

IRS Revises Proposed Regulations: Tax-Free Reorganizations Could Include Single Member LLCs

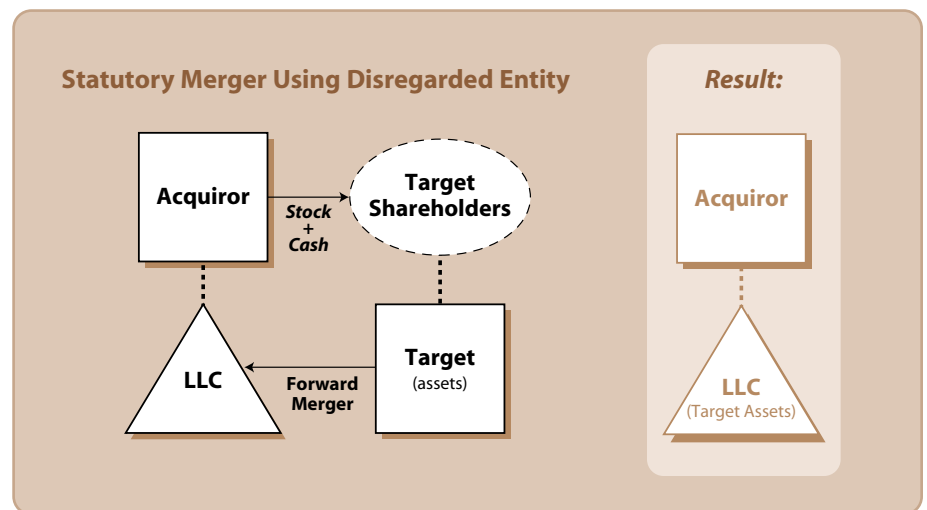
On November 14, 2001, the Internal Revenue Service continued its recent efforts to increase the flexibility of the Internal Revenue Code reorganization provisions. Specifically, the IRS issued proposed regulations that would treat the forward merger of a target corporation into a domestic “disregarded entity” owned by a domestic acquiring corporation as if the target had merged directly into the acquirer. A “disregarded entity” refers to a business entity with only one owner that is disregarded for tax purposes, but respected for other purposes. The most common example of a disregarded entity is a single member limited liability company that has not elected to be classified as a corporation for tax purposes.

These new proposed regulations, which will not be effective until finalized sometime next year, would permit a corporate acquirer to:

- Acquire a target corporation in a tax-free reorganization by paying aggregate consideration that includes a stock component representing as little as 50% of the total consideration;¹
- Isolate the target’s pre-existing liabilities;² and
- Eliminate the need, in some circumstances, for the acquirer’s stockholders to approve the transaction,³

while avoiding many of the constraints associated with a forward triangular merger that involves the merger of a target corporation into a corporate subsidiary of the acquirer.⁴

Moreover, in light of the IRS’s recent ruling regarding double mergers, addressed in a recent Cooley Alert, <http://www.cooley.com/publications.ix?section=Cooley+Alerts+%26+Bulletins&id=2783> if a reverse triangular



merger is followed by a merger of the target into a disregarded entity, an acquirer corporation will have the ability to not only simultaneously achieve the objectives noted above, but also to:

- Eliminate the corporate level tax exposure in the event the transaction does not qualify as a tax-free reorganization; and
- Effect a swift acquisition of the target by avoiding any required third-party consents (and resulting delays) often associated with a traditional forward merger.⁵

In light of these new rulings and regulations, we believe corporations should systematically consider utilizing disregarded entities as a tax-planning tool.

The Service has scheduled a public hearing on the Proposed Regulations for March 13, 2002. If adopted, these regulations will not become effective until final regulations are published. Should you have any questions, please contact any of the attorneys listed on the following page. ■

Notes

¹ The requirement that a substantial portion of the consideration in an “A” reorganization consist of acquirer stock stems from the historical “continuity of interest” requirement. The Service’s advance ruling guidelines require at least 50% stock consideration. However, case law permits a somewhat higher percentage of cash.

² Unlike a true direct or “forward” merger of the target into the acquirer, where the target disappears and the acquirer necessarily inherits the target’s liabilities by operation of law.

³ Although for tax purposes, the proposed regulations would treat the merger of a target corporation into an acquirer’s disregarded subsidiary as a forward merger of the target into the acquirer, under many state corporate law statutes the acquirer is not treated as a “constituent corporation,” and thus would not be required to obtain stockholder approval of the transaction.

⁴ Traditional forward triangular mergers, which require use of a corporate acquisition subsidiary, are only eligible for tax-free treatment under Code Section 368(a)(2)(D), while forward mergers involving disregarded entities will be governed by the much less restrictive requirements of Code Section 368(a)(1)(A). Section 368(a)(2)(D) requires, for

example, that the acquiror obtain substantially all of the target's assets, which limits the target's ability to engage in certain transactions, including distributions, redemptions or spin-offs made in connection with (or close in time to) the acquisition. Additionally, Section 368(a)(2)(D) can prove problematic if either a target stockholder or the acquiror has made a bridge loan to the target prior to the transaction.

⁵ If there is significant risk that third party consents may never be forthcoming, the parties may be limited to a traditional reverse triangular merger structure. Interestingly, if such contracts were entered into by target's wholly owned LLC (rather than by target, directly) third party consents might be avoided entirely, in the absence of a change-in-control consent provision.

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