Target's related section 332 liquidation).

55 *See* Rev. Rul. 2001-46, 2001-2 C.B. at 322-33; Treas. Reg. § 1.338(h)(10)-1(c)(2) and (e), Exs. 11-13; *see also* Rev. Rul. 2001-26, 2001-1 C.B. 1297 (integrating Target's acquisition pursuant to tender offer and reverse subsidiary merger; integrated transaction satisfied "control for voting stock" requirement and qualified as section 368(a)(2)(E) reorganization).

mechanics of state law not as an end in themselves but only as a means of ensuring compliance with reorganization treatment. Accordingly, we submit that, consistent with the purpose of the reorganization definition in 1934, the Government can promulgate Treasury Regulations that permit an acquisition to qualify as an A reorganization, notwithstanding the absence of a technical merger or consolidation.

A. Pre-1934 Revenue Act

Congress addressed corporate restructurings directly for the first time in the 1918 Revenue Act (the "1918 Act") by generally excepting the receipt of stock or securities in a "reorganization, merger or consolidation" from gain recognition.[56] The statute, however, did not define the terms "reorganization, merger or consolidation." In 1919, Treasury and the Bureau of Internal Revenue issued regulations that generally provided nonrecognition treatment to the following transactions: (i) the dissolution of corporation B and the sale of its assets to corporation A, (ii) the sale of its property by B to A and the dissolution of B, (iii) the sale

[56] Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1057, 1060 (1919). The initial income tax laws after enactment of the Sixteenth Amendment did not specifically address corporate reorganizations. Steven A. Bank, *Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Law*, 77 N.C. L. Rev. 1307, 1314-15 (1999) (hereinafter, "Federalizing the Tax-Free Merger"); *see also* Arnold R. Baar & George M. Morris, *Hidden Taxes in Corporate Reorganizations* 12-13 (1935) (hereinafter, "Baar & Morris") (discussing history). Treasury's initial guidance in this area was mixed. *See, e.g.*, Federalizing the Tax-Free Merger, *supra*, at 1314-15; Daniel Q. Posin, *Taxing Corporate Reorganizations: Purging Lenelope's Web*, 133 U. Pa. L. Rev. 1335, 1340 (1985) (discussing Treasury guidance). In addition, most of the Supreme Court cases that eventually evaluated restructurings under these early laws tended to find that the transactions were recognition events. *See*, *e.g.*, *Cullinan v. Walker*, 262 U.S. 134 (1923); *Rockefeller v. United States*, 257 U.S. 176 (1921); *United States v. Phellis*, 257 U.S. 156 (1921) (restructuring was taxable event to shareholders); s*ee also* Homer Hendricks, *Federal Income Tax: Definition of "Reorganization"* 45 Harv. L. Rev. 648, 648 (1931) (discussing authorities).

of the stock of B to A and the dissolution of B, (iv) the merger of B into A or (v) the consolidation of the corporations.[57]

Congress added the first statutory definition of a "reorganization" in the Revenue Act of 1921 (the "1921 Act"):

> The word "reorganization" as used in this paragraph includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected).[58]

The addition of the first parenthetical phrase above, which permitted non-recognition treatment when a corporation acquired a majority of Target's stock or substantially all of Target's assets, introduced a new ambiguity. More specifically, because the language did not identify the consideration to be delivered, some taxpayers argued that cash or short-term debt instruments were sufficient.[59]

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57 Regulations 45, Art. 1567 (1921); *see also* Avent, *supra* n. 25, at 5 (discussing regulatory developments).

58 Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 227, 230 (1921).

59 *See, e.g.*, Avent, *supra* n. 25, at 6-7; Federalizing the Tax-Free Merger, *supra* n. 56, at 1334-35 (discussing issues presented by this ambiguity). In the Revenue Act of 1924, Congress (i) changed "includes" to "means" in the first sentence of the reorganization definition to clarify that taxpayers could only achieve reorganization status through the specifically enumerated transaction structures and (ii) granted reorganization treatment to asset transfers to a transferee corporation, if, after the transaction, the transferor corporation or its shareholders (or both) were in control of the transferee corporation. *See* Revenue Act of 1924, ch. 234, § 203(h), 43 Stat. 253, 257

These statutory ambiguities, of course, produced litigation. In *Cortland Specialty Co. v. Commissioner*,[60] the IRS denied reorganization status where Target transferred substantially all of its assets to Acquirer in exchange for cash and short-term unsecured notes. The taxpayer argued that the COI test did not apply based on the plain language of the reorganization provision in the Revenue Act of 1926 (the "1926 Act"), which defined a reorganization as the transfer of substantially all of the properties of one corporation to another. The court concluded that the statute did not accord reorganization treatment to a "mere sale" of corporate assets.[61] Rather, a reorganization must embody the traditional features of a merger or consolidation, and, in such a merger or consolidation, "there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms."[62]

The Supreme Court generally endorsed the Second Circuit's *Cortland* opinion in *Pinellas Ice & Cold Storage Co. v. Commissioner*.[63] In *Pinellas,* Target transferred substantially all of its assets to Acquirer in exchange for cash and short-term notes. The Supreme Court concluded that reorganization treatment only applies where Target acquires "an interest in the affairs of the purchasing company more definite than that incident to ownership of . . . short-term . . . notes."[64] In the Court's view, this interpretation "harmonizes with the underlying purpose of the provisions in respect of exemptions . . . ."[65]

(1924). After this, the reorganization provision generally remained unchanged until, as discussed below, Congress revisited reorganizations in 1934.

[60] 60 F.2d 937 (2d Cir. 1932).

[61] *Id.* at 940.

[62] *Id.*

[63] 287 U.S. 462 (1933).

[64] *Id.* at 470.

[65] *Id.*

B. 1934 Revenue Act

In 1933, a subcommittee of the House Ways and Means Committee (the "Subcommittee") recommended generally eliminating the reorganization provisions because the provisions, among other things, were very complex and reorganizations were undertaken in many cases for tax avoidance purposes.[66] During hearings on the Subcommittee's proposals, Treasury argued that eliminating the reorganization provisions would reduce revenues because many shareholders at the time had built-in losses in their stock and many reorganization transactions were not "mere sales" and satisfied the policy goals of a tax-free reorganization.[67]

Upon consideration, the full House Ways and Means Committee decided to retain a modified provision, which defined a reorganization as:

> (A) a merger or consolidation, or
>
> (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or
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> (C) a recapitalization, or
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> (D) a mere change in identity, form, or place of organization of a corporation, however effected.[68]

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[66] *See* Subcomm. of the Comm. on Ways and Means, 73rd Cong., Prevention of Tax Avoidance (Preliminary Report of a Subcommittee of the Committee on Ways and Means) at 37-42 (1933).

[67] H. Comm. on Ways and Means, 73rd Cong., Statement of the Acting Secretary of the Treasury Regarding the Preliminary Report of a Subcommittee of the Committee on Ways and Means at 9-10 (1933).

[68] H.R. 7835, 73rd Cong. § 112(g) (1934).

The Ways and Means Committee intended the revised reorganization definition to "conform more closely to the general requirements of corporation law[]"[69] and, therefore, prohibit transactions that, in substance, were sales from qualifying as tax-free reorganizations, while permitting legitimate reorganizations required to strengthen a corporation's financial condition.[70] The Ways and Means Committee believed that confining reorganization treatment to transactions that preserved continuity on the part of Target shareholders would accomplish this objective. More specifically, the Ways and Means Committee cited the "commendable tendency" of courts to disregard the form of transactions, focus on the substance and limit reorganization status to restructurings that are "essentially changes only in form, with the stockholders continuing their former interest in the original enterprise."[71]

The Senate Finance Committee was concerned that the House provision would prevent reorganization treatment for many legitimate transactions because, at that time, several states had not enacted laws permitting technical mergers or consolidations or precluded these transactions from occurring with out-of-state corporations.[72] Accordingly, the Senate Finance Committee expanded the House's reorganization definition by adding the italicized language:

> (A) a *statutory* merger or consolidation, or
>
> *(B) the acquisition by one corporation in exchange solely for its voting stock of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of*

[69] H.R. Rep. 73-704 (1934), 1939-1 C.B. 554, 564.

[70] *Id.*

[71] *Id.*

[72] S. Rep. 73-558 (1934), 1939-1 C.B. 586, 598.

> *substantially all the properties of another corporation, or*
>
> (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or
>
> (D) a recapitalization, or
>
> (E) a mere change in identity, form, or place of organization of a corporation, however effected.[73]

Congress enacted the Senate Finance Committee's version of the legislation (such legislation, the "1934 Act").[74]

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73 *Id.* (emphasis added); s*ee also* Baar & Morris, *supra* n. 56, at 21 (discussing Senate Finance Committee action).

74 H.R. Rep. 73-1385 (1934), 1939-1 C.B. 627, 632; *see also* George S. Hills, *Definition—"Reorganization" Under the Revenue Act of 1934*, 12 Tax Mag. 411, 411 (1934) (discussing the 1934 Act). An E reorganization is a recapitalization, which generally involves a "reshuffling of a corporate structure within the framework of an existing corporation." *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 202 (1942). An F reorganization is a mere change in the identity, form or place of incorporation of one corporation, however effected. I.R.C. § 368(a)(1)(F); *see also Berghash v. Comm'r*, 43 T.C. 743, 752 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966) (An F reorganization "encompass[es] only the simplest and least significant of corporate changes. The [F] reorganization presumes that the surviving corporation is the same corporation as the predecessor in every respect, except for minor or technical differences.)". E reorganizations and F reorganizations are not subject to the technical COI and COBE provisions in the Treasury Regulations. *See* Treas. Reg. § 1.368-1(b). The Government concluded that the COI and COBE tests are necessary to ensure that an acquisitive transaction does not involve an otherwise taxable transfer of stock or assets but are unnecessary when the transaction involves only a single corporation. *See* 69 Fed. Reg. 49836, 49837 (Aug. 12, 2004), 2004-2 C.B. 501, 502.

Both the House and Senate versions of the reorganization definition confirm our position that preserving continuity on the part of Target shareholders was Congress's principal focus in enacting the reorganization provision. First, the House version limited reorganizations to transactions that by their nature generally preserve continuity, *i.e.*, the predecessors to current A and D reorganizations, section 368(a)(1)(E) reorganizations (each, an "E reorganization") and 368(a)(1)(F) reorganizations (each, an "F reorganization"). The Senate version then expanded the definition to include the predecessors to current B and C reorganizations but specifically inserted a "solely for voting stock" requirement to equate these transactions with those in the House version. The Senate Finance Committee report explains that "these transactions, *when carried out as prescribed in this amendment*, are themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment."[75] Thus, taken together, the House and Senate bills limited reorganization treatment to transactions that Congress thought would preserve continuity by Target shareholders either due to the nature of the transaction itself or by explicit statutory directive.

We find no indication that Congress focused on the technical merger mechanics of state law in enacting the 1934 Act, and we believe that Congress viewed these mechanics not as an end in themselves but only as a means of ensuring compliance with reorganization treatment. This conclusion is supported by the fact that there was no uniform definition of a "merger" or "consolidation," or uniformity as to either transaction's underlying requirements, at the time of the 1934 Act.[76] As two contemporary authors explained: "Neither state statutes nor the interpretations given them in different states are uniform. A reorganization which

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[75] S. Rep. 73-558 (1934), 1939-1 C.B. at 598 (emphasis added).

[76] *See*, *e.g.*, Avent, *supra* n. 25, at 13; Steven A. Bank, Taxing Divisive and Disregarded Mergers, 34 Ga. L. Rev. 1523, 1569-70 (2000) (hereinafter, "Taxing Divisive and Disregarded Mergers"); Federalizing the Tax-Free Merger, *supra* n. 56, at 19; Baar & Morris, *supra* n. 56, at 34-35 (discussing differences among state merger and consolidation laws). For further background discussion, see Comment, *Statutory Merger and Consolidation of Corporations*, 45 Yale L. J. 105, 106-07 (1935); Eldon Bisbee, *Consolidation and Merger*, 6 N.Y.U. L. Rev. 404, 405-06 (1929).

produces a merger or consolidation in one state may have a contrary result in another. In many states, the statutes and the decisions of the courts are silent on the subject."[77] Even with respect to the fundamental COI requirement, approximately seven states appeared to authorize a merger or consolidation that utilized consideration other than Acquirer stock.[78] In addition, some statutes and courts failed to distinguish between a merger and a consolidation and, contrary to modern practice, essentially used the terms interchangeably.[79] Simply stated, state corporation laws in

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[77] Baar & Morris, *supra* n. 56, at 34-35. Some courts at the time characterized asset sales as mergers. *See, e.g.*, *United States v. Republic Steel Corp.*, 11 F. Supp. 117, 119 (N.D. Ohio 1935) ("By the merger agreement, Corrigan agrees to sell and convey to Republic all of its business, property, assets, and good will . . . ; to distribute Republic securities received therefor pro rata among its stockholders; to dissolve and go out of business. . . ."); *see also* Taxing Divisive and Disregarded Mergers, *supra* n. 76, at 1569-70; Federalizing the Tax-Free Merger, *supra* n. 56, at 1358-59 (discussing lack of uniformity).

[78] *See*, *e.g.*, Taxing Divisive and Disregarded Mergers, *supra* n. 76, at 1568-69; Federalizing the Tax-Free Merger, *supra* n. 56, at 1358 (discussing issue).

[79] *See*, *e.g.*, *Chicago & E. Ill. R.R. Co. v. Doyle*, 100 N.E. 278, 280 (Ill. 1912) (arguing that, in a merger or consolidation, one of three results may occur: ". . . (1) An agreement or consolidation may be effected of two or more corporations and the corporate existence of each of the constituent companies continued; (2) the agreement may result in the merger of one or more corporations into another and provide for the continuance in existence of only one of the companies and the extinguishment of the others; (3) the consolidation may result in the extinction, at the same time, of all the constituent companies and the formation of a new corporation as the successor of all the contracting parties."); *Atlantic Coast Line R.R. Co. v. Cone*, 43 So. 514 (Fla. 1907) (repeatedly referring to the merger of one railroad company into another as a "consolidation and merger"); Conn. Gen. Stat. §§ 3462, 3465 (1930); 36 Del. Laws. 395-96 (1929); 1929 N.J. Laws 478 (1929) (failing to distinguish between merger and consolidation). *See also* Rudolph E. Paul, Selected Studies in Federal Taxation, 7-8 (1938) (discussing authorities); Baar & Morris, *supra* n. 56, at 39 (quoting two contemporary treatises that defined a "consolidation" to include a "merger").

1934 "were not drafted with the thought that their provisions would be a [criterion] of federal income tax liability."[80]

Based on the foregoing, we conclude that Congress did not view the particular mechanics of a technical merger or consolidation statute as critical or even important to the achievement of Congress's objectives in adopting the predecessor to section 368(a)(1)(A) in 1934. Therefore, we submit, the Government can promulgate Treasury Regulations that permit an acquisition to qualify as an A reorganization, notwithstanding the absence of a technical merger or consolidation.

III. A REORGANIZATION TREATMENT FOR FUNCTIONAL MERGERS

Section 368(a)(1)(A) describes an A reorganization as a "statutory merger or consolidation," but the statute does not define this term. When Congress adopted the 1934 Act, it did not foresee the emergence of the disregarded entity, which is unique in that it is a separate legal entity but, absent an election to the contrary, a division of the entity's owner for U.S. tax purposes.[81] This dual status, in turn, raises novel tax issues, as the treatment of DRE Mergers reveals. For example, by using a disregarded entity, Acquirer generally can acquire Target's assets for tax purposes without participating in the acquisition transaction for corporate law purposes. Section 368 is silent regarding its application to these hybrid entities and acquisitions involving such entities.

The 2001 Proposed Regulations recognized this and essentially interpreted section 368(a)(1)(A) to permit a *deemed* state law merger between Acquirer and Target, *i.e.*, a merger that did not occur as a state law matter. Approximately three years

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80 James E. Fahey, *Income Tax Definition of Reorganization*, 39 Colum. L. Rev. 933, 948 (1939); s*ee also* Clarence Castimore, *Effect of Recent Decisions upon Reorganization and Basis Problems*, 3 Inst. on Fed. Tax'n 130, 138 (1944) (The statutory merger or consolidation provision, "which at first was rather generally thought to be the easiest provision of the new statute to apply, has, strangely enough, been provocative of more recent litigation than any other section of the reorganization statute.").

81 *See* Treas. Reg. § 301.7701-2(a).

later, the Government again expanded the regulatory interpretation of a statutory merger or consolidation to allow a merger or consolidation effected under foreign law (a "Foreign Merger") to qualify as an A reorganization. These expansions have produced a practical definition of a "statutory merger or consolidation" in Treasury Regulation section 1.368-2 that sensibly addresses commercial transactions that did not exist in 1934. Employing a similar approach, the Government reasonably can interpret section 368(a)(1)(A) as applying to Functional Mergers which satisfy the same substantive requirements as a technical merger (without a statutory mechanic) and include Target's U.S. tax (but not legal) dissolution.[82]

A Functional Merger is the substantive equivalent of a statutory merger or consolidation as currently defined in Treasury Regulation section 1.368-2 and warrants treatment as an A reorganization, assuming the acquisition satisfies the business purpose, COI and COBE requirements in Treasury Regulation section 1.368-1. Functional Mergers comply with the Combination Test because Acquirer's disregarded entity, which is part of the transferee unit, holds all of Target's assets and liabilities immediately after the effective time. Functional Mergers also substantially satisfy the Simultaneity Test and the Dissolution Test because Target's assets and liabilities "become" the assets and liabilities of the transferee unit simultaneously with Target's related dissolution for U.S. tax purposes. In addition, as discussed above, our regulatory guidance would be consistent with the congressional intent in the 1934 Act to align the definition of a reorganization "more closely to the general requirements of corporation law," and, in doing so, prohibit transactions that, in substance, are sales from qualifying as tax-free reorganizations.[83]

Amending the current regulations to permit this result would conform the treatment of Functional Mergers to substantially equivalent transactions, would continue the Government's logical and measured pattern of adapting the

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[82] As Part IV below discusses, proposed regulatory amendments adopting this interpretation of section 368(a)(1)(A) would be valid under *Chevron* and its progeny.

[83] H.R. Rep. 73-704 (1934), 1939-1 C.B. at 564.

regulations to address modern commercial realities and would avoid traps for the unwary. The benefits of these regulatory amendments would include allowing taxpayers to obtain A reorganization treatment without the need to obtain potentially burdensome consents for the transfer of assets or the assumption of liabilities and broadening the scope of A reorganization treatment to include transactions involving entities organized in foreign countries that may not yet have technical merger statutes.[84]

This section of the article addresses in detail the two principal arguments against the qualification of a Functional Merger as an A reorganization: Functional Mergers do not involve, as acknowledged above, a fusion under an applicable statute of Target into a preexisting entity, and Target does not dissolve for all purposes.[85]

A. Fusion of Target's and Acquirer's Assets

Not surprisingly, given the literal language of section 368(a)(1)(A), historically some have argued that a state law merger or consolidation was sufficient by itself to achieve reorganization status without regard to the satisfaction of any other requirements such as the COI test.[86] Courts have consistently rejected the argument that the presence of a state law merger is a bright-line rule for reorganization treatment. In *Roebling v. Commissioner*[87]

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[84] *See* ABA 2007 Report, *supra* n. 7, at 17 (discussing certain benefits of treating a Stock Acquisition/Conversion as an A reorganization); *see also* Bernard T. Bress, *The New Cross-Border 'A' Regulations*, 16 J. Int'l Tax'n 14, 16 (June 2005) (noting limited existence of technical foreign merger statutes).

[85] T.D. 9242, 2006-1 C.B. at 423; *see also* NYSBA 2006 Letter, *supra* n. 7, at 8-9 (arguing against treatment of Functional Mergers as A reorganizations).

[86] Valentine Brookes, *The Continuity of Interest Test in Reorganizations—A Blessing or a Curse*, 34 Cal. L. Rev. 1, 32 (1946) ("A statutory merger should be a reorganization because the statute says it is."); *see also* Taxing Divisive and Disregarded Mergers, *supra* n. 76, at 1561-62; Baar & Morris, *supra* n. 56, at 37 (discussing issue).

[87] 143 F.2d 810 (3d Cir.), *cert. denied*, 323 U.S. 773 (1944).

and *Southwest Natural Gas Co. v. Commissioner*,[88] the courts concluded that technical mergers effected under New Jersey and Delaware law, respectively, did not qualify as A reorganizations because the acquisitions failed the COI test.[89]

Utilizing a statutory mechanic to effect Target's acquisition, in and of itself, does not further any reorganization policy. As the Texas merger statute that presumably led to the release of Revenue Ruling 2000-5 and the decisions in *Roebling* and *Southwest Natural Gas* effectively illustrate, the presence of a statutory mechanic is not necessarily an effective safeguard against divisive transactions or sales. Instead, as these authorities reinforce, the preservation and furtherance of reorganization policy, rather than compliance with formalities, should be the principal focus of Treasury Regulations interpreting section 368(a)(1)(A). As *Roebling* instructed, "[i]t is now settled that whether a transaction qualifies as a reorganization under the various Revenue Acts does not turn alone upon compliance with the literal language of the statute. The judicial interpretation has determined that something more may be needed and that, indeed, *under some circumstances, something less will do*."[90] Similarly, *Southwest Natural Gas* stated: "The authorities are clearly to the effect that the terms expressed in the statute are not to be given merely a literal interpretation but are to be considered and applied in accordance with the purpose of [the predecessor to section 368]."[91] As discussed below, the Government has recognized that A reorganization treatment need not require that Target's assets and liabilities become the direct assets and liabilities of Acquirer pursuant to a statutory mechanic.

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[88] 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951).

[89] *Southwest Natural Gas*, 189 F.2d at 335; *Roebling*, 143 F.2d at 814. In *Roebling*, Target shareholders received Acquirer bonds, and, in *Southwest Natural Gas*, Acquirer's stock represented less than one percent of the consideration received by Target shareholders. *Southwest Natural Gas*, 189 F.2d at 335; *Roebling*, 143 F.2d at 812.

[90] *Roebling*, 143 F.2d at 812 (emphasis added) (internal quotations omitted); *see Superior Coach of Fla. v. Comm'r*, 80 T.C. 895, 905 (1983) ("[It is a] general tax law principle that purely formal distinctions cannot obscure the substance of a transaction.").

[91] *Southwest Natural Gas*, 189 F.2d at 334.

In addition, the legislative history to the 1934 Act indicates that Congress intended the enactment of the reorganization provision to align the definition of a reorganization "more closely to the general requirements of corporation law," and, in doing so, prohibit transactions that, in substance, are sales from qualifying as tax-free reorganizations.[92] Congress accomplished this objective by limiting reorganizations to transactions that generally preserve continuity either by the nature of the transactions themselves (the predecessors to current A, D, E and F reorganizations) or by explicit statutory directive (the predecessors to current B and C reorganizations). In the 1934 Act, the technical merger mechanics of state law were, if anything, a means to this end and not an end in themselves. Consistent with the broader policies that Congress intended to further, the Government can interpret the statute flexibly to extend A reorganization treatment to Functional Mergers that are not technical mergers under applicable law but satisfy all of the applicable reorganization policies.

Functional Mergers appropriately consolidate Target's and Acquirer's assets and liabilities for tax purposes, notwithstanding the absence of a statutory fusion of Target into Acquirer, and permitting Functional Mergers to qualify as A reorganizations would be a natural application of the combining unit principle employed in the Treasury Regulations. Moreover, as the following history demonstrates, since 1984, the Government generally has applied a pragmatic approach to interpreting the requirements for a statutory merger or consolidation.

First, in Revenue Ruling 84-104,[93] the IRS treated a National Banking Act "consolidation" provision as a "merger" provision for section 368 purposes and concluded that Target's acquisition qualified as a tax-free reverse triangular merger under section 368(a)(2)(E). Section 368(a)(2)(E) only applies to mergers, and the IRS determined that the National Banking Act provision at issue in the revenue ruling effectively operated as a "merger" statute in which one of the combining corporations survived the transaction and no new corporation was formed, rather than as a "consolidation" statute in which a new corporation was created and the consolidating

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92 H.R. Rep. 73-704 (1934), 1939-1 C.B. at 564.

93 1984-2 C.B. 94.

corporations were extinguished.[94] Significantly, Revenue Ruling 84-104 marks the first time that the IRS bypassed legal formalities and analyzed the substance of an acquisition in concluding that it was a "merger" for section 368 purposes.

Second, DRE Merger treatment provides a valuable blueprint for expanding the regulatory definition of a statutory merger or consolidation. Although some commentators argued that, consistent with a disregarded entity's status as a division of Acquirer for U.S. tax purposes, the Treasury Regulations essentially should *deem* Target's merger into a disregarded entity to constitute a merger into Acquirer, the 2000 Proposed Regulations disallowed A reorganization treatment for a DRE Merger.[95] In the accompanying preamble, the Government concluded that:

> it is inappropriate to treat the state or Federal law merger of a target corporation into a Disregarded Entity . . . 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

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94 Rev. Rul. 84-104, 1984-2 C.B. 94, 95.

95 Prop. Treas. Reg. § 1.368-2(b)(1), 2000-1 C.B. 1226, 1228.

> Entities, and not under state or Federal merger law, the law on which Congress relied in enacting section 368(a)(1)(A).[96]

The Government reconsidered its position over the next year and replaced these regulations with the 2001 Proposed Regulations which permitted a DRE Merger to qualify as an A reorganization.[97] In the preamble to the 2001 Proposed Regulations, the Government stated: "Permitting certain transactions involving disregarded entities that have a single corporate owner to qualify as statutory mergers and consolidations for purposes of section 368(a)(1)(A) is appropriate because it is consistent with the general treatment of a disregarded entity as a division of its owner."[98]

Much of the same reasoning that the Government relied on in 2001 supports the treatment of Functional Mergers as A reorganizations. In the case of both a DRE Merger and a Functional Merger, no state law merger occurs between Acquirer and Target. The only merger involved in a DRE Merger, *i.e.*, the merger between Target and the acquiring disregarded entity, cannot qualify as an A reorganization because the acquiring disregarded entity is not a "party to a reorganization" within the meaning of section 368(b). Instead, as the preamble to the 2000 Proposed Regulations necessarily recognized, A reorganization treatment is only available for a DRE Merger because of a *fictional* merger between Acquirer and Target that does not occur under state law. The similarities between a DRE Merger and a Functional Merger are striking, and both fully comply with all applicable reorganization policies. Without any significant extension of its approach to date, the Government can similarly treat Functional Mergers, which comply with all of the substantive requirements of technical mergers, as A reorganizations and, in

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96 65 Fed. Reg. 31115, 31117 (May 16, 2000), 2000-1 C.B. at 1227.

97 Prop. Treas. Reg. § 1.368-2(b)(1)(ii), 2001-2 C.B. at 557-58.

98 66 Fed. Reg. 57400 (Nov. 15, 2001), 2001-2 C.B. at 556.

doing so, provide consistent treatment to substantially equivalent transactions.[99]

In 2006, the Government reversed another longstanding policy and amended the Treasury Regulations to allow Foreign Mergers to qualify as A reorganizations.[100] In the preamble to the 2005 regulations that proposed this change, the Government explained that a reexamination of the issue was necessary "in light of the purposes of the statute and changes in domestic and foreign law since 1935," and concluded that a foreign merger or consolidation should qualify as an A reorganization if the acquisition satisfies the "functional criteria" in the regulations.[101] The Foreign Merger rule significantly expanded the scope of A reorganizations to apply to transactions that generally were not

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[99] We note that A reorganization treatment is available for Target's state law merger into Acquirer's newly formed disregarded entity that has no assets or liabilities prior to the merger. *See* ABA 2007 Report, *supra* n. 7, at 18. The same economics underlay Functional Mergers; none of the transactions involve the fusion of Target's assets and liabilities with those of a preexisting entity. In addition, in several General Counsel Memoranda, the Government has recognized the benefit of providing consistent treatment to transactions that produce substantially similar economic results. *See, e.g.*, Gen. Couns. Mem. 39102 (Dec. 21, 1983) (concluding that Revenue Ruling 70-107, which holds that a parent corporation's assumption of Target liabilities in a putative triangular C reorganization violates the "solely for voting stock" requirement, is "incorrect" because, among other things, the revenue ruling imposes an "artificial distinction" between A reorganizations and C reorganizations); Gen. Couns. Mem. 34918 (June 23, 1972) ("[W]e think it would be inconsistent with the developing tax pattern under the 1954 Code regarding carryover of attributes across the line of fusion, to maintain that [tax attributes] like those involved here may be carried over in a merger or a consolidation, but never in a 'C' reorganization, even where the economic realities in all of these transactions are exactly the same."). This rationale is similar to our argument in this article that a Functional Merger's lack of a technical merger should not preclude A reorganization treatment if the acquisition satisfies all of the applicable reorganization policies.

[100] *See* Treas. Reg. § 1.368-2(b)(1)(ii); *see also* Rev. Rul. 57-465, 1957-2 C.B. 250 (former Treasury Regulations precluded foreign law merger from qualifying as A reorganization).

[101] 70 Fed. Reg. 746 (Jan. 5, 2005), 2005-1 C.B. 533.

contemplated when Congress adopted the 1934 Act and the Government promulgated the initial Treasury Regulations interpreting the meaning of a statutory merger or consolidation.[102]

Finally, the current Treasury Regulations treat as an A reorganization Target's state law merger into a tax partnership in which Target holds an equity interest if Target's shareholders receive stock of Target's partner in the merger and the partnership becomes a disregarded entity of Target's partner upon consummation of the merger.[103] Notably, if Target's sole asset is its partnership interest, no assets move from Target to Acquirer pursuant to the applicable merger, which is generally a hallmark of a state law merger.[104] Also, an A reorganization historically has involved two corporations. We submit that, if the Treasury Regulations are now sufficiently functional as to treat an appropriate merger occurring between a corporation and a partnership as an A reorganization, the regulations have already endorsed the principles necessary to allow Functional Mergers to qualify as A reorganizations.

In sum, the Government's recent amendments to the A reorganization regulations demonstrate that reorganization policies do not require that Target's assets and liabilities become the direct assets and liabilities of Acquirer pursuant to a statutory mechanic. Rather, an A reorganization now requires only a combination of Target's and Acquirer's assets and liabilities under U.S. tax rules, and not a direct merger of two corporations.

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102 *Cf.* Baar & Morris, *supra* n. 56, at 36 (noting that many states around this time prohibited mergers between in-state and out-of-state corporations).

103 *See* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 11. These mergers generally also present issues under Subchapter K of the Code. Those issues are beyond the scope of this article. *See* ABA 2007 Letter, *supra* n. 7, at 25-35 (discussing Subchapter K issues).

104 *See* ABA 2007 Report, *supra* n. 7, at 11 n. 36; *see also Comm'r v. Gilmore's Est.*, 130 F.2d 791, 793 (3d Cir. 1942) (rejecting the IRS's argument that a holding company's downstream merger into its subsidiary was not a reorganization because "all of the definitions of the term 'merger' require that there be a transfer of property[]" beyond the holding company's formal surrender of its subsidiary's shares).

Functional Mergers achieve the same U.S. tax result as a DRE Merger; in both, Acquirer holds Target's assets and liabilities through a disregarded entity, and Target ceases to exist for U.S. tax purposes. In addition, it advances no tax policy to deny A reorganization treatment to a Functional Merger when the same economic results can be achieved by Target merging upstream directly into Acquirer which then contributes Target's assets to a disregarded entity. To the maximum extent possible, substantially similar transactions should receive consistent tax treatment in order to avoid traps for the unwary and advance general reorganization policies.

B. Necessity of Legal Dissolution

The Dissolution Test, which requires that Target cease its separate legal existence for all purposes, is the second requirement for A reorganization treatment at issue.[105] We note that section 368(a)(1)(A) does not contain an explicit dissolution requirement,[106] and the Treasury Regulations interpreting a "statutory merger or consolidation" did not explicitly require Target's dissolution until the 2000 Proposed Regulations. Those proposed regulations required that Target "ceas[e] to exist[]," while the 2001 Proposed Regulations required Target's dissolution as a separate legal entity "for all purposes."[107] The 2003 Regulations then inserted a proviso clarifying that an acquisition still satisfies the Dissolution Test if, following the effective time of the acquisition, applicable law permits, among other things, Target to act with respect to assets or obligations of the combining entity that arose before the effective time.[108] As discussed below, because legal dissolution is neither required by the statute nor essential to reorganization status, Target's dissolution for U.S. tax purposes should suffice to obtain A reorganization treatment.[109]

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[105] Treas. Reg. § 1.368-2(b)(1)(ii)(B).

[106] By contrast, there is an explicit dissolution requirement for C and acquisitive D reorganizations. *See* I.R.C. §§ 354(b), 368(a)(2)(G).

[107] Prop. Treas. Reg. § 1.368-2(b)(1)(ii)(B), 2001-2 C.B. at 557; Prop. Treas. Reg. § 1.368-2(b)(1), 2000-1 C.B. at 1228.

[108] *See* T.D. 9038, 2003-1 C.B. 524.

[109] *See* ABA 2007 Report, *supra* n. 7, at 10-11.

Legal dissolution was not an indispensable requirement of reorganization status at the time of the 1934 Act.[110] *Cortland*, one of the seminal cases on the understanding of a "merger" or "consolidation," recognized the variance among states with respect to the underlying requirements. More specifically, the Court of Appeals for the Second Circuit explained:

> A merger *ordinarily* is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corporation alone survives. A consolidation involves a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company. . . . *Undoubtedly such statutes vary in the different states particularly in respect to how far the constituent companies may be deemed to survive the creation of the new or modified corporate structure, but we believe that the general purpose of them all has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form*.[111]

Three 1935 Supreme Court cases address the relationship between formal dissolution and reorganization qualification under the predecessor reorganization provisions in the 1926 Act and the

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110 *See, e.g.*, Baar & Morris, *supra* n. 56, at 72 ("On this issue of the necessity of a dissolution, or change in corporate form, it is again suggested that the difficulty arises from the fact that these terms, as applied to corporations, are inherently statutory. Dissolution, or other material change in corporate form, may be the effect of the procedure for merger or consolidation required by the statutes of one state, and not be the effect under the laws of another jurisdiction.") (internal footnotes omitted); *see also* Taxing Divisive and Disregarded Mergers, *supra* n. 76, at 1543-44; Federalizing the Tax-Free Merger, *supra* n. 56, at 1346-47 (discussing legal dissolution requirement). *Compare Commonwealth v. First Nat'l Bank & Trust Co.*, 154 A. 379, 380 (Pa. 1931) (dissolution not required) *with First State Bank of Mangum v. Lock*, 237 P. 606, 609 (Okla. 1925) (dissolution required).

111 *Cortland*, 60 F.2d at 939 (emphasis added).

Revenue Act of 1928 (the "1928 Act"). These cases interpreted the reorganization provision in the above revenue acts to permit Target's transfer of substantially all of its assets to Acquirer to qualify as a reorganization despite the fact that Target remained in existence.[112] In *Helvering v. Minnesota Tea Co.*,[113] for example, the Supreme Court explained: "it is said the transferor was not dissolved, and therefore the transaction does not adequately resemble consolidation. But dissolution is not prescribed, and we are unable to see that such action is essential to the end in view."[114] This case law strongly supports the determination that formal dissolution is not an indispensable prerequisite to reorganization status.[115]

More recent authorities similarly support the conclusion that legal dissolution is not essential to reorganization status. As discussed above, in Revenue Ruling 84-104,[116] the IRS treated a combination effected under a National Banking Act "consolidation" provision as a "merger" provision for section 368 purposes.[117] The fact that, under the relevant National Banking Act statute, the merger subsidiary "merged into and continued" in the surviving entity did not preclude reorganization treatment.[118] In addition, a consolidation or amalgamation in which two or more corporations combine and continue in the resulting entity can qualify as an A reorganization on the theory that, even if the governing law provides that the existence of the consolidating or

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[112] *See G. & K. Mfg. Co. v. Helvering*, 296 U.S. 389 (1935); *Helvering v. Minn. Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

[113] 296 U.S. 378 (1935).

[114] *Id.* at 386.

[115] In interpreting the 1928 Act, the Tax Court stated (in *dicta*) that it believed that a technical merger still required Target's dissolution, notwithstanding these Supreme Court cases. *See Pillar Rock Packing Co. v. Comm'r*, 34 B.T.A. 571, 574 (1935), *aff'd*, 90 F.2d 949 (9th Cir. 1937). In affirming the Tax Court's judgment, the Court of Appeals for the Ninth Circuit did not address this issue.

[116] 1984-2 C.B. 94.

[117] *Id.* at 95.

[118] *See* ABA 2007 Report, *supra* n. 7, at 15.

amalgamating entities continues in the resulting corporation, the separate legal existence of these regarded entities ceases.[119] The Treasury Regulations thus disregard the continued existence of the consolidating or amalgamating entities as essentially divisions of the resulting entity, which is similar to a disregarded entity's status as a division of its corporate owner.[120]

The Government's flexible application of the explicit dissolution requirement in the case of C and acquisitive D reorganizations is also instructive. Target's U.S. tax dissolution suffices to satisfy this requirement and address the Government's divisive transaction concerns.[121] Alternatively, if Target does not elect to become a disregarded entity, the Government may permit Target's deferral of its actual liquidation for up to one year after its acquisition and/or allow Target's deemed liquidation and sale of its stock to an unrelated party.[122]

In sum, in the case of Functional Mergers, Target's U.S. tax dissolution either by means of a state law conversion to an LLC or Target's election to be treated as a disregarded entity of Acquirer adequately protects against the risk of a divisive transaction and,

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[119] T.D. 9242, 2006-1 C.B. at 424; *see* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 12.

[120] *See also Int'l Paper Co. v. Broadhead*, 662 So. 2d 277, 279 (Ala. Civ. App. 1995) ("It is well-settled that the merger of two corporations does not end the existence of either, rather the existence of both continues under the merged status.") (internal quotations omitted).

[121] *See*, *e.g.*, *Dover*, 122 T.C. at 347 ("[The IRS] specifically acknowledges that, for tax purposes, [the corporation's disregarded entity election] constituted a deemed section 332 liquidation . . . and states that there is no difference between [such election] and an actual section 332 liquidation."); Priv. Ltr. Rul. 2012-24-006 (June 15, 2012) (state law conversion to LLC that was a disregarded entity of corporate owner treated as a C reorganization).

[122] *See, e.g.*, Rev. Proc. 89-50, 1989-2 C.B. 631 (establishing requirements for this treatment in the case of C and acquisitive D reorganizations); Priv. Ltr. Rul. 93-35-045 (Jun. 8, 1993) (Target's acquisition qualified as a D reorganization where Target maintained its corporate existence under state law in order to isolate Target's charter and licenses for resale; acquisition satisfied requirements of Revenue Procedure 89-50).

therefore, should suffice for A reorganization purposes. In addition, in permitting a DRE Merger to qualify as an A reorganization, the Government necessarily concluded that U.S. tax principles should trump local law formalities in determining A reorganization qualification. That is, Acquirer and Target do not merge directly under local law, and Target's assets and liabilities "become" Acquirer's assets and liabilities solely for U.S. tax purposes.[123] It is entirely consistent with this policy determination to modify the Dissolution Test to focus exclusively on whether Target ceases to exist for U.S. tax purposes.[124]

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[123] *See* Treas. Reg. § 1.368-2(b)(1)(ii)(A).

[124] Based on our reading of the preamble to Treasury Regulation section 1.368-2 and the examples, the current regulations fail to treat a Stock Acquisition/Conversion as an A reorganization solely because Target's legal existence does not cease under local law. *See* Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 9 (Stock Acquisition/Conversion did not qualify as an A reorganization because Target did not cease its separate legal existence; although Target became a disregarded entity, Target continued to exist as a juridical entity after the conversion); T.D. 9242, 2006-1 C.B. at 423 ("[T]he 2003 temporary regulations provide that a transaction can only qualify as a statutory merger or consolidation if the target corporation ceases its separate legal existence for all purposes. The final regulations retain this requirement. In a conversion, the target corporation's legal existence does not cease to exist under state law. Its legal existence continues in a different form. Therefore, a stock acquisition of a target corporation followed by the conversion of the target corporation from a corporation to a limited liability company under state law cannot qualify as a statutory merger or consolidation under these final regulations."). Therefore, a Stock Acquisition/Conversion should qualify as an A reorganization even if the Government accepts only the portion of our argument contending that Target's U.S. tax dissolution suffices under section 368(a)(1)(A).

C. Policy Conclusion

As a threshold matter, section 368 is silent regarding its application to transactions involving disregarded entities. Notably, the Government has already determined that A reorganization treatment does not require that Target's assets and liabilities become the direct assets and liabilities of Acquirer pursuant to a statutory mechanic. Accordingly, we submit that the fact that Functional Mergers are not effected pursuant to a technical merger statute does not preclude their qualification as A reorganizations.

At the time of the 1934 Act, Congress presumably considered two alternatives for effecting asset reorganizations: (i) a technical merger or consolidation under state law or (ii) an actual transfer of assets and liabilities by a transferor corporation. It is easy to understand why special safeguards are necessary if the latter case is to qualify as a C reorganization. More specifically, the "substantially all of the properties" and liquidation requirements aim to prevent a divisive transaction from qualifying as a reorganization unless the transaction satisfies the exacting requirements of section 355.[125] Consistent with these policy objectives, under our proposal, A reorganization treatment would not apply to transactions such as contractual transfers of Target's assets where Acquirer does not assume Target liabilities that remain outstanding after the transaction. This acquisition would fail the Combination Test because Acquirer's transferee unit would not acquire all of Target's assets and liabilities. Although less clear, A reorganization treatment also may not be appropriate for transactions such as the acquisition of all of Target's stock followed by Target's liquidation under local law. These transactions may fail the Simultaneity Test if they would not result in the immediate acquisition of all of Target's assets and liabilities by Acquirer's transferee unit.[126]

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[125] *See* Rev. Rul. 2000-5, 2000-1 C.B. at 437.

[126] An example in the Treasury Regulations concludes that this transaction does not constitute an A reorganization because Acquirer does not acquire all of Target's assets either by filing a certificate of dissolution or simultaneously with the cessation of Target's separate legal status. The example explains that Target must first transfer its assets to its creditors to satisfy liabilities and can then transfer its remaining assets to Acquirer. *See* Treas. Reg. § 1.368-2(b)(1)(iii),

By contrast, the above concerns are absent in a Functional Merger, and, therefore, it is not necessary to test a Functional Merger under the more restrictive rules of section 368(a)(1)(C) (or section 354 and section 368(a)(1)(D) in the case of a transaction among affiliates) to further any reorganization policy. Target's stock acquisition and conversion or check-the-box election, as the case may be, (i) result in the transferee unit's acquisition of all of Target's assets and liabilities in compliance with the Combination Test, (ii) result in Target's dissolution for U.S. tax purposes in satisfaction of the policy of the Dissolution Test and (iii) occur pursuant to a single plan in satisfaction of the policy of the Simultaneity Test.[127] Although a check-the-box election does not change Target's status from a corporate standpoint in the same manner as a conversion, the transaction effects, for U.S. tax purposes, the same transfer of Target's assets and liabilities and Target's dissolution and, therefore, should receive the same tax treatment as a second-step transaction involving a related conversion.

Functional Mergers are the *de facto* equivalents of technical mergers. Recent amendments to the A reorganization regulations demonstrate that reorganization policies do not require Target's assets and liabilities to become the direct assets and liabilities of Acquirer pursuant to a statutory mechanic; instead, an A reorganization now requires only a combination of Target's and Acquirer's assets and liabilities under U.S. tax rules, and not a direct, technical merger of two corporations. In addition, section

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Ex. 10; *see also* Del. Code. Ann. tit. 8, § 278 (2013) (a corporation continues for at least three years after dissolution for purposes of winding up affairs).

[127] The Treasury Regulations include an example confirming that the Combination Test does not impose a "substantially all of the properties" requirement. *See* Treas. Reg. 1.368-2(b)(1)(iii), Ex. 8 (pursuant to a single plan, Target sold 50 percent of its assets, distributed the proceeds to shareholders and merged into Acquirer in an A reorganization). In permitting DRE Mergers to qualify as A reorganizations, the Government did not impose a "substantially all of the properties" or "solely for voting stock" requirement or any other requirement beyond those generally applicable to all A reorganizations. Similarly, we find no basis to subject Functional Mergers to any additional requirements as a condition to A reorganization qualification.

368(a)(1)(A) does not contain an explicit dissolution requirement, and legal dissolution was not a prerequisite to reorganization treatment in 1934. Therefore, Target's U.S. tax dissolution should suffice for A reorganization purposes. Like technical mergers, Functional Mergers accomplish, for U.S. tax purposes, the simultaneous transfer of all of Target's assets and liabilities to Acquirer and Target's dissolution. Accordingly, we recommend that the Government amend Treasury Regulation section 1.368-2 to permit a Functional Merger to qualify as an A reorganization.[128]

Finally, while this article focuses on the specific transactions about which the Government requested comments, substantially similar reasoning would also support extending A reorganization treatment to a wholly owned tax corporation's standalone (i) conversion under local law to an LLC or other entity eligible to be treated as a disregarded entity or (ii) election to change its U.S. tax classification to a disregarded entity, in each case, where the entity's owner for U.S. tax purposes is a tax corporation and section 332 is inapplicable. As noted above, these standalone transactions generally constitute a complete liquidation of the tax corporation under section 332.[129] However, if the corporate parent retransfers such a significant portion of the liquidated subsidiary's assets to one or more of the parent's other subsidiaries that section 332 would not apply, the deemed transactions represented by the conversion or check-the-box

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[128] The attached Appendix reflects our recommended changes to Treasury Regulation section 1.368-2(b)(1)(ii)-(iii).

[129] *See*, *e.g.*, Priv. Ltr. Rul. 2012-52-014 (Dec. 28, 2012) (conversion); Treas. Reg. § 301.7701-3(g)(1)(iii) (election to change entity classification from tax corporation to disregarded entity). For a liquidation to satisfy section 332, (i) the parent corporation must own, on the date of the adoption of the plan of liquidation and at all times until receiving the relevant subsidiary's property, at least 80 percent of the total voting power and value of the subsidiary's stock, (ii) the distribution generally must be made in complete cancellation of all of the subsidiary's stock, (iii) the property transfer must occur within a single taxable year, (iv) the fair market value of the subsidiary's assets must exceed its liabilities on the date of the adoption of the plan of liquidation and at all times until the parent corporation receives the property, and (v) the parent corporation must not be exempt from U.S. tax. *See* I.R.C. §§ 332(b)(1)-(3), 337(b)(2); Treas. Reg. § 1.332-2(b).

election, as applicable, must qualify as a reorganization to receive tax-free treatment.[130] If the liquidated subsidiary had recently distributed significant assets (*e.g.*, in redemption of a minority shareholder's stock), it may not be possible to satisfy the "substantially all of the properties" requirement that is necessary for C reorganization treatment. In those cases, the standalone conversion or check-the-box election should qualify as an A reorganization because like a Functional Merger the deemed transactions satisfy the Combination Test and the policies of the Simultaneity Test and the Dissolution Test.

IV. AUTHORITY FOR PROPOSED AMENDMENTS

The Government undoubtedly possesses the authority to amend Treasury Regulation section 1.368-2 to permit a Functional Merger to qualify as an A reorganization. In *Chevron*, the Supreme Court described the inquiry a court undertakes in assessing a regulation's validity:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress. If, however, the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's

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[130] *See*, *e.g.*, Rev. Rul. 69-617, 1969-2 C.B. 57 (upstream merger of a more than 80 percent-owned subsidiary into its majority shareholder, followed by a contribution of the former subsidiary's assets and liabilities to a new corporation, did not qualify as a section 332 liquidation but did qualify as an A reorganization and section 368(a)(2)(C) dropdown).

> answer is based on a permissible construction of the statute.[131]

As discussed below, our proposed regulatory amendments satisfy this standard.

A. *Chevron* Step One

The first step under *Chevron* ("Step One") asks whether Congress has "directly addressed the precise question at issue."[132] In our case, the "precise question at issue" is whether section 368(a)(1)(A) can apply to transactions that are the substantive equivalents of technical mergers and are consistent with all applicable reorganization policies.[133] That is, in most cases, the likely reorganization provisions that a Functional Merger might satisfy are sections 368(a)(1)(A), 368(a)(1)(C) and 368(a)(1)(D). However, a Functional Merger, in form, does not fit squarely within the statutory text of any of these provisions. Instead, the IRS generally recasts Functional Mergers for U.S. tax purposes so that these transactions qualify in appropriate cases as a C reorganization or D reorganization, as the case may be.[134] The question is whether the Government also can recast Functional Mergers as A reorganizations. We believe that the Government can do so.

The Supreme Court has explained that "Congress . . . may not have expressly delegated authority or responsibility to implement a particular provision or fill a particular gap. Yet it can still be apparent from the agency's generally conferred authority

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[131] *Id.* at 842-43.

[132] *Id.* at 843.

[133] *See Mayo Foundation for Medical Ed. & Research v. United States*, 131 S. Ct. 704, 711 (2011) (the Code exempts from taxation under the Federal Insurance Contributions Act services performed for an educational institution by a student who is enrolled and regularly attending classes at such institution; the Supreme Court framed the precise question as whether a medical resident was a "student" for exemption purposes).

[134] Rev. Rul. 2004-83, 2004-2 C.B. 157 (two-step acquisition treated as a D reorganization); Rev. Rul. 67-274, 1967-2 C.B. 141 (two-step acquisition treated as a C reorganization).

and other statutory circumstances that Congress would expect the agency to be able to speak with the force of law when it addresses ambiguity in the statute or fills a space in the enacted law, even one about which Congress did not actually have an intent as to a particular result."[135] These instructions apply here.

Section 368 does not define the term "statutory merger or consolidation." The Treasury Secretary generally has the authority to promulgate all "rules and regulations" necessary to enforce the Code.[136] As discussed above, at the time of the 1934 Act, Congress obviously did not foresee the advent of disregarded entities and the novel tax issues they raise. For example, by using a disregarded entity, Acquirer generally can be treated as acquiring Target's assets for tax purposes without Acquirer's participation in the acquisition transaction for corporate law purposes. Recognizing this, the 2001 Proposed Regulations essentially interpreted section 368(a)(1)(A) to permit a *deemed* state law merger between Acquirer and Target, *i.e.*, a merger that did not occur as a state law matter. In doing so, the Government necessarily concluded that the statute was silent as to the precise issue of the statute's application to DRE Mergers which raise issues that Congress did not foresee (or address) in 1934.[137] Similarly, the Government reasonably can interpret section 368(a)(1)(A) as applying to Functional Mergers, which satisfy the substantive requirements of a technical merger (without a statutory mechanic) and include Target's U.S. tax (but not legal) dissolution. In addition, as discussed above, our regulatory guidance would be consistent with the congressional intent in the 1934 Act to align the definition of a reorganization "more closely to the general requirements of corporation law," and, in doing so, prohibit transactions that, in substance, are sales from qualifying as a tax-free reorganization.[138]

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[135] *United States v. Mead Corp.*, 533 U.S. 218, 229 (2001) (internal quotations omitted).

[136] I.R.C. § 7805(a).

[137] The Government's conflicting positions in the 2000 Proposed Regulations and the 2001 Proposed Regulations also demonstrate that the statute's application to transactions involving disregarded entities is subject to more than one reasonable interpretation.

[138] H.R. Rep. 73-704 (1934), 1939-1 C.B. at 564.

The decisions of the Courts of Appeals in *McNamee v. Department of the Treasury*[139] and *Littriello v. United States*[140] upholding the validity of the CTB Regulations are instructive in terms of the deference courts grant the Government in its application of longstanding Code provisions to entities such as LLCs and transactions involving them. In those cases, a disregarded entity's owner assessed for the entity's unpaid employment taxes[141] unsuccessfully argued that the CTB Regulations were inconsistent with the longstanding statutory definitions of "corporation" and "partnership" in the Code and thus were invalid.[142] In rejecting the challenge in *McNamee*, the Court of Appeals for the Second Circuit determined: "In light of the emergence of limited liability companies and their hybrid nature, and the continuing silence of the Code on the proper tax treatment of such companies in the decade since the present regulations became effective, we cannot conclude that the above Treasury Regulations, providing a flexible response to a novel business form, are arbitrary, capricious, or unreasonable."[143]

These principles support the determination that our proposed regulatory amendments satisfy Step One. In most cases, a Stock Acquisition/Conversion will involve a corporation's conversion to an LLC, the entity whose classification was at issue in *McNamee* and *Littriello*, and the other cases involving a conversion or a Stock Acquisition/CTB Election involve hybrid entities that are very similar to an LLC. *McNamee* and *Littriello* addressed the application of the entity classification statute in section 7701 to LLCs and similar hybrid entities, while this article addresses the application of section 368(a)(1)(A) to acquisitions involving LLCs and other hybrid entities. The statutes are similarly silent regarding their application to hybrid entities and acquisitions involving such entities.

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139 488 F.3d 100 (2d Cir. 2007).

140 484 F.3d 372 (6th Cir. 2007), *cert. denied*, 552 U.S. 1186 (2008).

141 The Government subsequently finalized Treasury Regulations that generally treat a disregarded entity as a corporation for employment tax purposes. *See* Treas. Reg. § 301.7701-2(c)(2)(iv)(A).

142 *See McNamee*, 488 F.3d at 109; *Littriello*, 484 F.3d at 378.

143 *McNamee*, 488 F.3d at 109.

Finally, the Supreme Court's recent decision in *U.S. v. Home Concrete & Supply, LLC*[144] would not bar adoption of our proposed treatment. In *Home Concrete*, the Court ruled that one of its prior decisions controlled over a contrary interpretation of the Code set forth in the Treasury Regulations. Functional Mergers are relatively new structures.[145] The case law addressing A reorganizations generally interprets the applicable Treasury Regulations, and no case law specifically addresses the treatment of a Functional Merger as an A reorganization.[146] Accordingly, case law does not foreclose the Government's adoption of our interpretation of section 368(a)(1)(A).

Based on the foregoing, our proposed regulatory amendments satisfy Step One.

B. *Chevron* Step Two

Step Two requires that our proposed regulatory amendments represent a "permissible construction" of section 368(a)(1)(A).[147] For the reasons discussed above, Functional Mergers are the substantive equivalents of a statutory merger or consolidation as currently defined in Treasury Regulation section 1.368-2, and amending the regulations to treat these transactions as A reorganizations would continue the Government's logical extension of the regulations to address modern commercial realities and avoid traps for the unwary. Our proposal also would

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144 *United States v. Home Concrete & Supply, LLC*, 132. S. Ct. 1836 (2012).

145 In 1977, Wyoming became the first state to enact an LLC statute. *See* 1977 Wyo. Sess. Laws ch. 158, § 1 (1977). In 1997, the Government finalized the CTB Regulations. *See* T.D. 8697, 1997-1 C.B. 215.

146 *See Russell v. Comm'r*, 40 T.C. 810, 822-23 (1963); *Andersen v. Comm'r*, 23 T.C.M. (CCH) 589, 1964 Tax Ct. Memo. LEXIS 237, at 20 (1964) (citing former Treasury Regulations in holding that A reorganization treatment required state law merger); *cf. George v. Comm'r*, 26 T.C. 396, 403-04 (1956) (acquisition qualified as a C reorganization; court declined to address whether acquisition, which failed technical state law requirements, also qualified as an A reorganization).

147 *Chevron*, 467 U.S. at 843.

be consistent with a disregarded entity's status as a division of its owner and would give effect to the tax consolidation of Acquirer's and Target's assets and liabilities that occurs pursuant to a Functional Merger. For these reasons, our proposed regulatory amendments are a reasonable interpretation of the statute.[148]

The Supreme Court's decision in *Mayo Foundation for Medical Education & Research v. United States*[149] reinforces this conclusion. In *Mayo*, the Supreme Court clarified that courts should assess the validity of tax regulations under Step Two in *Chevron*, rather than a less deferential, multi-factor standard used in *National Muffler Dealers Association, Inc. v. United States*,[150] which preceded *Chevron*.[151] In doing so, the Court clarified that tax regulations under the Code are subject to the same standard as other regulations and reasoned that "[f]illing gaps in the Internal Revenue Code plainly requires the Treasury Department to make interpretive choices for statutory implementation at least as complex as the ones other agencies must make in administering their statutes."[152] In *Mayo*, the Court declined to view regulations with "heightened skepticism" where the regulations varied over time or the Government adopted the regulations many years after the relevant statute's enactment or because of the manner in which the regulations evolved.[153] Instead, in an area of law as complex as tax, "'the agency Congress vests with administrative responsibility must be able to exercise its discretion to meet changing conditions and new problems.'"[154]

Mayo also rejected the suggestion that courts owed the Government less deference with respect to Treasury Regulations enacted pursuant to the general grant of authority under section 7805(a), which would be the case if the Government adopts our

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148 *See id.* at 844.

149 131 S. Ct. 704 (2011).

150 440 U.S. 472 (1979).

151 *Mayo*, 131 S. Ct. at 712.

152 *Id.*

153 *Id.*

154 *Id.* at 713 (quoting *Bob Jones Univ. v. United States*, 461 U.S. 574, 596 (1983)).

proposed regulatory amendments, than with respect to regulations enacted pursuant to a specific grant of authority. Rather, general and specific grants of authority are equivalent, and section 7805(a) authority is "a very good indicator of delegation meriting *Chevron* treatment."[155]

The Government clearly has the authority to modify the Treasury Regulations under section 368(a)(1)(A) to reflect changing circumstances, including the emergence of new legal entities and acquisition structures. More specifically, it would be a permissible construction of section 368(a)(1)(A) to amend the regulations to permit Functional Mergers to qualify as A reorganizations given that these transactions are the substantive equivalents of technical mergers.

Accordingly, our proposed regulatory amendments satisfy Step Two and would be valid.

V. CONCLUSION

The meaning of a statutory merger or consolidation in section 368(a)(1)(A) has not been static. Rather, the term has evolved over time to extend A reorganization treatment to new transactions, unforeseen in 1934, that effectively combine Target's and Acquirer's assets and liabilities for U.S. tax purposes. Significantly, in the course of this evolution, the Government has appropriately recognized that A reorganization treatment is available even where Target's assets and liabilities do not become the direct assets and liabilities of Acquirer pursuant to a statutory mechanic. A DRE Merger, which can qualify as an A reorganization even though no state law merger occurs between Acquirer and Target, is perhaps the most powerful example of this development. Just as a DRE Merger qualifies as an A reorganization because of a fictional merger between Acquirer and

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[155] *Id.* at 714 (internal quotations omitted). In addition, *Mayo* noted that the Government adopted the Treasury Regulations at issue there only after notice and comment procedures, which the Court treated as an important indicator that the regulations warranted *Chevron* deference. *Id.* The Government presumably would follow similar notice and comment procedures if it were to adopt our proposed regulatory amendments.

Target, the Government similarly can treat a Functional Merger, which is the substantive equivalent of a technical merger, as a statutory merger or consolidation under the Treasury Regulations. In addition, as discussed above, Target's legal dissolution is not necessary for A reorganization purposes, and Target's U.S. tax dissolution should suffice. Finally, our proposed regulatory amendment to allow Functional Mergers to qualify as A reorganizations would not conflict with Congress's intent in enacting A reorganizations, which was to preserve COI by Target's shareholders, and would be valid under *Chevron* and its progeny.

APPENDIX

1. In Treasury Regulation section 1.368-2(b)(1)(ii), **<u>add</u>** the italicized language: "a statutory merger or consolidation is a transaction *(A)* 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, *or (B) in which the following events occur pursuant to a plan that includes the acquisition of all of the outstanding stock of the combining entity of each transferor unit.*"; and

   <u>replace</u> "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.";

   with: "The combining entity of each transferor unit ceases its separate existence for all Federal income tax purposes."

2. Revise Example 9 in Treasury Regulation section 1.368-2(b)(1)(iii) to provide that the transactions described therein qualify as an A reorganization.