

Tax Tip

By *Stephen L. Owen*

Using Disregarded Entities in Corporate Reorganizations



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Code Sec. 368¹ describes the different transactions that qualify as “reorganizations” under the Code. A transaction qualifying as a “reorganization” generally results in deferral of tax on gain built into the assets and the receipt of stock of the participating corporations.²

One of the transactions that Code Sec. 368 includes as a “reorganization” is a “statutory merger or consolidation” pursuant to Code Sec. 368(a)(1)(A). This form of “reorganization” offers considerable flexibility over other forms of “reorganizations,” in that there is no statutory restriction on the permissible consideration; the only limit on consideration being imposed by the “continuity of proprietary interest” rules,³ which are generally interpreted to permit as much as 50 to 60 percent of consideration, other than stock of the acquiror.⁴ Additionally, statutory mergers and consolidations can allow merging corporations to transfer valuable assets, such as contract rights, by operation of state law, rather than by a deed, assignment or other private instrument of transfer.

A “statutory merger or consolidation” clearly includes the merger of two corporations accomplished by operation of state corporate law. State corporate laws, however, also provide for the merger of corporations with entities other than corporations, such as partnerships⁵ and limited liability companies.⁶ These other entities have the potential to be classified as entities disregarded as separate from their owners for federal income tax purposes.⁷ This raises the question whether “statutory merger or consolidation” encompasses the merger of a corporation into a disregarded entity, as in the following situation:



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Example 1: Acquiror, a C corporation, wishes to acquire Target Corp., an S corporation, all of the stock of which is owned by A. The parties would like to structure a merger of Target Corp. into Acquiror, with A receiving Acquiror's stock. However, a direct merger into Acquiror would subject the assets of Acquiror to Target Corp.'s liabilities. The transaction could also require an Acquiror stockholder vote. The deal is revised so that Acquiror forms a single-member LLC (SMLLC) into which Target Corp. merges. SMLLC is the survivor and A receives Acquiror's stock.

Would the fact that SMLLC is a disregarded entity allow the transaction to qualify as a "statutory merger or consolidation" under Code Sec. 368(a)(1)(A)?

In proposed regulations issued in 2000,⁸ the IRS's initial conclusion was that this transaction would not qualify as a statutory merger or consolidation under Code Sec. 368(a)(1)(A). This was not the answer that tax professionals wanted to hear.⁹ However, updated proposed regulations were issued in 2001,¹⁰ which provided that this transaction *would* qualify for non-recognition treatment under Code Sec. 368(a)(1)(A). In Temporary Regulations issued on January 24, 2003, generally effective for transactions occurring on or after January 24, 2003, the IRS followed the approach of this second set of proposed regulations.

On January 23, 2006, the IRS issued final regulations (the "Final Regulations") on this topic.¹¹ While the IRS has acknowledged that there remain many unanswered questions in this area, the Final Regulations offer significant guidance to entrepreneurs and their tax advisors in structuring acquisitions and dispositions of business entities. Here are some illustrative examples.

In Example 1 above, why would Acquiror not simply form a wholly owned subsidiary *corporation* and structure the transaction as a tax-free reorganization under Code Sec 368(a)(2)(D) (*i.e.*, a "forward-triangular merger")? Acquiror would still be able to isolate the liabilities of Target Corp., and the transaction would not require the vote of Acquiror's stockholders. First, there may be state income tax benefits in operating the Target Corp.'s business in a single-member

LLC (*e.g.*, some states, such as Maryland, do not permit consolidated returns, so losses of a subsidiary corporation may be trapped in the subsidiary). In addition, qualifying as a merger under Code Sec. 368(a)(1)(A) is easier than in the case of a triangular merger under Code Sec. 368(a)(2)(D).

The Final Regulations provide absolute clarity that the transaction described in Example 1 qualifies for tax-free treatment under Code Sec. 368(a)(1)(A).¹² What if Acquiror has a wholly owned subsidiary corporation ("Sub") that has substantial assets? Acquiror, for business reasons, desires to acquire Target Corp. under the Sub "umbrella" in exchange for Acquiror's stock, but does not want Sub's assets to be exposed to the liabilities of Target Corp.

Whether it is a single-member LLC, a QSub or a QRS, a disregarded entity offers business planners a variety of potential opportunities to achieve tax as well as non-tax objectives.

Example 2. Sub forms an SMLLC. Target Corp. merges into SMLLC with SMLLC surviving. The stockholders of Target Corp. receive stock of Acquiror.

The Final Regulations¹³ provide that this transaction will qualify for tax-free treatment as if Target Corp. had merged into Sub, assuming that the forward triangular merger requirements of Code Sec. 368(a)(2)(D) are satisfied.

What if a target corporation is merged into a disregarded entity in exchange for interests in the disregarded entity?

Example 3. Acquiror, an S corporation, owns all of the interests of SMLLC. Target Corp. merges into SMLLC and the Target Corp. stockholders receive 50 percent of the interests in SMLLC. SMLLC survives in the merger.

The Final Regulations¹⁴ provide that this transaction does not qualify as a "statutory merger or consolidation." As a result of the merger, SMLLC is treated as having converted from a disregarded entity to a partnership for federal income tax purposes. Acquiror is deemed to have contributed to the partnership all of the assets, subject to all of the liabilities, held by SMLLC immediately before the merger. Target Corp. is deemed to have contributed all of its assets, subject to all of its liabilities, to the partnership and to have simultaneously distributed 50 percent of the SMLLC interests to

the Target Corp. stockholders in complete liquidation. The deemed liquidation of Target Corp. would trigger gain to the extent the value of the Target Corp. assets exceeds basis.¹⁵

What if Acquiror and Target Corp. are partners in the A/TC Partnership, and Acquiror wishes to acquire Target Corp. in exchange for Acquiror's stock?

Example 4. Acquiror forms SMLLC. Target Corp. merges into SMLLC, and the Target Corp. stockholders receive Acquiror stock.

This transaction qualifies as a "statutory merger or consolidation," as discussed in Example 1 above. The twist is that the A/TC Partnership becomes a disregarded entity as a result of the merger because all of its interests are held by Acquiror, directly or indirectly (through SMLLC). The conversion of A/TC Partnership to a disregarded entity should not have adverse tax consequences.

Example 5. Target Corp. merges into A/TC Partnership. The Target Corp. stockholders receive Acquiror's stock. As a result of the merger, A/TC Partnership becomes a disregarded entity because all of its interests are owned by Acquiror.

The Final Regulations conclude that this transaction qualifies as a statutory merger or consolidation for purposes of Code Sec. 368(a)(1)(A). All of the assets and liabilities of Target Corp. become the assets and liabilities of A/TC Partnership, a disregarded entity.

Note that, in all cases that are deemed to be statutory mergers or consolidations for purposes of Code Sec. 368(a)(1)(A), the target is not a disregarded entity. What happens if the target in the merger is a disregarded entity?

Example 6. Target Corp. owns 100 percent of the interests of Target LLC, a disregarded entity. Acquiror wishes to acquire Target LLC by having it merge into SMLLC, a disregarded entity wholly owned by Acquiror. Acquiror will issue its stock to Target Corp. pursuant to the merger. As a result of the merger, all of the assets and liabilities of Target LLC (but not those of Target Corp.) will become assets and liabilities of SMLLC.

The Final Regulations conclude that this transaction does not satisfy the requirements of Code Sec.

368(a)(1)(A). (Note that this transaction might qualify for tax-free treatment under Code Sec. 368(a)(1)(C) if the requirements applicable to such a reorganization are satisfied).

A QSub also is a disregarded entity. What happens if the parent corporation of a QSub merges with another entity?

Example 7. Target Corp. is an S corporation. Target Corp. owns all of the stock of Target Sub, a QSub. Target Corp. will merge into SMLLC, a single-member LLC owned by Acquiror. SMLLC will survive. The stockholders of Target Corp. will receive stock of Acquiror.

As a result of the merger, all of the assets and liabilities of Target Corp., including the stock of Target Sub, will become assets and liabilities of SMLLC. Under applicable regulations,¹⁶ the transaction is treated as a deemed transfer of the assets of Target Sub to SMLLC, followed by a deemed contribution of these assets to a new Target Sub by SMLLC in exchange for Target Sub stock. This deemed "drop-down" of assets as part of the merger does not cause the merger to fail to qualify for tax-free treatment under Code Sec. 368(a)(1)(A).¹⁷ It should be noted that Target Sub's QSub status terminates upon the merger. Target Sub will thereupon become a C corporation immediately following the merger, unless Acquiror is an S corporation and a new election is made to treat Target Sub as a QSub.¹⁸ Under Rev. Rul. 2004-85,¹⁹ this new QSub election must be made effective immediately following the merger.²⁰ If the QSub election is not made effective immediately following the merger, Target Sub will not be eligible to be treated as a QSub (or as an S corporation if, for example, its stock is spun off and it would otherwise be eligible to be an S corporation) until the expiration of the five-year re-election prohibition period under Code Sec. 1361(b)(3)(D). Rev. Proc. 2004-49²¹ offers a way to request relief from the IRS for a late QSub election in this context.

The foregoing rules regarding QSubs are applicable to QSubs where the parent S corporation transfers all of the QSub stock to another S corporation in a taxable sale or in a tax-free reorganization under Code Sec. 368(a), except where the tax-free reorganization qualifies under Code Sec. 368(a)(1)(F).

Example 8. S-1 Corp. is an S corporation that owns all of the stock of QSub-1. A, the sole

stockholder of S-1 Corp., forms S-2 Corp. S-2 Corp. has no assets or liabilities and is eligible to be an S corporation. S-1 Corp. merges into S-2 Corp.

This transaction qualifies as a tax-free reorganization under Code Sec. 368(a)(1)(F). Under Rev. Rul. 64-250,²² when an S corporation merges into a newly formed corporation in a transaction qualifying under Code Sec. 368(a)(1)(F), and the newly formed corporation meets the requirements of Subchapter S, the merging corporation's S election does not terminate,

but instead, remains in effect for the newly formed surviving corporation. The newly formed corporation is treated as a "continuation" of the merging S corporation. As a result, the QSub elections for subsidiaries of the merging S corporation will not terminate.

The concept of a "disregarded entity" is relatively new. Whether it is a single-member LLC, a QSub or a QRS ("qualified REIT subsidiary"), a disregarded entity offers business planners a variety of potential opportunities to achieve tax as well as non-tax objectives. This column has considered a few of these opportunities.

ENDNOTES

¹ All Code Section references are to the Internal Revenue Code of 1986 (the "Code"), as amended, unless otherwise indicated.

² See, e.g., Code Sec. 354, which provides for nonrecognition of gain or loss on exchange of securities in a corporation that is a party to a reorganization or for other securities in that corporation or another corporation also a party to the reorganization; Code Sec. 361, which provides for nonrecognition of gain or loss on the exchange by a corporation, which is a party to a reorganization, of its property for securities in another corporation also a party to the reorganization; and Code Secs. 358, 362 and 381, which provide for the carryover of certain tax attributes between corporations that are party to a reorganization and between shares of stock in such corporations surrendered and received in the transaction.

³ Reg. §1.368-1(e).

⁴ Compare, for example, "reorganizations" under Code Sec. 368(a)(1)(B) (sole consideration allowed is voting stock), Code Sec.

368(a)(1)(C) (in addition to voting stock, other limited forms of consideration allowed; also "substantially all" assets of target must be transferred) and Code Sec. 368(a)(2)(D) ("substantially all" assets of target must be transferred).

⁵ See Del. Code Ann 8. §263.

⁶ See Del. Code Ann 8. §264.

⁷ Reg. §301.7701-3(a). In addition to "eligible entities" that are disregarded under Reg. §301.7701-3(b), the potential for a merger involving a qualified subchapter S subsidiary or "QSub" (as defined in Code Sec. 1361(b)(3)(B)) or a qualified REIT subsidiary (as defined in Code Sec. 856(i)(2)), both of which are disregarded entities, further necessitated the establishment of a rule regarding mergers and disregarded entities. See T.D. 9038, 68 FR 3384, January 24, 2003 (announcing the January 2003 Proposed Regulations).

⁸ 65 FR 31115.

⁹ Even under the proposed regulations, this transaction might have qualified for tax-free

treatment under Code Sec. 368(a)(1)(C), but the requirements of this provision are more difficult to satisfy.

¹⁰ 66 FR 57400.

¹¹ T.D. 9242, 71 FR 4259, Jan. 23, 2006.

¹² Reg. §1.368-2 (b)(iii), Ex. 2.

¹³ Reg. §1.368-2(b)(iii), Ex. 4.

¹⁴ Reg. §1.368-2(b)(iii) Ex. 7.

¹⁵ Code Sec. 336. This could be even more costly if Target Corp. were subject to the built-in gain provisions of Code Sec. 1374.

¹⁶ Reg. §1.1361-5(b)(1) and §1.1361-5(b)(3) Ex. 9.

¹⁷ Code Sec. 368(a)(2)(C).

¹⁸ Rev. Rul. 2004-85, 2004-2 CB 189, IRB 2004-33, 189.

¹⁹ *Id.*

²⁰ Under Reg. §1.1361-3(a)(4), a QSub election cannot be effective more than 2 months and 15 days prior to the date of filing (nor more than 12 months of after the date of filing).

²¹ Rev. Proc. 2004-49, 2004-2 CB 210, IRB 2004-33, 210.

²² Rev. Rul. 64-250, 1964-2 CB 333.

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