

PRACTICING LAW INSTITUTE  
TAX STRATEGIES FOR CORPORATE ACQUISITIONS,  
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FINANCINGS, REORGANIZATIONS AND  
RESTRUCTURINGS 2005

Proposed Regulations Would Permit Cross-Border “A” Reorganizations  
For the First Time in 70 Years

July 2005

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**I. INTRODUCTION**

Section 368(a)(1)(A)<sup>1</sup> provides that the term “reorganization” includes “a statutory merger or consolidation.” Since 1935, this term has been defined to exclude mergers under foreign law. On January 5, 2005, however, the Department of the Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued proposed amendments to Temp. Treas. Reg. § 1.368-2(b)(1) (which defines the term “statutory merger or consolidation”) that would reverse this longstanding interpretation – an interpretation for which there is no strong policy support. The proposed amendments expand the definition of statutory merger to include certain mergers effected pursuant to the laws of a foreign country or a United States territory in addition to the laws of the United States, a State, or the District of Columbia. The proposed amendments also remove the limitations in the current temporary regulations on the ability of a target corporation to merge into a foreign corporation or disregarded entity. In order to qualify as a merger, however, cross-border mergers must satisfy the same requirements as domestic mergers, namely that the merged entity must transfer all of its assets to the acquiring entity and go out of existence and the shareholders of the merged entity receive acquiring stock.

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<sup>1</sup> Unless otherwise indicated, references to section are to the Internal Revenue Code of 1986, as amended (the “Code”), and to the Treasury Regulations thereunder.

Concurrently with the proposed regulations, Treasury and the Service issued proposed regulations under sections 358, 367, and 884 to address, among other issues, the collateral consequences of cross-border corporate reorganizations.<sup>2</sup>

This article will briefly describe the history of the merger statute and applicable regulations and the amendments in the proposed regulations. The article will then examine the disparities created by the current rules and the benefits provided by the proposed regulations. As discussed herein, the proposed amendments offer additional flexibility for corporate restructurings while preserving the requirements for a merger that have evolved under United States tax law, which limits the potential for any abuse. Treasury and the Service should be commended for the issuance of these proposed regulations.

## **II. BACKGROUND**

### **A. History of Merger Statute**

Section 368(a)(1)(A) includes in the term “reorganization” a “statutory merger or consolidation” (an “A” reorganization). The provision originated in 1921, when the statute defined reorganization to include 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).”<sup>3</sup>

In 1934, Congress separated this rule into two distinct provisions. The predecessor of sections 368(a)(1)(B) and (C) treated as a reorganization “the acquisition by one corporation in exchange solely for all or part of its voting stock: of at least 80 per centum of the

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<sup>2</sup> A detailed discussion of these proposed regulations is beyond the scope of this article.

<sup>3</sup> Revenue Act of 1921, ch. 136, section 202(c)(2), 42 Stat. 227, 230.

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 substantially all the properties of another corporation.”<sup>4</sup> The predecessor of section 368(a)(1)(A) continued to treat a ”merger or consolidation” as a reorganization but qualified the term with the word “statutory.”<sup>5</sup> The legislative history explained that the qualification was intended to make the definition conform more closely to the general requirements of corporation law.<sup>6</sup>

B. History of Merger Regulations

Since they were promulgated in 1935, the corporate reorganization regulations defined the phrase “statutory merger or consolidation” as a “merger or a consolidation effected in pursuance of the corporation laws of a State or Territory or the District of Columbia.”<sup>7</sup> Thus, the statute has always been interpreted to exclude mergers involving foreign corporations.<sup>8</sup>

Effective on January 1, 1997, the so-called check-the-box regulations introduced the concept of a disregarded entity, which is an entity that is ignored as separate from its owner

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<sup>4</sup> Revenue Act of 1934, ch. 277, section 112(g)(1)(B), 48 Stat. 680, 705.

<sup>5</sup> Revenue Act of 1934, ch. 277, section 112(g)(1)(A), 48 Stat. 680, 705.

<sup>6</sup> H.R. Rep. No. 73-704, at 14 (1934). The separation of the two provisions was intended to permit reorganization treatment for transactions that were sufficiently similar to mergers or consolidations, even though mergers and consolidations were not permitted in all 48 states and were not generally permitted between corporations organized in different states. S. Rep. No. 73-558, at 16-17 (1934).

<sup>7</sup> Art. 112(g)-2, 1934 Act Regulations 86 (1935). The definition was modified later in 1935 to add a reference to the laws of the United States. See T.D. 4585, XIV-2 C.B. 54-55 (1935). This modified definition was unchanged by later iterations of the regulations. See Treas. Reg. § 1.368-2(b) (Jan. 1, 1955) and the amendments to Treas. Reg. § 1.368-2 by T.D. 7422 (Jan. 1, 1976).

<sup>8</sup> See also Rev. Rul. 57-465, 1957-2 C.B. 250 (concluding that a merger between two foreign corporations could not, by definition, qualify as an “A” reorganization).

for federal tax purposes.<sup>9</sup> These regulations required Treasury and the Service to revisit the definition of statutory merger or consolidation to consider how it should be applied in the context of disregarded entities. On May 16, 2000, Treasury and the Service issued proposed regulations under section 368(a)(1)(A).<sup>10</sup> The 2000 proposed regulations retained the same basic definition of statutory merger or consolidation as the 1955 regulations, except that they deleted the word “corporation” in order to conform the regulations to the Service’s long-standing position that a merger or consolidation may qualify as an “A” reorganization even if it is undertaken pursuant to laws other than the corporation law of the relevant jurisdiction.<sup>11</sup> The 2000 proposed regulations also added certain requirements to qualify as an “A” reorganization:<sup>12</sup>

In order to qualify as a reorganization under section 368(a)(1)(A), the transaction must be a merger or consolidation involving two corporations effected pursuant to the laws of the United States or a State or territory, or the District of Columbia. In addition, by operation of such a merger law, the transaction must result in one corporation acquiring the assets of the merging corporation and the merging corporation ceasing to exist. Similarly, by operation of such a consolidation law, the transaction must result in one newly formed corporation acquiring the assets of both consolidating corporations, and both consolidating corporations ceasing to exist.

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<sup>9</sup> Treas. Reg. § 301.7701-3(a). Thus, the assets and liabilities of a disregarded entity are treated as owned, and its activities are treated as actually performed, by its owner. If the owner is a corporation, the activities of the disregarded entity are treated as if they were conducted by a division or a branch of the corporation. Treas. Reg. § 301.7701-2(a).

<sup>10</sup> Prop. Treas. Reg. § 1.368-2(b)(1) (May 16, 2000) (the “2000 proposed regulations”).

<sup>11</sup> See Rev. Rul. 84-104, 1984-2 C.B. 94 (treating a consolidation pursuant to the National Banking Act, 12 U.S.C. 215, as a merger for federal tax purposes).

<sup>12</sup> Prop. Treas. Reg. § 1.368-2(b)(1) (emphasis added).

These additional requirements were consistent with existing case law.<sup>13</sup> The 2000 proposed regulations took the position that the merger of a target corporation into a disregarded entity owned by a corporation could not qualify as an “A” reorganization, because the owner of the disregarded entity, the only potential “party to the reorganization” within the meaning of section 368(b), was not a party to the state or federal law merger transaction.<sup>14</sup>

Commentators criticized the 2000 proposed regulations as being inconsistent with the check-the-box regulations, which treat a disregarded entity as not separate from the corporate owner for all federal tax purposes. On November 15, 2001, the Treasury and the Service withdrew the 2000 proposed regulations and issued new proposed regulations that permitted certain statutory mergers into disregarded entities to qualify as “A” reorganizations, if all of the

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<sup>13</sup> See, e.g., Vulcan Materials Co. v. United States, 446 F.2d 690, 694 (5th Cir. 1971) (stating that “the distinguishing characteristics of a merger are (1) an assumption by the surviving corporation ‘of all the rights and liabilities of the disappearing entities,’ . . . and (2) the cessation of the ‘separate existence of all the constituent corporations . . . except the one into which the others of such constituent corporations have been merged. . . .’”) (citations omitted); Fisher v. Commissioner, 108 F.2d 707, 709 (6th Cir. 1939) (stating that “[a] merger ordinarily is the absorption by one corporation of the properties and franchises of another whose stock it has acquired. . . . In cases of merger, the merged corporation ceases to exist”); Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932) (stating that “[a] merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock is 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. In each case interests of the stockholders and creditors of any company which disappears remain and are retained against the surviving or newly created company.”); Rev. Rul. 2000-5, 2000-1 C.B. 436 (stating that “[h]istorically, corporate law merger statutes have operated to ensure that ‘[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.’”).

<sup>14</sup> Preamble to Prop. Treas. Reg. § 1.368-2(b)(1), 65 Fed. Reg. 31,115, 31,117 (2000). The 2000 proposed regulations also took the position that a merger of the disregarded entity into the target could not qualify as a merger because such a transaction would be divisive and, therefore, in violation of the additional requirements for a merger imposed by the 2000 proposed regulations. Id. at 31,116-31,117. This continues to be the case under the current temporary regulations.

assets and liabilities of the target were transferred to the acquiror and the target went out of existence.<sup>15</sup> The 2001 proposed regulations did not substantively change the definition of statutory merger or consolidation from the 2000 proposed regulations, except to delete the word “Territory” from the types of jurisdictions pursuant to the laws of which a transaction may be effected. This change was intended to make the definition of statutory merger or consolidation consistent with the definition of domestic under section 7701(a)(4).<sup>16</sup> As discussed below, however, a number of new terms were introduced in order to accommodate the application of the regulation to disregarded entities. Also, as discussed below, mergers involving one or more foreign entities were carved out of the 2001 proposed regulations, because cross-border mergers were the subject of a separate guidance project.<sup>17</sup>

On January 24, 2003, Treasury and the Service made certain minor clarifications to the 2001 proposed regulations and issued them as temporary regulations.<sup>18</sup>

On January 5, 2005, Treasury and the Service completed the next phase of their anticipated guidance project on cross-border mergers, and issued proposed regulations under sections 358, 367, and 884 to address the collateral consequences of cross-border corporate reorganizations. For example, the proposed regulations include special basis rules that are intended to preserve section 1248 amounts in reorganizations and priority rules where sections

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<sup>15</sup> Prop. Treas. Reg. § 1.368-2(b)(1) (Nov. 15, 2001) (the “2001 proposed regulations”).

<sup>16</sup> Preamble to Prop. Treas. Reg. § 1.368-2(b)(1), 66 Fed. Reg. 57,400, 57,401 (2001). Section 7701(a)(4) defines the term “domestic” when applied to a corporation or partnership as “created or organized in the United States or under the law of the United States or of any State . . . .” I.R.C. § 7701(a)(4), as amended by section 1906(c) of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1525.

<sup>17</sup> Preamble to Prop. Treas. Reg. § 1.368-2(b)(1), 66 Fed. Reg. at 57,401.

<sup>18</sup> Temp. Treas. Reg. § 1.368-2T(b)(1) (Jan. 24, 2003) (the “2003 temporary regulations”).

367(a) and (b) both apply to a transaction. As a result of the completion of this phase of the guidance project, Treasury and the Service proposed amendments to the 2003 temporary regulations that would expand the definition of statutory merger or consolidation to include transactions effected pursuant to the laws of a foreign country or a United States territory and eliminate the carve-out for mergers involving foreign entities.<sup>19</sup>

C. Description of 2003 Temporary Regulations and 2005 Proposed Regulations

1. 2003 Temporary Regulations

The 2003 temporary regulations define a statutory merger or consolidation as follows:<sup>20</sup>

[A] transaction effected pursuant to the laws of the United States or a State or the District of Columbia in which, as a result of the operation of such laws, the following events occur simultaneously at the effective time of the transaction—

(A) All of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (each a transferor unit) become the assets and liabilities of one or more members of one other combining unit (transferee unit); and<sup>21</sup>

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<sup>19</sup> Prop. Treas. Reg. § 1.368-2(b)(1) (Jan. 5, 2005) (“2005 proposed regulations”).

<sup>20</sup> Temp. Treas. Reg. § 1.368-2T(b)(1)(ii).

<sup>21</sup> The requirement that all of the assets of the transferor unit be transferred is not intended to impose a “substantially all” requirement on “A” reorganizations. Rather, it is intended to ensure that divisive transactions do not qualify as “A” reorganizations. Thus, a transaction that is preceded by a distribution of assets by the combining entity of the transferor unit to its shareholders may qualify as a statutory merger even if the substantially all requirement applicable to certain other types of reorganizations would not be satisfied. Prop. Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 8; Temp. Treas. Reg. § 1.368-2T(b)(1)(iv), Ex. 8; Preamble to Prop. Treas. Reg. § 1.368-2(b)(1), 66 Fed. Reg. at 57,401; Preamble to Temp. Treas. Reg. § 1.368-2T(b)(1), 68 Fed. Reg. 3384, 3385 (2003).

(B) The combining entity of each transferor unit ceases its separate legal existence for all purposes . . . .

Several new terms were introduced by the 2003 temporary regulations for purposes of defining statutory merger or consolidation to accommodate disregarded entities. A disregarded entity is defined as a business entity that is disregarded as an entity separate from its owner for federal tax purposes. Examples include domestic single-member limited liability companies that do not elect to be treated as corporations, qualified REIT subsidiaries, and qualified subchapter S subsidiaries.<sup>22</sup> A combining entity is defined as a business entity that is a corporation (as defined in Treas. Reg. § 301.7701-2(b)) that is not a disregarded entity.<sup>23</sup> A combining unit is comprised solely of a combining entity and all disregarded entities, if any, owned by the combining entity.<sup>24</sup>

A simple example illustrates how the temporary regulations apply to mergers involving corporations and disregarded entities.

Example 1 – Basic Disregarded Entity Merger: P, a corporation, forms a wholly owned limited liability company (“LLC”), which is treated as a disregarded entity. T, an unrelated corporation, merges into LLC pursuant to a state merger statute, with the T shareholders receiving P voting stock.

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<sup>22</sup> Temp. Treas. Reg. § 1.368-2T(b)(1)(i)(A).

<sup>23</sup> Temp. Treas. Reg. § 1.368-2T(b)(1)(i)(B). Treas. Reg. § 301.7701-2(b) defines a corporation as: (i) a business entity organized under a federal or state statute if the statute describes or refers to the entity as incorporated or as a corporation, body corporate, or body politic; (ii) an entity that defaults to or elects association status under Treas. Reg. § 301.7701-3; (iii) a business entity organized under a state statute if the statute describes or refers to the entity as a joint-stock company or joint-stock association; (iv) an insurance company; (v) a state-charged business entity conducting banking activities if any of its deposits are insured under the Federal Deposit Insurance Act or a similar federal statute; (vi) a business entity wholly owned by a state or political subdivision thereof, or a business entity wholly owned by a foreign government or any other entity described in Treas. Reg. § 1.892-2T; (vii) a business entity that is taxable as a corporation under a provision of the Code other than section 7701(a)(3); and (viii) certain specifically enumerated foreign entities (known as “per-se corporations”).

<sup>24</sup> Temp. Treas. Reg. § 1.368-2T(b)(1)(i)(C).

Under the 2003 temporary regulations, this transaction would qualify as a statutory merger for purposes of section 368(a)(1)(A). In this example, T is a combining entity; because it owns no disregarded entities, it is also a combining unit; and because it is transferring the assets and liabilities pursuant to the merger, it is the transferor unit. P is also a combining entity; P and LLC together constitute a combining unit; and because they are receiving the assets and liabilities in the merger, they are the transferee unit. Because all of the assets and liabilities of T (the transferor unit) become the assets and liabilities of one or more members of the transferee unit (here, LLC), and T goes out of existence, the transaction qualifies as a statutory merger.<sup>25</sup> Note that T could have distributed a significant portion of its assets (e.g., half) prior to the merger without disqualifying the merger, because section 368(a)(1)(A) does not impose a substantially all requirement.<sup>26</sup>

The 2003 temporary regulations carve out mergers involving foreign entities. The 2003 temporary regulations provide that the following entities must be domestic: (i) the combining entity of the transferor unit; (ii) the combining entity of the transferee unit; (iii) any disregarded entity of the transferee unit that receives assets in the merger; and (iv) any entity between the combining entity of the transferee unit and the disregarded entity receiving the

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<sup>25</sup> Temp. Treas. Reg. § 1.368-2T(b)(1)(iv), Ex. 2.

<sup>26</sup> Prop. Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 8; Temp. Treas. Reg. § 1.368-2T(b)(1)(iv), Ex. 8. However, T could not dispose of an amount of assets that would cause it to fail to satisfy the continuity of business enterprise requirement of Treas. Reg. § 1.368-1(d). The “substantially all” requirement is discussed in more detail in section III.A.1., below.

assets.<sup>27</sup> The reason for the carve-out was that mergers involving foreign entities were the subject of a separate guidance project.<sup>28</sup>

Example 2 – Foreign Entity Carve-Out: P, a corporation, owns a wholly owned foreign disregarded entity, FDE, and FDE wholly owns a US disregarded entity, USDE. T, an unrelated corporation, merges into FDE pursuant to a state statutory merger, with the T shareholders receiving P stock.

In this example, both combining entities (T and P) are domestic. However, the disregarded entity receiving the assets (FDE) is foreign. Thus, the merger is carved out of the definition of a statutory merger under Temp. Treas. Reg. § 1.368-2T(b)(1)(iii). Similarly, if T had merged into USDE, the merger would be carved out of the definition of statutory merger, because the entity between the combining entity of the transferee unit (P) and the disregarded entity receiving the assets (USDE) must also be domestic.

## 2. 2005 Proposed Regulations

The 2005 proposed regulations expand the definition of statutory merger or consolidation to encompass transactions effected pursuant to the laws of foreign countries and US territories.<sup>29</sup> They accomplish this by changing the language “a transaction effected pursuant to the laws of the United States or a State or the District of Columbia” to “a transaction effected

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<sup>27</sup> Temp. Treas. Reg. § 1.368-2T(b)(1)(iii).

<sup>28</sup> Preamble to Prop. Treas. Reg. § 1.368-2(b)(1), 66 Fed. Reg. at 57,401; Preamble to Temp. Treas. Reg. § 1.368-2T(b)(1), 68 Fed. Reg. at 3386.

<sup>29</sup> This expansion of the definition of statutory merger or consolidation had been suggested to Treasury and the IRS at least as early as 2000. See Letter from the New York State Bar Association, Tax Section, to Charles O. Rossotti and Jonathan Talisman (Apr. 6, 2000) (published in *Worldwide Tax Daily*, 2000 WTD 83-35); see also Thomas L. Evans, “Respecting Foreign Mergers Under U.S. Law,” 21 *Tax Notes Int'l* 393 (July 24, 2000) (both urging Treasury and the IRS to expand the definition of statutory merger or consolidation to include certain mergers effected pursuant to foreign law).

pursuant to the statute or statutes necessary to effect the merger or consolidation.”<sup>30</sup> The preamble states that the phrase “statute or statutes” is not intended to prevent transactions effected pursuant to legislation from qualifying as mergers or consolidations where such legislation is supplemented by administrative or case law.<sup>31</sup> The 2005 proposed regulations contain the following example to illustrate the expanded rule:

Example 3 – Foreign Merger: Z and Y are entities organized under the laws of Country Z and classified as corporations for federal tax purposes. Z and Y combine. Pursuant to the statutes of Country Q, the following events occur simultaneously: all of the assets and liabilities of Z become the assets and liabilities of Y, and Z’s separate existence ceases for all purposes.

The example concludes that the transaction qualifies as a statutory merger or consolidation, because (i) the assets and liabilities of Z, the combining entity and sole member of the transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and (ii) Z ceases its separate legal existence for all purposes.<sup>32</sup>

The preamble to the 2005 proposed regulations explains the reason for the expanded definition. Although there was no indication in the legislative history of the 1934 changes to the definition of reorganization that Congress intended to exclude transactions effected under foreign law, Treasury regulations adopted in 1935 interpreted the term “statutory merger” to mean a transaction effected pursuant to domestic laws. Treasury and the Service continue to believe that such a restriction is a reasonable interpretation of the statute, but they nonetheless believe that changes in the purposes of the statute and in both domestic and foreign

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<sup>30</sup> Compare Temp. Treas. Reg. § 1.368-2T(b)(1)(ii) with Prop. Treas. § 1.368-2(b)(ii).

<sup>31</sup> Preamble to Prop. Treas. Reg. § 1.368-2(b)(1), 70 Fed. Reg. 746, 746 (2005).

<sup>32</sup> Prop. Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 9.

law since 1935 warrant a reexamination of the definition. The preamble notes that many foreign jurisdictions now have merger or consolidation statutes that operate in material respects like those of the states—that is, assets and liabilities transfer by operation of law—and that transactions effected pursuant to such statutes should be treated as reorganizations if they otherwise satisfy the functional criteria applicable to domestic transactions.<sup>33</sup>

The 2005 proposed regulations also delete the carve-out for mergers involving foreign entities. As a result, a transaction may qualify as a statutory merger or consolidation regardless of whether the following entities are foreign or domestic: (i) the combining entity of the transferor unit; (ii) the combining entity of the transferee unit; (iii) any disregarded entity of the transferee unit that receives assets in the merger; and (iv) any entity between the combining entity of the transferee unit and the disregarded entity receiving the assets.<sup>34</sup>

### **III. ANALYSIS OF 2005 PROPOSED REGULATIONS**

#### **A. Benefits of 2005 Proposed Regulations**

##### **1. In General**

In general, US residents that own shares of foreign corporation stock (“US Shareholders”) must determine the US tax consequences of holding their shares by applying US law. Accordingly, a US shareholder of a foreign corporation that engages in a merger transaction under foreign law may be subject to US tax unless the transaction qualifies as a “reorganization” under section 368(a)(1). Under current law, a merger transaction effected pursuant to foreign law does not qualify as an “A” reorganization, because, as noted above, by

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<sup>33</sup> Preamble to Prop. Treas. Reg. § 1.368-2(b)(1), 70 Fed. Reg. at 746.

<sup>34</sup> See Preamble to Prop. Treas. Reg. § 1.368-2(b)(1), 70 Fed. Reg. at 746; Temp. Treas. Reg. § 1.368-2T(b)(1)(iii).

definition, such a transaction cannot be a “statutory merger or consolidation.” Likewise, forward-triangular mergers<sup>35</sup> and reverse triangular mergers<sup>36</sup> undertaken pursuant to foreign law are not available because both types of reorganizations require that the transaction would otherwise qualify as an “A” reorganization. As a result, merger transactions carried out under foreign law are treated as tax-free reorganizations under US law only if they satisfy the more stringent requirements of section 368(a)(1)(C) (a “C” reorganization)<sup>37</sup> or 368(a)(1)(D) (a “D” reorganization).<sup>38</sup>

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<sup>35</sup> I.R.C. § 368(a)(2)(D).

<sup>36</sup> I.R.C. § 368(a)(2)(E).

<sup>37</sup> A transaction will qualify as a “C” reorganization only if it meets a number of requirements that are not applicable to “A” reorganizations. First, the acquisition of the target company’s assets must be in exchange solely for acquiring company voting stock. I.R.C. § 368(a)(1)(C). The so-called boot relaxation rule does allow a limited amount of “boot” (i.e., cash or other property) to be used as consideration, but the amount of boot may not exceed 20% of the total consideration. I.R.C. § 368(a)(2)(B)(iii). However, for purposes of computing the 20% limit, assumptions of target liabilities by the acquiring corporation are treated as boot, which in most cases forecloses the ability to use the boot relaxation rule. I.R.C. § 368(a)(2)(B).

Second, the acquiring corporation must acquire “substantially all” of the target company’s assets in the transaction. For advance ruling purposes, the Service defines substantially all as assets representing at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets held by the corporation immediately prior to the transfer. Rev. Proc. 77-37, 1977-2 C.B. 568.

<sup>38</sup> The “D” reorganization requirements are similarly narrow and are unlikely to apply to most acquisitive foreign merger transactions, because a transaction qualifies as a “D” reorganization treatment only if the merging corporations are “controlled” by the same group of shareholders. I.R.C. § 368(a)(1)(D). For purposes of this rule, “control” is defined as 50% or more of the total voting power or value or the outstanding shares of the corporation. I.R.C. §§ 368(a)(2)(H)(i); 304(c)(1). As a result, the typical merger scenario where the target shareholders receive a minority interest in the acquiring corporation does not qualify as a “D” reorganization. In addition, like the “C” reorganization, the “D” reorganization has a substantially all requirement. I.R.C. § 354(b)(1)(A).

## 2. Current Law Results in Disparate Treatment of US and Foreign Entities

As the following examples demonstrate, a foreign merger transaction may be taxable for US tax law purposes even though, had the transaction been effected pursuant to US state or federal merger law, the transaction would have been tax free.

### Example 4 – Amalgamation Qualifying as a “C” Reorganization:

T, a Province Q Limited Company with a single US shareholder (SH), amalgamates with P, also a Province Q Limited Company, pursuant to the law of Province Q. By operation of law, the assets of T and P become assets of a new entity (“Amalco”), P and T cease their separate existence, and SH and the P shareholders receive shares of Amalco stock as consideration. SH receives 30% of Amalco’s outstanding shares.

Assuming that all other requirements applicable to reorganizations are satisfied,<sup>39</sup> if this transaction were effected under Delaware corporate law it would qualify as a statutory merger or consolidation and, therefore, as an “A” reorganization. However, because the transaction is carried out under Province Q law and not US law, it cannot qualify as an “A” reorganization under current law. The amalgamation would not qualify as a “D” reorganization because SH does not own 50% or more of Amalco’s outstanding stock (by vote or value) after the transaction is completed. However, the transaction should qualify as a “C” reorganization since SH receives solely Amalco voting stock as consideration and Amalco acquires substantially all of the T and P assets in the transaction.

A slight change in the facts can lead to a different outcome under the US reorganization rules. Consider the following examples.

### Example 5 – Amalgamation Not Qualifying as a Reorganization:

Same facts as Example 4, except that, immediately before the amalgamation, T distributes more than 20% of its assets to SH.

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<sup>39</sup> In particular, these examples assume that the transaction satisfies the business purpose, continuity of interest, and continuity of business enterprise requirements. See Treas. Reg. § 1.368-1(d), (e).

If this transaction were effected under Delaware corporate law it would qualify as an “A” reorganization. However, this transaction cannot qualify as an “A” reorganization under current law, because it is not pursuant to US law. The transaction would still not qualify as a “D” reorganization because of the failure to satisfy the control requirement. In addition, the transaction would not qualify as a “C” reorganization because Amalco did not acquire substantially all of T’s assets in the transaction.

Example 6 – Fusion Not Qualifying as a Reorganization: T, is a country M entity treated as a corporation for US tax purposes. U, a US corporation, owns all of the outstanding shares of T. In a “fusion” transaction carried out pursuant to country M law, T transfers all of its assets to P (also a country M entity treated as a corporation for US tax purposes), dissolves, and U receives P shares and cash as consideration. The cash constitutes 50% of the total consideration paid by P in the transaction and the shares of P stock represent a 5% interest in P.

If this transaction were effected under Delaware law, it would qualify as an “A” reorganization. However, this transaction cannot qualify as an “A” reorganization under current law, because it is not pursuant to US law. In addition, the transaction would not qualify as a “C” reorganization because the amount of boot in the transaction exceeds 20% of the total consideration. The transaction also would not qualify as a “D” reorganization because U does not control P when the transaction is completed.

For a variety of reasons, the parties to the above transactions may find it difficult to find a structure that satisfies the US reorganization requirements. In Example 5, P may be unable (or unwilling) to receive the assets that T distributed to SH, or SH may be unwilling to give up control of the distributed assets. In Example 6, P may be unable (or unwilling) to reduce the amount of cash consideration and increase the amount of P stock offered to U, because P may want to limit U’s ownership interest in P. On the other hand, U may not be interested in

receiving less cash in the deal. If the shareholder in each case is also concerned about having to pay additional US tax as a result of the transaction, the parties could find themselves at an impasse that could require a significant amount of time and effort to overcome.

3. The 2005 Proposed Regulations Eliminate the Disparity

There is no policy reason to treat the transaction differently depending on whether the entities are foreign or domestic. The proposed regulations would eliminate the disparate treatment in Examples 4-6, above. In Examples 4 and 5, the amalgamation would qualify as an “A” reorganization, because it is a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation (i.e., Province Q amalgamation law), all of the assets (other than those distributed in the transaction) and liabilities (except to the extent satisfied or discharged in the transaction) of each member of one or more combining units (i.e., P and T) become the assets and liabilities of one or more members of another combining unit (i.e., Amalco), and P and T cease to exist. In Example 6, the fusion would qualify as an “A” reorganization, because it is effected pursuant to the statute or statutes necessary to effect the merger or consolidation (i.e., Country M fusion law), all of the assets and liabilities of T become the assets and liabilities of P, and T ceases to exist.

Thus, the proposed regulations reduce or eliminate many of the issues described above, thereby saving P, T, and their shareholders significant amounts of time and money in negotiating a tax efficient transaction structure that was acceptable for tax and non-tax reasons to all involved.

The proposed regulations would also eliminate a similar disparity with respect to transactions involving disregarded entities. As described above, under current law, a transaction effected pursuant to US law in which the assets and liabilities of a target corporation become

assets of a non-US disregarded entity does not qualify as an “A” reorganization. Under the proposed regulations, which would eliminate Temp. Treas. Reg. § 1.368-2T(b)(1)(iii), the transaction described in Example 2, above, should qualify as an “A” reorganization, provided that all of the other requirements applicable to an “A” reorganization are satisfied.

While the proposed regulations clearly benefit US shareholders, they also benefit foreign corporations with substantial US shareholder pools that have historically been required for practical business reasons to structure their transactions to satisfy the narrow “C” or “D” reorganization requirements while simultaneously working to prevent the transaction from becoming taxable under local law.<sup>40</sup> This balancing act generally requires a substantial amount of time and effort (as well as money) which in the end may result in a structure that is optimal for neither the corporation nor its shareholders.

As the following example demonstrates, the proposed regulations also afford US corporations with foreign subsidiaries some additional flexibility in making foreign acquisitions.

Example 7 – Triangular Merger: P, a US corporation, owns all of the outstanding shares of S, a country M entity treated as a corporation for US tax purposes. T is a country M entity treated as a corporation for US tax purposes that has a significant number of US shareholders. In a transaction carried out pursuant to country M law, T transfers all of its assets to S and dissolves. T’s shareholders receive cash and shares of P stock as consideration. The cash constitutes 50% of the total consideration paid by S in the transaction and the shares represent a 5% interest in P.

This transaction would have qualified as a forward triangular merger had it been carried out pursuant to Delaware law. However, because the transaction is carried out under country M law, it cannot qualify as a forward triangular merger under current law. Instead, it

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<sup>40</sup> In many cases, the amount of potential US tax is minute compared to potential tax liability in the local jurisdiction, which makes such structurings particularly inefficient and only adds to the frustration with US law.

must satisfy either the “C” or “D” reorganization rules to qualify for tax-free treatment in the US. The transaction, as structured, could not qualify under the “C” or “D” reorganization rules because of the amount of cash consideration involved. Under the proposed regulations, however, the transaction could qualify as a forward triangular merger.<sup>41</sup>

#### B. Safeguards Provided in 2005 Proposed Regulations

Although the benefits provided by the 2005 proposed regulations are significant, they do not appear to result in potential for abuse. Rather, the rules governing cross-border mergers appear to mirror their domestic counterparts in that foreign law, like state law, provides the means for the combination of entities, while the federal tax law characterizes the combination as a statutory merger or consolidation.<sup>42</sup> This is because all combinations, whether effected pursuant to foreign or domestic law, must result in (i) all of the assets and liabilities of the transferor unit becoming the assets and liabilities of one or more members of the transferee unit, and (ii) the combining entity of the transferor unit ceasing its legal existence for all purposes.<sup>43</sup>

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<sup>41</sup> Practically speaking, however, such structures may not be possible under the corporate laws of many jurisdictions. A Service official recently noted that he hoped other countries will change their laws to accommodate triangular mergers. See Lee Sheppard, “News Analysis: IRS Official Defends Proposed Cross-Border Merger Regs,” 2005 TNT 14-12 (Jan. 24, 2005) (“Hal Hicks, IRS associate chief counsel (international), told the ABA Tax Section’s Foreign Activities of U.S. Taxpayers Committee he hopes that other countries will change their laws.”).

<sup>42</sup> It is well-settled that compliance with a state corporate merger statute does not, by itself, qualify a transaction as an “A” reorganization. See, e.g., Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir. 1951) (holding that a state law merger was not an “A” reorganization because there was not sufficient continuity of interest); Roebing v. Commissioner, 143 F.2d 810 (3d Cir. 1944) (same); Rev. Rul. 2000-5, 2000-1 C.B. 436 (holding that state law merger did not qualify as an “A” reorganization where transaction was divisive).

<sup>43</sup> In addition, the business purpose, continuity of interest, and continuity of business enterprise requirements must be satisfied.

To illustrate these safeguards, consider the applicability of the regulations to mergers involving hybrid and reverse hybrid entities.

Example 8 – Merger Into Hybrid Entity: Y is a Country G entity with two US shareholders, neither of whom is a corporation for US tax law purposes. Y is a hybrid entity, treated as a corporation for Country G tax purposes and as a partnership for US tax purposes. Z is a Country G AG, which is treated as a corporation for both Country G and US purposes. Z merges into Y pursuant to a Country G law that provides for the transfer of all of the assets and liabilities of Z to Y and the cessation of Z's existence for all purposes.

On its face, this example appears similar to Example 9 in the 2005 proposed regulations (i.e., Example 3, above). However, for U.S tax purposes, Y is treated as a partnership. Therefore, Y does not qualify as a combining entity, so there is no transferee unit. Because the assets and liabilities of Z do not become assets and liabilities of one or more members of a transferee unit, the transaction cannot qualify as an “A” reorganization.<sup>44</sup> This is true even if the transaction were reversed, because there likewise cannot be a transferor unit without a combining entity.

What if Y checked the box to elect to be taxed as a corporation for US tax purposes immediately before the merger? If an eligible entity classified as a partnership elects to be classified as an association, the check-the-box regulations deem the following transactions to occur: (i) the partnership is deemed to contribute its assets to a newly formed corporation (“Newco”) in exchange for all of the outstanding stock of Newco; and (ii) the partnership is deemed to distribute the stock of Newco to its partners in complete liquidation.<sup>45</sup> The tax

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<sup>44</sup> Cf. Prop. Treas. Reg. § 1.368-2(b)(1)(iii), Ex. 5.

<sup>45</sup> Treas. Reg. § 301.7701-3(g)(1)(i).

treatment of a change in classification is determined under all relevant provisions of the Code and general principles of tax law, including the step-transaction doctrine.<sup>46</sup>

The deemed contribution of assets to Newco is tested as a section 351 transaction. Section 351(a) provides that no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation if, immediately after the exchange, such person or persons are in control of the corporation.<sup>47</sup> Two issues are raised by the check-the-box election: (i) whether the control immediately after requirement is satisfied, and (ii) whether the deemed section 351 transaction has a sufficient business purpose.

With respect to the control issue, if the Z shareholders obtain more than 20 percent of the stock of the combined entity in the merger, and if the merger of Z into Y is part of the same plan as Y's check-the-box election (i.e., the deemed section 351 transaction), the Service could integrate the transactions and conclude that the shareholders of Y lack the requisite control of Y immediately after the transaction. However, where a section 351 transaction is part of a larger, overall reorganization, the Service has concluded that the other transferors may be treated as co-transferors for purposes of satisfying the control requirement of section 351.<sup>48</sup> Thus, in this

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<sup>46</sup> Treas. Reg. § 301.7701-3(g)(2).

<sup>47</sup> For this purpose, control is defined as at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation. I.R.C. §§ 351(a), 368(c).

<sup>48</sup> See Treas. Reg. § 1.1361-5(b)(3), Ex. 3; Rev. Rul. 76-123, 1976-1 C.B. 94; Rev. Rul. 68-357, 1968-2 C.B. 144. But see Rev. Rul. 68-349, 1968-2 C.B. 143 (concluding otherwise where newly formed corporation was mere continuation of the co-transferor and formed solely for the purpose of enabling the transferor to transfer appreciated assets without gain recognition).

example, Z could be treated as a co-transferor, so that Y's shareholders together with Z satisfy the control requirement.<sup>49</sup>

With respect to the business purpose issue, although neither section 351 nor the regulations thereunder impose a business purpose requirement, there is authority that appears to impose a business purpose requirement on section 351 transactions.<sup>50</sup> Nonetheless, the Service has acknowledged that courts have generally not required a strong showing of business purpose in order to satisfy the section 351 standard.<sup>51</sup> Thus, assuming that Y could point to some

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<sup>49</sup> Even though Z would be treated as a co-transferor for purposes of the transaction qualifying under section 351 with respect to Y and its partners, Z is nonetheless treated as merging into Newco in an "A" reorganization.

<sup>50</sup> See, e.g., Estate of Kluener v. Commissioner, 154 F.3d 630 (6th Cir. 1998); Caruth v. United States, 688 F. Supp. 1129 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989); Rev. Rul. 91-47, 1991-2 C.B. 16; Rev. Rul. 60-331, 1960-2 C.B. 189; Rev. Rul. 55-36, 1955-1 C.B. 340.

<sup>51</sup> See, e.g., IRS Chief Counsel Advice 200117039 (Mar. 13, 2001) (stating that [w]hile courts have consistently acknowledged the [business purpose] doctrine, it has proven extremely easy for taxpayers to satisfy the requirement. In fact, we are unaware of a case in which an exchange otherwise meeting the requirements of section 351 was disqualified and rendered a taxable exchange solely for lack of sufficient business purpose"); F.S.A. 200122022 (Feb. 23, 2001) (noting that "courts have generally not imposed an exceptionally high standard" in making business purpose determinations); F.S.A. 200126016 (Mar. 29, 2001) (stating that "[c]ourts have recognized that a taxpayer may benefit from nonrecognition treatment under I.R.C. § 351 as long as a valid, non-tax business purpose partially motivated the transaction"); F.S.A. 200134002 (Mar. 23, 2001) (noting that the Service knows of no cases in which an exchange otherwise meeting the requirements of section 351 was disqualified and rendered a taxable exchange solely for lack of sufficient business purpose).

However, the Tax Court has implied that a business purpose is never needed to make a check-the-box election. Dover Corp. v. Commissioner, 122 T.C. 324, 351, n.19 (2004) (stating that "[n]or do the check-the-box regulations require that the taxpayer have a business purpose for such an election or, indeed, for any election under those regulations. Such elections are specifically authorized 'for federal tax purposes'"). Note, however, that Dover involved a deemed section 332 liquidation, which, unlike section 351, has generally not been held to require a business purpose. See, e.g., Rev. Rul. 2003-125, I.R.B. 2003-52 (deemed section 332 liquidation to obtain worthless stock deduction); Rev. Rul. 75-521, 1975-2 C.B. 120 (permitting purchase of stock to achieve requisite ownership percentage to engage in section 332

business purpose for checking-the-box, it should be treated as a section 351 transaction.<sup>52</sup>

Let's consider the consequences if Y is a reverse hybrid entity.

Example 9 – Merger Into Reverse Hybrid Entity: Y is a Country G entity with two US shareholders, neither of whom is a corporation for US tax law purposes. Y is a reverse hybrid entity, treated as a partnership for Country G tax purposes and as a corporation for US tax purposes. Z is a Country G AG, which is treated as a corporation for both Country G and US purposes. Z merges into Y pursuant to a Country G law that provides for the transfer of all of the assets and liabilities of Z to Y and the cessation of Z's existence for all purposes.

In this example, Y is a corporation for US federal tax purposes; therefore, it is a combining entity. The real hurdle in this example is whether Country G law permits a merger of a corporation into a partnership. Assuming such a merger is permitted by foreign law, it should qualify as a statutory merger or consolidation, because (i) the assets and liabilities of Z, the combining entity of the transferor unit, become the assets and liabilities of Y, the combining entity and sole member of the transferee unit, and (ii) Z ceases its separate legal existence for all purposes.

As illustrated by these examples, cross-border mergers appear to raise no greater potential for abuse than domestic mergers. It was, therefore, reasonable to conclude that, as long as the merger satisfies the functional requirements of the 2005 proposed regulations, as well as the additional nonstatutory requirements of business purpose, continuity of interest, and continuity of business enterprise, it should qualify as a statutory merger or consolidation,

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liquidation); see also Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956) (permitting sale of stock to avoid section 332 treatment).

<sup>52</sup> Note, however, that because Y is a hybrid entity, it already has limited liability for local law purposes. Thus, this common justification for section 351 transactions is not available to Y.

regardless of whether it is pursuant to foreign or domestic law. The 2005 proposed regulations recognize the increased globalization of today's marketplace and increase flexibility in planning business combinations by removing technical and economically inefficient impediments (such as the substantially all requirement).