

entity that is disregarded as an entity separate from the combining entity of the transferor unit for Federal tax purposes, provided that those assets become assets of the transferee unit.

E. Additional Examples

One commentator suggested that the scope of the proposed regulations be clarified through additional examples. The following paragraphs describe the suggested examples and the extent to which they have been incorporated in these temporary regulations.

1. QSub That Becomes a C Corporation

A QSub may cease to be a disregarded entity because of an event that renders the subsidiary ineligible for QSub status, such as a merger into an entity owned by a C corporation. For example, suppose Z, an S corporation, owns all of the stock of B, a QSub, and Z merges with and into X, an entity that is disregarded as an entity separate from Y, a C corporation. B's status as a QSub will terminate at the end of the day on which the merger occurs. *See* Treas. Reg. § 1.1361-5(a)(1)(iii). A commentator suggested that, in this case, it is not clear whether B is a member of the transferor unit. If B were treated as a member of the transferor unit, the transaction may not qualify as a statutory merger or consolidation because the assets of B may not become assets of the transferee unit. If, however, B were not treated as a member of the transferor unit, the transaction may qualify as a statutory merger or consolidation. The commentator suggested that B should not be treated as a member of the transferor unit. Alternatively, the commentator suggested that the principles of *Example 9* of § 1.1361-5(b)(3) could be applied to this case. In *Example 9* of § 1.1361-5(b)(3), the acquisition of the stock of a QSub is treated as a transfer of the QSub's assets followed by the transfer of those assets by the acquirer to a new corporation.

The IRS and Treasury agree with the commentator that the principles illustrated by *Example 9* of § 1.1361-5(b)(3) apply to determine whether the merger of Z into X qualifies as a statutory merger or consolidation. In particular, the transaction should be treated as a transfer of B's assets to X followed by a transfer of such assets by X to a new corporation. Accordingly, the transaction may qualify as a statutory merger or consolidation provided that the other requirements of a statutory merger or consolidation are satisfied. These temporary regulations include an example illustrating this result.

2. Transitory Surviving Disregarded Entity

One commentator suggested that the 2001 proposed regulations be amended to provide an example in which the surviving disregarded entity in an otherwise qualifying statutory merger or consolidation is transitory. For example, suppose corporation Z merges into X, an entity that is disregarded as separate from corporation Y. In the transaction, the shareholders of Z exchange their Z stock for Y stock. Immediately after the merger of Z into X and as part of a plan that includes that merger, X merges into Y. The commentator noted that, in Rev. Rul. 72-405 (1972-2 C.B. 217), the IRS held that a forward triangular merger of a target corporation into a newly formed controlled corporation of a parent corporation followed by the liquidation of the controlled corporation into the parent corporation would be treated as a reorganization under section 368(a)(1)(C) rather than a reorganization under sections 368(a)(1)(A) and 368(a)(2)(D). The commentator suggested that the principles of Revenue Ruling 72-405 should not be applied to prevent the merger of Z into X from qualifying as a reorganization under section 368(a)(1)(A).

The IRS and Treasury agree that the merger of Z into X followed by the merger of X into Y does not implicate the principles of Revenue Ruling 72-405. Because the merger of X into Y does not alter the identity of the tax owner of the former assets of X, that merger would be disregarded. The IRS and Treasury do not believe that an additional example is necessary to illustrate this result.

F. The Domestic Entity Requirement

The 2001 proposed regulations provide that a transaction in which any of the assets and liabilities of a combining entity of a transferor unit become assets and liabilities of one or more disregarded entities of the transferee unit cannot qualify as a statutory merger or consolidation unless such combining entity, the combining entity of the transferee unit, such as disregarded entities, and each business entity through which the combining entity of the transferee unit holds its interests in such disregarded entities is organized under the laws of the United States or a State or the District of Columbia. One commentator suggested that where an entity that is disregarded as an entity separate from the combining entity of the transferor unit becomes an entity that is disregarded as an entity separate from the combining entity of the transferee unit, whether such

disregarded entity is organized under the laws of the United States or a State or the District of Columbia is not relevant to whether the transaction qualifies as a statutory merger or consolidation. The IRS and Treasury agree and have clarified the domestic entity requirement to exclude such disregarded entities.

Another comment suggested that the domestic entity requirement be eliminated for the disregarded entity into which a target corporation is merged and each business entity through which the combining entity holds its interests in the disregarded entity into which a target corporation is merged. Although these temporary regulations retain that requirement for those entities, as described in the preamble to the 2001 proposed regulations, the IRS and Treasury are continuing to consider further revisions to the regulations under section 368(a)(1)(A) to address statutory mergers and consolidations that involve one or more foreign corporations, including transactions involving a disregarded entity.

Special Analyses

It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Richard M. Heinecke, Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record keeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows: