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When Is a Merger Not a Merger?

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An acquisition of the business of one corporation by another corporation can be structured on a wholly or partly tax-free basis if the transaction qualifies as a "reorganization" under Internal Revenue Code section 368(a). "Reorganization" status carries with it a whole range of tax consequences that may not be applicable in other transaction forms, including wholly- or partially-tax-free treatment for both the target corporation and its shareholders and a "carryover" of tax attributes from the target corporation to the acquiring corporation.

Section 368(a)(1) lists various categories of "reorganizations," the first of which is described in section 368(a)(1)(A) as a "statutory merger or consolidation." The Treasury Regulations provide little guidance on the definition of these terms, stating only, "In order to qualify as a reorganization under section 368(a)(1)(A) the transaction must be a merger or consolidation effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia."[1]

Not every transaction that is a merger effected pursuant to the corporation laws of a state will qualify as a "reorganization" for tax purposes. For example, a "reorganization" will not have taken place unless the transaction satisfies the additional nonstatutory requirements of "continuity of business enterprise under the modified corporate form" and "continuity of interest." "Continuity of business enterprise" means that the acquiring corporation must either continue the target corporation's historic business or use a significant part of the target corporation's historic business assets in a business, and "continuity of interest" means that a substantial part of the value of the proprietary interest in the target corporation must be exchanged for a proprietary interest in the acquiring corporation.[2] Thus, a merger of one corporation into another, in which the shareholders of the target corporation receive only cash as consideration for their shares, will not be a "reorganization." However, if a "substantial part" of the consideration received by the shareholders of the target corporation consists of stock of the acquiring corporation, the transaction may still constitute a "reorganization," even though those shareholders also receive a substantial amount of taxable cash "boot."

Unlike the treatment of statutory mergers, where the main requirements for tax-free treatment are found in the "continuity of interest" and "continuity of business enterprise" rules, other transaction forms must meet additional statutory requirements in order to be treated as "reorganizations." For example, the term "reorganization" includes the "acquisition by one corporation, in exchange *solely* for all or part of its *voting stock* [and for the assumption by the acquiring corporation of liabilities of the target corporation] ..., of *substantially all of the properties* of another corporation", so long as the target corporation is liquidated in pursuance of the plan of reorganization (a so-called "C reorganization").[3] By contrast, in the case of a statutory merger directly into another corporation, stock in which is issued to the shareholders of the target corporation, the transaction does not have to meet the "solely for voting stock" test or the "substantially all of the properties" test. The statutory merger is, therefore, a much more flexible tool for effecting a corporate acquisition.

Recent years have seen a proliferation of tax rules under which certain entities that exist for state law purposes are disregarded as entities separate from their owners for Federal tax purposes. These include certain entities formed as corporations under state law, such as a "qualified REIT subsidiary" (*i.e.,* any corporation if 100% of the stock of such corporation is held by a real estate investment trust) or a "qualified subchapter S subsidiary" (*i.e.,* a domestic corporation itself eligible to be an S corporation if 100% of the stock of such corporation is held by an S corporation and the S corporation elects to treat such corporation as a qualified subchapter S subsidiary).[4] They also include many entities not formed as corporations (such as business trusts and limited liability companies) that have only a single owner.[5] The common thread in all of these definitions is that a disregarded entity (or "DE") has only a single owner.

Qualified REIT subsidiaries and qualified subchapter S subsidiaries are generally corporations under state law, so state merger laws would permit them to merger with other corporations. Moreover, many more "modern" state laws permit mergers between corporations and noncorporate entities.

On May 16, 2000, the Internal Revenue Service published in the *Federal Register* a Notice of Proposed Rulemaking which proposed Treasury Regulations to address the question of whether a merger between two entities, one of which is a corporation (both under state law and for Federal tax purposes) and the other of which is, for Federal tax purposes, disregarded as an entity separate from its corporate owner may qualify as a "reorganization." The proposed Regulations address two situations: (1) a merger of a target corporation into a DE, in which the shareholders of the target corporation receive as part of their consideration stock in a corporation which is the sole owner of the DE; and (2) a merger of a DE into an acquiring corporation.

In the Supplementary Information to the Notice of Proposed Rulemaking, the Service recognized that there are substantial arguments in favor of treating a merger of a corporation into a DE wholly-owned by another corporation as a "statutory merger" for Federal tax purposes. The Service found those arguments unpersuasive.

In the Service's view, a "statutory merger" must be a "combination of the assets and liabilities of two corporations *through a merger under state or Federal law*." When a merger is into a DE, the combination of the assets of the target corporation and of the corporate owner of the DE occurs only through the Federal *tax law's* legal fiction that the acquiring entity is disregarded; no combination occurs under state or Federal *merger* law. Since Congress indicated in the legislative history to a 1934 amendment to the reorganization provisions—the amendment that added the word "statutory"—that it wanted the tax definition to "conform more closely to the general requirements of corporation law" and since the owner of the DE is not a party to the state law merger transaction, the proposed Regulations take the position that the merger of a corporation into a DE wholly-owned by a corporation cannot be a "statutory merger."[6] However, such transaction may still qualify as some other form of "reorganization," such as a C reorganization, or other nontaxable transaction, if it independently satisfies the requirements for that form.

The Service also concluded that a merger of a DE, even one wholly-owned by a corporation, into a corporation did not constitute a "statutory merger." In this regard, the Service expressed two concerns. First, it is in the nature of a "merger" that the merged corporation cease to exist. Since, the only entity which could be treated as the merged corporation for tax purposes, *i.e.*, the owner of the DE, would continue to exist in such a transaction, no "merger" of a corporation can be considered to have occurred. Second, allowing a merger of a DE into a corporation to be treated as a "statutory merger" would allow the "statutory merger" rules to be used to effect a division of a corporation on a tax-free basis (by effecting a merger of a DE which did not own "substantially all of the properties" of the target corporation, while the remaining properties remained behind or were acquired by a different acquiror in a separate transaction), without compliance with the detailed and highly restrictive statutory rules[7] intended to govern when tax-free divisive transactions are permitted.

The new Regulations are proposed to be effective for transactions occurring on or after the date of their publication as final Regulations. We can expect some further comment (and controversy) about the Service's position. Meanwhile, we can speculate whether any planner will be aggressive enough to challenge the Service's position, either before or after the effective date of final Regulations.

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1 Treasury Regulation section 1.368-2(b)(1).

2 *See* Treasury Regulation section 1.368-1(b), (d)(1), (e)(1)(i).

3 Internal Revenue Code section 368(a)(1)(C), (2)(G).
Under some circumstances, the "solely" test is relaxed and up to 20% of the total consideration may consist of money or property other than voting stock of the acquiring corporation. Internal Revenue Code section 368(a)(2)(B).

4 Internal Revenue Code sections 856(i)(2), 1361(b)(3)(B).

5 Treasury Regulation section 301.7701-3(b)(1). An election can be made to treat a wholly-owned noncorporate entity as a corporation for tax purposes. Treasury Regulation section 301.7701-3(a). Different rules apply to foreign entities. Treasury Regulation section 301.7701-3(b)(2).

6 Implicit in the proposed Regulations is a further conclusion that, since a DE is not a "corporation" for Federal tax purposes, a merger of a corporation into a DE also cannot satisfy the statutory requirements for a "triangular" statutory merger.

7 Found in Internal Revenue Code section 355.