2024-OTA-228
Nonprecedential

OFFICE OF TAX APPEALS

STATE OF CALIFORNIA

In the Matter of the Consolidated Appeals of: **MCGARVEY-CLARK REALTY, INC.;** **AVIS BUDGET GROUP, INC.**	OTA Case Nos. 18083623 & 18083632

OPINION

Representing the Parties:

For Appellants:	Jeffrey M. Vesely, Attorney Zachary Atkins, Attorney
For Respondent:	Michael R. Laisne, Tax Counsel Brian Werking, Tax Counsel III D. Todd Watkins, Tax Counsel IV
For Office of Tax Appeals:	Mai C. Tran, Tax Counsel IV

A. LONG, Administrative Law Judge: Pursuant to Revenue and Taxation Code (R&TC) section 19045,[1] McGarvey-Clark Realty, Inc. (McGarvey) and Avis Budget Group, Inc. (Avis) (collectively, appellants) appeal actions by respondent Franchise Tax Board (FTB) proposing for the 1999 tax year: $36,597.00 in additional tax, a late filing penalty of $9,149.25, and applicable interest for McGarvey; $12,568,703.00 in additional tax, a late filing penalty of $1,955,030.14, and applicable interest for Avis.[2]

Office of Tax Appeals (OTA) Administrative Law Judges Andrew Kwee, John O. Johnson, and Andrea L.H. Long held an oral hearing for this matter in Sacramento, California,

[1] Unless otherwise indicated, all references to statutes and regulations are to those in effect for the tax year at issue.

[2] Appellants dispute the imposition of the late filing penalties and applicable interest on the basis that the correct assessment of additional tax is zero, and as a result, the late filing penalties and interest should be reduced to zero.

on December 16, 2022. At the conclusion of the hearing, the record was closed, and this matter was submitted for an opinion.

ISSUES

1. Whether FTB issued timely Notices of Proposed Assessment (NPAs) to appellants.
2. Whether appellants' transaction constitutes a "statutory merger" that qualifies as a tax-free reorganization under Internal Revenue Code (IRC) section 368(a)(1)(A).[3]

FACTUAL FINDINGS

Background

1. PHH Holdings Corporation (PHH Holdings) was a direct wholly-owned subsidiary of PHH Corporation (PHH Corp). PHH Corp was wholly owned by Cendant Corporation (Cendant). Thus, PHH Holdings was an indirect wholly-owned subsidiary of Cendant (now, Avis). On April 4, 1999, PHH Holdings reincorporated in Texas.[4] PHH Holdings owned, among other things, the various entities which composed the vehicle management and fuel card business (the Fleet Business).
2. During the years at issue, McGarvey was a subsidiary of Cendant.[5]
3. Avis Group Holdings, Inc. (Avis Holdings)[6] operated a car rental business. Avis Holdings sought to acquire the Fleet Business from PHH Holdings. Avis Holdings wholly owned Avis Fleet Leasing and Management Corporation (AFLMC), a Texas corporation. Cendant owned approximately 19 percent of Avis Holdings.

[3] California generally conforms to the federal provisions for corporate reorganizations and distributions through R&TC sections 23251 and 24451.

[4] The predecessor corporation (Maryland Co.) to PHH Holdings was incorporated in Maryland. Maryland Co. was a holding company that, through various direct and indirect corporate subsidiaries, limited liability companies, and partnerships, engaged in the fleet car rental business. PHH Holdings was incorporated in Texas to be the successor corporation to Maryland Co. In April 1999, Maryland Co. merged with PHH Holdings and Maryland Co. went out of existence with PHH Holdings surviving the merger.

[5] McGarvey is now a subsidiary of Realogy Holdings Corporation. Realogy Holdings Corporation was spun off from Cendant in 2006.

[6] Avis Holdings was previously named Avis Rent A Car, Inc.

The Transaction

4. On June 30, 1999, PHH Holdings and PHH Corp transferred the Fleet Business to AFMLC, and AFMLC transferred to PHH Corp total proceeds of $4,566,033,380, net of deferred taxes and transaction costs More specifically, in connection with the transaction, the following occurred:

   a. PHH Corp and PHH Holdings transferred to AFLMC the subsidiaries and assets constituting the Fleet Business, including Vehicle Management Services, LLC, Wright Express, LLC, and certain North American and European subsidiaries and assets of PHH Holdings.
   b. In return, AFLMC transferred to PHH Corp $3,001,666,380 in cash and a note for $30 million and delivered to PHH Holdings (a) 7,200,000 shares of AFLMC Series A convertible preferred stock, with a fair market value of $360 million; and (b) 40,000 shares of AFLMC Series C preferred stock with a fair market value of $2,000,000 (so that PHH Holdings received total stock valued at $362 million).[7]
   c. Upon receipt of the AFLMC Series A and Series C stock, PHH Holdings transferred the stock to PHH Corp,[8] and PHH Corp transferred 131 shares of PHH Holdings Series B common stock to AFLMC. As a result, AFLMC received approximately 11 percent of the equity ownership in PHH Holdings, and PHH Corp retained approximately 89 percent of the equity ownership of PHH Holdings.
   d. In return for the Fleet Business, AFLMC also assumed $1.44 billion of various intercompany liabilities owed to PHH Corp by the Fleet Business, including liabilities owed by PHH Holdings.
   e. PHH Holdings and AFMLC both survived the transaction and remained in existence after the transaction.

[7] According to their 2001 Form 10-K, appellants "sold its fleet business" in 1999 and received additional consideration of $3 billion in cash and a $30 million receivable from AFLMC as part of the transaction. Appellants contend that the $3 billion represented the Fleet Business intercompany indebtedness and AFLMC effectively assumed this $3 billion indebtedness as part of the transaction. Appellants thus contend that the $3 billion represented repayments of debt due to appellants as related party creditors, relying on their 1999 Form 8-K and the "merger" transaction documents. It appears however that, according to the Closing Agreement, appellants and the IRS agreed that appellants received from AFLMC additional cash consideration of approximately $3 billion and the $30 million note.

[8] After the merger, PHH Corp sold the Series C stock to a third-party investor.

5. The transfer of the assets was accomplished pursuant to an "Agreement and Plan of Merger and Reorganization," which describes the transaction as a merger that would be conducted pursuant to Texas law. In their income tax reporting, appellants took the position that the transfer of the Fleet Business occurred in a transaction that qualified as a merger under Texas law,[9] and therefore qualified as a tax-free reorganization under IRC section 368(a)(1)(A). As a result, appellants did not report any taxable gain or loss in 1999 on the disposition of the Fleet Business to AFLMC on their state and federal income tax returns. PHH Holdings merged with AFLMC pursuant to Texas corporation law.
6. According to a schedule prepared by appellants that they provided to the IRS, had the 1999 transaction been a taxable transaction, the gain would have been $1,581,820,275. As a result of treating the transaction as a tax-free merger under IRC section 168(a)(1)(A), AFLMC did not amortize the acquired Fleet Business assets at a stepped-up basis on its federal and state tax returns for tax years 1999 through 2001.
7. According to FTB's records, appellants filed their original California tax returns on November 1, 2000.

<u>Reacquisition of the Fleet Business and Sale of the European Fleet Business</u>

8. On March 1, 2001, PHH Corp reacquired the Fleet Business through a transaction in which Avis Acquisition Corp., a wholly owned subsidiary of PHH Corp, merged into Avis Holdings. Avis Holdings owned 100 percent of AFLMC, which had acquired the Fleet Business through the 1999 transaction. Avis Holdings continued as the surviving corporation and, through AFLMC, indirectly owned the Fleet Business.
9. In November 2001, appellants sold the European portion of the Fleet Business for $908,887,731, resulting in gain of $621,425,785. According to appellants, the gain was a

[9] Texas corporation laws permit divisive mergers whereby both the acquiring and target corporations may continue their existence after the merger. The Texas divisional merger provisions came into existence when Texas adopted the revised Texas Business Corporation Act in 1989. (Texas Business Corporation Act, 71st Leg., R.S., ch. 801, § 26, 1989 Tex. Gen. Laws 3610, 3629.) Texas Business Corporation Act, Art. 1.02 (11) defined "merger" to mean: (a) the division of a domestic corporation into two or more new domestic corporations or into a surviving corporation and one or more domestic or foreign corporations or other entities; or (b) the combination of one or more domestic corporations with one or more domestic or foreign corporations or other entities resulting in (i) one or more surviving domestic or foreign corporations or other entities, (ii) the creation of one or more new domestic or foreign corporations of other entities, or (iii) one or more surviving domestic or foreign corporations or other entities and the creation of one or more new domestic or foreign corporations or other entities.

result of a joint venture entered into by Avis Holdings and BNP Paribas involving the European fleet in 2000, and the subsequent liquidation of the partnership in 2001. Thus, the related gain was a deferred gain from 2000 recognized in 2001.

10. Since appellants treated the 1999 transaction as a nontaxable merger, appellants used the original basis for the European fleet assets of $287,461,946, instead of the stepped-up cost basis applicable had the transaction been treated as a taxable transaction. In addition, appellants did not claim depreciation on the property, plant, and equipment, or amortization of goodwill and intangibles applicable had the transaction been treated as a taxable transaction.

Federal Audit and Closing Agreement

11. The IRS audited appellants for the 1998 through 2002 tax years and examined the transactions between AFLMC and PHH Holdings during the audit period.

12. At audit, the IRS determined that the 1999 transaction between AFMLC and PHH Holdings did not comply as a tax-free reorganization under IRC section 368(a)(1)(A). The IRS determined that, based on the schedule provided by appellants, PHH Holdings sold the Fleet Business to AFMLC in 1999 resulting in taxable gain of $1,581,820,275.

13. The IRS reasoned that a transaction effectuated under a corporate law merger statute must result in one corporation acquiring the assets of the target corporation by operation of the corporate law merger statute and the target corporation ceasing to exist. Since PHH Holdings and AFLMC both survived the transaction, the IRS found that the transaction was a sale of the Fleet Business, rather than a merger that qualified as a Type A reorganization under IRC section 368(a)(1)(A).

14. The IRS further reasoned that the transaction did not satisfy the continuity of interest requirement under Treasury Regulation section 1.368-1(a) since PHH Corp only received AFLMC stock equal to 11 percent of the outstanding stock of PHH Holdings as of the date of the sale which was below the 50 percent threshold provided by Revenue Procedure 77-37.

15. In addition, there were other unrelated Revenue Agent Report (RAR) adjustments totaling $143,644,671.

16. Appellants and the IRS agreed to assess the liability in the 2002 tax year. As a result of this agreement, and due to an offsetting net operating loss carryover, the IRS

Form 4549-A reflects zero adjustments to income and zero taxable income for the 1999 tax year. Form 886-A shows that the agreed upon tax liability was based on a comparison of the net present value (NPV) of the amount paid against the NPV of the amount of additional tax that the IRS would have collected had the transaction been taxable, taking into consideration the additional depreciation and amortization to which appellants and Avis Holdings would have been entitled to in the years subsequent to the 1999 transaction. The IRS agreed with appellants' resolution since the NPV of disallowing the nonrecognition treatment of the 1999 transaction was $9,200,000, whereas appellants' resolution offered an NPV of $12,400,000.

17. On February 13, 2007, appellants and the IRS executed a closing agreement memorializing the terms of their agreement.

a. The closing agreement contains several recitals, beginning with the word "WHEREAS." As relevant to this Opinion, one of the recitals states the following:

> WHEREAS, the [IRS] has examined the transaction and determined that the reorganization does not comply as a tax neutral reorganization consistent with I.R.C. § 368(a)(1)(A), but was instead a sale in 1999 of Taxpayer's Fleet Business.

b. After the recitals, a caption states, "NOW, THEREFORE, IT IS HEREBY DETERMINED AND AGREED for federal income tax purposes that . . . ." Eighteen numbered paragraphs follow the caption.

c. The first paragraph states that the gain on the sale of the European Fleet Business in 2001 would remain the same at $621,425,785.

d. Paragraphs 2 and 3 relate to the correct amount of foreign tax credits available for the 2001 taxable year and the foreign tax credits available for carryforward from the 2002 taxable year.

e. Paragraph 4 states that Avis Holdings will not claim deductions for, nor reinstate or amend its filed consolidated federal tax returns for tax years 1999 through 2001 to increase or to seek previously unclaimed depreciation and amortization deductions for Fleet Business assets.

f. With respect to the Fleet Business assets, Paragraph 5 states that appellants would not claim deductions for, nor restate or amend their filed consolidated federal tax returns for the 2001 through 2005 tax years to increase or to seek, previously unclaimed depreciation and amortization deductions for the Fleet Business assets.

g. Paragraph 7 states: "Taxpayer will not be required to file an amended federal tax return for its 1999 taxable year to report its alleged $1,581,820,275 gain from the sale of its Fleet Businesses, but will instead compensate the government through the agreements provided in paragraphs 1 through 5 of this Closing Agreement and through the payment of additional income tax for the 2002 tax year."

h. Paragraphs 8 and 10 state that appellants agreed to pay additional income tax of $60,075,581, plus interest of $11,433,399, for a total tax liability of $71,508,980 for the 2002 tax year.

i. Paragraph 6 states that, as of December 31, 2005, appellants possessed an amortizable intangible asset, including goodwill, associated with the Fleet Business with an adjusted basis at that time of $204,311,374 with 8.5 years remaining thereon available for ratable amortization.

18. On June 15, 2006, appellants fully satisfied the tax liability.

19. On July 17, 2006, the IRS recorded the liability and payment on appellants' Business Master File transcript for the 2002 tax year.

<u>FTB Audit, Protest, and Appeal</u>

20. According to FTB's records, appellants filed amended California tax returns for the 1999 through 2002 tax years in January 2009. However, the amended tax returns did not disclose the federal adjustment finding that the 1999 transaction was taxable.

21. On October 20, 2009, FTB received the RARs, IRS Forms 4549-A, and Forms 886-A for the 1998 through 2002 tax years from the IRS. Form 4549-A shows the $60,075,581 additional tax liability assessed by the IRS for the 2002 tax year that was not included in any of the amended California tax returns appellants filed for the 1999 through 2002 years.

22. FTB subsequently began an audit of appellants in 2009 for taxable years 1998 through 2002.

23. On September 21, 2012, appellants signed a waiver to extend the statute of limitations for the 1998 through 2002 tax years to December 31, 2013.

24. FTB determined that the statute of limitations was still open on the issue for 1999. FTB further determined that the 1999 transaction was not a tax-free reorganization under IRC section 368(a)(1)(A) due to the applicability of Revenue Ruling 2000-05, 2000-1 C.B. 426 (Revenue Ruling 2000-05) and the failure to satisfy the continuity of shareholder interest requirement. On November 20, 2013, FTB issued NPAs to appellants proposing additional tax and penalties consistent with these determinations.
25. Appellants protested the NPAs.
26. On June 29, 2018, FTB issued Notices of Action affirming the NPAs.
27. Appellants then timely appealed to OTA.

DISCUSSION

Issue 1. Whether FTB issued timely NPAs to appellants.

Applicable Law

If the IRS makes a change or correction to "any item required to be shown on a federal tax return, including any gross income, deduction, penalty, credit, or tax for any year," the taxpayer must report the federal change to FTB within six months after the date the federal determination becomes final and shall concede the accuracy of the federal determination or state wherein it is erroneous. (R&TC, § 18622(a).) A final determination is defined as "an irrevocable determination or adjustment of a taxpayer's federal tax liability from which there exists no further right of appeal either administrative or judicial." (Cal. Code Regs., tit. 18, § 19059(e).) A closing agreement is an example of a final federal determination. (Cal. Code Regs., tit. 18, § 19059(e)(1).) The date of each final federal determination is the date on which each adjustment or resolution resulting from a federal examination is assessed within the meaning of IRC section 6203 (which provides that the IRS shall record the liability of the taxpayer pursuant to the applicable rules and regulations). (R&TC, § 18622(d); Treas. Reg. § 301.6203-1.)

If the taxpayer or the IRS reports the change or correction within six months after the final federal determination, FTB may issue an NPA "resulting from" those adjustments within two years from the date of the notice. (R&TC, §19059(a).) If the taxpayer or the IRS reports that change or correction after the six-month period, FTB may issue an NPA "resulting from" those adjustments within four years from the date of the notification. (R&TC, §19060(b).) If neither the taxpayer nor the IRS reports the change or correction, FTB may issue an NPA "resulting from" those adjustments at any time. (R&TC, §19060(a).) The specific statute of limitations set forth in R&TC section 19060 override the general statute of limitations set forth in R&TC section 19057. (*Appeal of Valenti*, 2021-OTA-093P.)

R&TC section 19067(a) provides that, prior to the time prescribed for mailing a notice of an NPA expires, taxpayers may consent in writing to extend the statute of limitations for FTB to issue an NPA within the extended period agreed upon.

Discussion

Appellants contend that the NPAs are barred by the general four-year statute of limitations. Appellants argue that the extended statutes of limitations provided by R&TC sections 19059 and 19060 do not apply here. Appellants assert that the extended statutes of limitations only apply for final federal changes that apply for the particular tax year audited by the IRS. Appellants thus argue that if there is no final federal change for a specific tax year, or the final federal changes for that tax year do not apply under California law, FTB cannot issue an NPA for that tax year. Appellants contend that the IRS did not make a final federal determination that the merger constituted a taxable transaction and, instead appellants settled with the IRS based on the risks of litigation. Appellants note that the closing agreement provided that they were not required to file amended 1999 federal tax returns and they were precluded from filing amended returns for the audit years to take depreciation and amortization deductions that they would have been entitled to had the transaction been taxable. Appellants contend that, as the closing agreement did not make any changes to the 1999 tax year, the IRS audit position was not the basis of a final federal determination. Appellants argue that they were not required to report any federal changes for the 1999 tax year to FTB and therefore the statute of limitations was not extended by R&TC sections 19059 or 19060.

FTB contends that the IRS made a final federal determination that the transaction was a taxable sale. FTB contends that, although the additional federal tax liability was imposed on appellants' 2002 tax year, since the final federal determination resulted in a change for appellants' 1999 state tax liability, the extended statutes of limitations provided by R&TC sections 19059 and 19060 apply. FTB points out that the closing agreement provides that the IRS determined that the transaction was taxable.

The first issue to address is whether FTB's proposed assessment for the 1999 tax year resulted from a final federal determination. The closing agreement is a final federal determination. (Cal. Code Regs., tit. 18, § 19059(e)(1).) The scope of a closing agreement is strictly construed to encompass only the issues enumerated in the agreement itself. (*Analog Devices, Inc. v. Commissioner* (2016) 147 T.C. 429, 445-446.) Any recitals in a closing agreement are not binding on the parties. (See *id.* at p. 446.) However, recitals are explanatory and can give insight into the intent of the parties. (See *Estate of Magarian v. Commissioner* (1991) 97 T.C. 1, 5; see also Rev. Proc. 68-16, sec. 6.05(3) ["It is important to distinguish between matters which are merely informative and explanatory and matters which are being agreed upon. The former should be segregated from the latter and should ordinarily be reflected in the introductory recitals contained in the WHEREAS clauses …. [T]he latter … should ordinarily be preceded by the caption 'NOW IT IS HEREBY DETERMINED AND AGREED[.]"].)

Closing agreements are contracts and are construed according to the intent of the parties as of the time of entering into the agreement. (*Analog Devices v. Commissioner*, *supra*, 147 T.C. at p. 446; *Long v. Commissioner* (1989) 93 T.C. 5, 10.) The contract must be read as a whole, and the contract must be interpreted in context. (*In re New Valley Corp.* (3d Cir. 1996) 89 F.3d 143, 149.)

As noted in the closing agreement, the recitals state that the IRS determined that the 1999 transaction did not qualify as a tax-free reorganization pursuant to IRC section 368(a)(1)(A) and instead constituted a taxable sale of assets. Appellants contend that there was no final federal determination because they did not agree to the IRS's determination that the transaction was taxable as stated in the recitals of closing agreement.

In review of the closing agreement as a whole, Paragraph 7 states that appellants will not be required to file an amended 1999 federal tax return "but will instead compensate the government" through the execution of the closing agreement and by paying additional income tax for the 2002 tax year. To effectuate the compensation to the government, Paragraphs 4 and 5 prohibits appellants and Avis Holdings from seeking unclaimed depreciation and amortization deductions for the Fleet business assets. When read in conjunction with the recitals stating that the IRS believed that appellants' 1999 transaction did not qualify as tax-free reorganization, it becomes clear that the matters that were agreed upon reflect to accord finality to the tax consequences stemming from the 1999 transaction. Although the IRS and appellants agreed to have appellants report additional taxes in 2002 and not in 1999, it does not change the fact that the parties were seeking to remedy the IRS's determination that the 1999 transaction was not a tax-free transaction. Therefore, FTB's proposed assessment for the 1999 tax year did result from the closing agreement, which is a final federal determination.

The second issue is what was the date of the final federal determination in this appeal. The date of the final federal determination is the date that the adjustment is assessed pursuant to IRC section 6203. (R&TC, § 18622(d).) IRC section 6203 provides that the assessment is made by recording the liability on the taxpayer's record in accordance with the rules and regulations prescribed by the IRS. Treasury Regulation section 301.6203-1 states that an assessment is made, through supporting records, by an assessment officer signing the summary record of the assessment. The summary record shall contain the identification of the taxpayer, the character of the liability assessed, the taxable period, if applicable, and the amount of the assessment. (*Ibid*.) A record of assessment includes a Master File Transcript, such as an Individual Master File or a Business Master File. (Rev. Rul. 2007-21, 2007-1 C.B. 865.)

Based on appellants' Business Master File for the 2002 tax year, on July 17, 2006, the IRS assessed $60,075,581 in additional tax for the 2002 tax year consistent with the closing agreement. Therefore, the date of the final federal determination is July 17, 2006. (R&TC, § 18622(d); IRC, § 6203.) Since the additional tax is required to be shown on appellants' federal tax returns, R&TC section 18622 requires appellants to report the additional federal tax liability to FTB. Although appellants filed amended state tax returns for 1999 and 2002, they did not report the additional federal tax liability to FTB. The IRS notified FTB of the federal adjustment on October 20, 2009, more than six months after the date of the final federal determination. Therefore, FTB was required to issue a proposed assessment by October 20, 2013, four years after the date of notification. (R&TC, §19060(b).) However, since appellants signed a waiver with FTB to extend the statute of limitations for the 1998 through 2002 tax years to December 31, 2013, the NPAs issued on November 20, 2013, were timely.

Appellants contend that even if the closing agreement opened the statute of limitations for proposing an assessment, FTB should be limited to issuing the proposed assessment for 2002 and subsequent years. However, there is nothing in R&TC section 18622 or 19060 that precludes FTB from issuing a proposed assessment for 1999 based on the closing agreement (i.e., final federal determination) for 2002. R&TC section 19060 merely requires that the assessment must be additional tax "resulting from" a final federal determination. R&TC section 18622 requires a taxpayer to report a change to "any item required to be shown on a federal tax return," including tax, for "any year."

Appellants point out that the California Legislature was concerned that California was unable to pursue certain tax liabilities that resulted from federal changes relating to net operating losses and credits since the prior version of R&TC section 18622 only required taxpayers report federal changes to gross income or deductions. Appellants assert that, when the Legislature amended R&TC section 18622 to require taxpayers to report federal changes to any item required to be shown on a tax return for "any year," the Legislature intended that R&TC section 18622 (and the corresponding statutes of limitations in R&TC sections 19059 and 19060) would only allow additional assessments of tax due to final federal adjustments in the year of the adjustment and subsequent years. Appellants rely on the Senate bill analysis on the 1999 amendments[10] to R&TC section 18622 and FTB's audit procedure manual.[11] Appellants primarily rely on language in the Senate bill analysis stating that the Legislature recognized that certain federal changes may not change California tax in the year of the federal change but change California tax due in a subsequent year. Appellants interpret this analysis to mean that the Legislature only intended to allow additional tax assessments for years subsequent to the year of the federal change.

Generally, ascertaining the Legislature's intent is done by first looking to the words of the statute and trying to give effect to the usual, ordinary import of the language, at the same time not rendering any language mere surplusage. (*People v. Pacific Landmark, LLC* (2005) 129

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[10] Since the 1999 amendments were effective October 10, 1999 (Stats. 1999, c. 987 (S.B. 1229), § 56.), the amendments apply to the 1999 tax year. Subdivision (d) of R&TC section 18622 was added October 10, 1999, by S.B. 1229, Chapter 987.

[11] Rather than supporting appellants' argument, it appears that the FTB audit manual supports FTB's position. In Example 1 of the manual, the taxpayer takes net operating loss (NOL) deductions in years 1 through 7. The IRS audits year 7 and determines that there is an additional liability for year 2 and disallows the NOL carryforward resulting in a deficiency in year 6. Year 2 is barred by the general California and federal statute of limitations. However, FTB can issue an assessment for year 2 due to the extended statute of limitations for federal adjustments. FTB explains that the taxpayer has a reporting requirement under R&TC section 18622 which reopens the statute of limitations under R&TC sections 19059 and 19060. Further, R&TC sections 19059 and 19060 do not limit California adjustments to the same year as the federal assessments. Therefore, although there is a federal deficiency for year 6, FTB can issue an assessment for year 2 based on the federal deficiency for year 6. Accordingly, applying the logic from Example 1 to the facts before OTA would result in a finding that FTB is allowed to issue an assessment for the 1999 tax year based on final federal adjustment to 2002.

Cal.App.4th 1203, 1213.) The words must be construed in context and in light of the nature and obvious purpose of the statute where they appear. (*Ibid*.) In matters of statutory construction, unless otherwise defined, words in a statute will be interpreted as taking their ordinary, contemporary, common meaning. (*Transwestern Pipeline Co., LLC v. 17.19 Acres of Property Located in Maricopa County* (9th Cir. 2010) 627 F.3d 1268, 1270.) Courts have consulted dictionary definitions in determining the plain meaning of language. (*Ibid*.)

R&TC section 18622's requirement that a taxpayer report changes for "any year" is clear and unambiguous. It is presumed that when the Legislature enacted the term "any year," the Legislature meant what it said. (*Amalgamated Sugar Co. LLC v. Vilsack* (9th Cir. 2009) 563 F.3d 822, 829.) In addition, the Senate bill analysis is not inconsistent with R&TC section 18622. The Legislature merely provided one example of how the amended language would apply and that does not preclude a broader application of the statute.

Further, unless there is some ambiguity in the language of a statute, the analysis ends with the statute's plain language. (*Amalgamated Sugar Co. LLC v. Vilsack*, *supra*, 563 F.3d at p. 829.) The plain language of R&TC sections 19059 and 19060 is not ambiguous. R&TC sections 19059 and 19060 authorize FTB to assess additional tax "resulting from" a final federal adjustment. If the Legislature wanted to limit FTB's ability to assess tax only to subsequent years, it could have revised R&TC sections 19059 and 19060 when they revised R&TC section 18622. It did not. Statutes of limitations must be interpreted with a strict construction in favor of the taxing agency. (*Shockley v. Commissioner* (11th Cir. 2012) 686 F.3d 1228.) Appellants have not demonstrated that FTB is precluded from assessing additional tax in this appeal.

For the foregoing reasons, FTB issued timely NPAs for the 1999 tax year resulting from the final federal determination for the 2002 tax year.

<u>Issue 2. Whether appellants' transaction constitutes a "statutory merger" that qualifies as a tax-free reorganization under IRC section 368(a)(1)(A).</u>

Applicable Law

A proposed assessment issued by FTB based on a final federal determination is presumed correct, and taxpayers bear the burden of proving error. (*Appeal of Gorin*, 2020-OTA-018P.)

IRC section 354(a)(1) generally provides that a shareholder recognizes no gain or loss if stock or securities in a corporation that is a party to a reorganization are, pursuant to a plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation that is a party to the reorganization. IRC section 368(a)(1) limits the definition of the term "reorganization" to seven kinds of transactions that may qualify for tax-free treatment pursuant to IRC section 354 if various conditions are satisfied.[12] One of these transactions is "a statutory merger or consolidation" also known as a Type A reorganization. (IRC, § 368(a)(1)(A).) As effective prior to January 24, 2003, Treasury Regulation section 1.368-2(b)(1) provided that a statutory merger or consolidation must be "effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia." (Treas. Reg. § 1.368-2(b)(1).)[13]

The Internal Revenue Code does not define "merger or consolidation." However, in ordinary usage, a "merger" would refer to two corporations combining into a single corporation. (See Black's Law Dict. (3d 1933) p. 1181, col. 1.) Consistent with this ordinary usage, in construing whether certain transactions qualify as a "merger," courts have noted 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 . . . . In each case interests of the stockholders and creditors of any company which disappears remain and are retained against the suviving [sic] or newly created company." (*Cortland Specialty Co. v. Commissioner* (2d Cir. 1932) 60 F.2d 937, 939, cert. den., 288 U.S. 599 (*Cortland*).)[14]

Discussion

FTB contends that appellants' 1999 transaction did not qualify for tax-free treatment because the transaction resulted in multiple surviving entities which, pursuant to Revenue Ruling 2000-05, disqualifies the transaction from meeting the definition of a statutory merger.

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[12] Prior to its current iteration in IRC section 368, these provisions were found in section 112(g) of the Revenue Act of 1934, 48 Stat. 680. (See *Helvering v. Southwest Consol. Corp.* (1942) 315 U.S. 194.) Pursuant to the Revenue Act of 1954, 68A Stat. 120, the provisions were renumbered to IRC section 368.

[13] See IRS Proposed Rules, Statutory Mergers and Consolidations, 68 FR 3384-01, 2003-1 C.B. 524, 2003 WL 158498 (Jan. 24, 2003).

[14] When California law conforms to federal law, case law and federal rulings applicable to the Internal Revenue Code are persuasive authority in interpreting the California statute. (*J.H. McKnight v. Franchise Tax Board* (2003) 110 Cal.App.4th 978, at fn. 1.)

Appellants contend that the 1999 transaction qualified as a statutory merger because the transaction was effected under Texas corporation law as required by Treasury Regulation section 1.368-2(b)(1) and that the liquidation requirement was not added to the definition of statutory merger until the IRS issued Revenue Ruling 2000-05. Appellants contend that Revenue Ruling 2000-05 should be given no weight in considering this appeal. Appellants also contend that, even if Revenue Ruling 2000-05 was considered by OTA, Revenue Ruling 2000-05 was decided after the 1999 tax year at issue and, as such, should not apply retroactively.

Definition of "Merger"

While appellants contend that the 1999 transaction qualified as a statutory merger because it satisfied Treasury Regulation section 1.368-2(b)(1), that is not the end of the inquiry. Although the transaction may be labeled as a "merger" under Texas corporation law, it is not dispositive of the question whether the transaction was a statutory merger for federal income tax purposes. (See *Roebling v. Commissioner* (3d Cir. 1944) 143 F.2d 810, 812.) While a taxpayer may satisfy the literal requirements of a statute, the taxpayer must show that what happened is what the statute intended. (*Gregory v. Helvering* (1935) 293 U.S. 465, 469.) "Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule." (Treas. Reg. § 1.368-1(b).) State law cannot alter the essential characteristics required to enable a taxpayer to obtain exemption under the provisions of the federal income tax laws. (*Roebling v. Commissioner*, *supra*, at p. 812.) Appellants' position, which would allow the Texas corporation law to alter the essential characteristics of a statutory merger for federal income tax purposes, runs afoul of this tenet. The terms expressed in IRC section 368 are not to be given merely a literal interpretation but are to be considered and applied in accordance with the purpose of the statute. (*Southwest Natural Gas Co. v. Commissioner* (5th Cir. 1951) 189 F.2d 332, 334.)

Prior to the Revenue Act of 1934, Congress defined reorganization as a merger or consolidation, including the acquisition by one corporation of substantially all the properties of another corporation for voting stock. In 1934, Congress added the term "statutory" to merger or consolidation to clarify that mergers had to conform to mergers effected under state corporation law. (IRC, §112(g)(1)(A) [the predecessor to IRC, § 368(a)(1)(A)].) Congress also separated the parenthetical provision, ". . . acquisition by one corporation of substantially all the properties of another corporation . . .” for voting stock into its own provision. (IRC, §112(g)(1)(B) [the predecessor to IRC, § 368(a)(1)(C)].) Congress did not define “merger” in the revisions.

For purposes of statutory construction, when a term is not defined, the ordinary meaning of merger that existed when Congress enacted the statute is considered. (*Transwestern Pipeline Co., LLC v. 17.19 Acres of Property Located in Maricopa County*, *supra*, 627 F.3d 1268.) Before 1934, there were no state laws that allowed a transaction where both corporations survived to qualify as a merger. When Congress revised IRC section 368, the common ordinary definition of “merger” contemplated that one of the corporations in a merger would cease to exist or be absorbed by the other corporation. (See Black’s Law Dict. (3d 1933) p. 1181, col. 1; Ballentine’s Law Dict. (1923) p. 308, col. 1.)

In addition, courts consistently define a merger as the union of two or more corporations by the transfer of property of all to one of them which continues in existence, the others being swallowed up or merged therein. (*Cortland, supra,* 60 F.2d at 939; *Metropolitan Edison Co. v. Commissioner* (3d Cir. 1938) 98 F.2d 807, 810; *Fisher v. Commissioner* (6th Cir. 1939) 108 F.2d 707, 709; *Vulcan Materials Company v. U.S.* (5th Cir. 1971) 446 F.2d 690, 694; see *Thurber v. Commissioner* (1st Cir. 1936) 84 F.2d 815, 818.) “[A] merger is the absorption by one corporation of the properties and franchises of another whose stock it has acquired, whereupon the merged corporation ceases to exist and the merging corporation along [sic] survives.” (*Ahles Realty Corporation v. Commissioner* (2d Cir. 1934) 71 F.2d 150.)[15] Although appellants point out that the above case law is *dicta*, that is because, prior to Texas defining a “merger” as including transactions in which no company is absorbed into another, no party had raised this issue. The decisions are persuasive in understanding the commonly accepted definition of merger.

Further, this definition of merger is consistent with Congress’s understanding of statutory merger as evidenced in later legislative history. Senate reports regarding later revisions to IRC section 368 recognized Congress’s intent that divisive reorganizations be governed by IRC

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[15] This is further supported by contemporary legal commentary at that time which opined that the transaction must be a “technical” merger wherein one corporation is absorbed by another in order to qualify as a “merger” under IRC section 112(g)(1) (the predecessor to IRC section 368). (Homer Hendricks, *Developments in the Taxation of Reorganizations* (1934) 34 Colum. L. Rev. 1198, 1199. See also Homer Hendricks, *Federal Income Tax: Definition of "Reorganization"* (1932) 45 Harv. L. Rev. 648, 651–652 [“strictly speaking, a merger means the *absorption* of one corporation by another” (emphasis in original)].) Appellants point to law articles suggesting that the definition of merger did not include a dissolution requirement, those articles were written well after 1934, and therefore not contemporaneous to the time when Congress revised the definition of reorganization.

section 355. (S. Rep: No. 1622, 83d Cong., 2d Sess. 274 (1954).) In a senate report discussing the changes to Type C reorganizations (reorganizations under IRC section 368(a)(1)(C)), the report stated that "[i]n the case of a statutory merger or consolidation, the transferor is liquidated by operation of law." (S. Rep. No. 169, 98th Cong., 2d Sess. 204 (1984).) Legislative history suggests that Congress intended that statutory merger transactions result in one entity ceasing to exist in order to qualify as a "merger" for purposes of IRC section 368.

Appellants have not pointed to any federal authorities suggesting that this interpretation is contrary to federal statutes, case law, or legislative history. Instead, appellants rely on *J.A. Nelson Co. v. Helvering* (1935) 296 U.S. 374, *Helvering v. Minnesota Tea* (1935) 296 U.S. 378, and *G. & K. Mfg. Co. v. Helvering* (1935) 296 U.S. 389. However, these cases dealt with the parenthetical in the predecessor to IRC section 368(a)(1)(A) (i.e., "merger and 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 substantially all the properties of another corporation)"). Those cases state that for transactions where a transferor corporation did not liquidate, the transaction still qualified as a reorganization if substantially all of the transferor corporation's property is transferred to the transferee corporation. Those cases did not address whether the term "merger or consolidation" required a liquidation of one of the corporations. Rather, the courts noted that the parenthetical expanded the terms "merger and consolidation" to include transactions that did not meet the ordinary definition of merger or consolidation. Therefore, even though there was no liquidation in the above cases, so long as the taxpayers could demonstrate a continuity of interest, the taxpayers met the definition. However, appellants argue that they meet the definition of "statutory merger or consolidation," which no longer contains the expansive parenthetical language.[16] Therefore, those cases are not helpful in determining the requirements of a statutory merger for this appeal.

Appellants also raise *Commissioner v. Gilmore's Estate* (1942) 130 F.2d 791 (*Gilmore*). There, the issue was whether a "statutory merger" required a merger transaction effected by New Jersey corporation law to result in the holding company's property to be transferred to the operating company. The holding company and an operating company entered into a merger agreement whereby the operating company continued as the surviving company vested with all

[16] Appellants do not claim that they qualify for a Type C reorganization (i.e., an acquisition by one corporation of substantially all the properties of another corporation is a reorganization where payment was effectuated with the acquiror's voting stock). (IRC, § 368(a)(1)(C).)

rights and property of the holding company and all shareholders of the holding company surrendered their stock for shares in the surviving corporation. The transaction followed all of the requirements under the New Jersey corporation law. The court in *Gilmore* determined that the transaction was a merger, even though there was no transfer of property from the holding corporation to the merged corporation. Unlike appellants' transaction, the holding company stock in *Gilmore* was cancelled and the holding company ceased to exist after completing the transaction. *Gilmore* was decided on different terms, whether property had to be transferred. Therefore, *Gilmore* is of limited use in this appeal.

IRS Deference

FTB relied in part on Revenue Ruling 2000-05 for determining that appellants' transaction was not a tax-free statutory merger. Appellants contend that OTA should give little weight to Revenue Ruling 2000-05. OTA disagrees.[17]

Rulings, interpretations, and opinions of the IRS constitute a body of experience and informed judgment to which OTA may look to for guidance. (*J.H. McKnight v. Franchise Tax Board* (2003) 110 Cal.App.4th 978.) The weight of such guidance depends on the thoroughness of the agency's consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control. (*Skidmore v. Swift & Co.* (1944) 323 U.S. 134, 140.) However, if the agency's interpretation violates the specific language of the statute or is otherwise contrary to law, courts are free to disregard the agency's interpretation. (5 U.S.C. § 706(2)(A); *Thomas Jefferson University v. Shalala* (1994) 512 U.S. 504, 512.)

Regarding the first factor, the thoroughness in the IRS's consideration in making its ruling, the IRS reviewed IRC sections 354 and 368 within the context of the Revenue Act of 1934's purpose to prevent tax avoidance. The IRS interpreted a "statutory merger" as a transaction effected under a state's corporate law merger statute that must result in one corporation acquiring the assets of the target corporation by operation of the corporate law merger statute and the target corporation ceasing to exist. The IRS noted that, in 1921, Congress defined a reorganization as including ". . . a merger or consolidation (including the acquisition by

[17] Even if Revenue Ruling 2000-05 is disregarded, the prior precedents discussed above support finding that a statutory merger requires one corporation to cease to exist. Giving the prior precedents' independent weight from Revenue Ruling 2000-05, appellants' transaction did not satisfy the requirements to be a statutory merger.

one corporation . . . of substantially all the properties of another corporation)." In 1934, Congress split this definition into two separate provisions. In the predecessor of the current IRC section 368(a)(1)(C), an acquisition by one corporation of substantially all the properties of another corporation was a reorganization where payment was effectuated with the acquiror's voting stock. In the predecessor of current IRC section 368(a)(1)(A), the terms "merger or consolidation" were qualified by requiring that the transactions be "statutory" mergers and consolidations. The word "statutory" was added to the definition of a reorganization so that the definition would conform closer to the general requirements of state corporation laws. (See H. R. Rep. No. 704, 73d Cong., 2d Sess. 14 (1934).) In 1984, Congress specifically required the liquidation of the acquired corporation in reorganizations under both IRC sections 368(a)(1)(C) and 368(a)(1)(D) to prevent such reorganizations from being used in divisive transactions that did not satisfy IRC section 355. (S. Rep. No. 1622, 83rd Cong., 2d Sess. 274 (1954); S. Rpt. No. 169, 98th Cong., 2d Sess. 204 (1984); see Rev. Rul. 57-518, 1957-2 C.B. 253.)

The IRS reasoned that, in contrast to IRC sections 368(a)(1)(C) and 368(a)(1)(D), no specific liquidation requirement was necessary for statutory mergers in IRC section 368(a)(1)(A) because, at the time Congress revised IRC section 368, state corporate law merger statutes contemplated only one corporation surviving a merger. Thus, the IRS concluded that state law mergers in which the target corporation transfers only certain assets and liabilities and remains in existence after the transaction do not qualify as Type A reorganizations.

The IRS was thorough in its analysis as it considered the applicable case law; furthermore, legislative history suggests that Congress intended for statutory merger transactions to result in one entity ceasing to exist in order to qualify as a "merger" for purposes of IRC section 368. Accordingly, this factor weighs in favor of deference.

The second factor is whether the reasoning of the ruling is valid. As discussed above, the prior precedents support the reasoning in Revenue Ruling 2000-05. Appellants have not provided any legal authorities suggesting otherwise. Therefore, the reasoning in Revenue Ruling 2000-05 is valid and this factor weighs in favor of deference.

The third factor is whether the ruling is consistent with earlier and later pronouncements. Revenue Ruling 2000-05 is consistent with earlier and later pronouncements of what constitutes a merger. As noted previously, the courts have interpreted merger to mean a transaction where one corporation is absorbed by another and ceases to exist. This is consistent with Congress's later understanding of a statutory merger and Congress's intent that divisive transactions be governed by IRC section 355. Furthermore, when the IRS promulgated formal regulations, the IRS defined "statutory merger" consistent with Revenue Ruling 2000-05. Therefore, the ruling is consistent with earlier and later pronouncements and this factor weighs in favor of deference.

As for "all those factors which give it power to persuade, if lacking power to control" (*Skidmore v. Swift & Co.*, *supra*, 323 U.S. at p.140), the IRS's interpretation in Revenue Ruling 2000-05 is persuasive. The IRS's interpretation is consistent with the contemporary ordinary meaning of the term "merger." Case law and legislative history also support this interpretation.[18] Moreover, Revenue Ruling 2000-05 is consistent with the requirement that a taxpayer must satisfy both the terms of the statutory specifications and the statute's underlying assumptions and purposes. (Treas. Reg. § 1.368-1(b).) Appellants have not put forth any authorities to suggest that the IRS, Congress, or the courts ever took a contrary definition of "statutory merger." After considering the *Skidmore* factors, OTA declines appellants' request to give Revenue Ruling 2000-05 no weight in considering this appeal.

<u>Retroactivity of Revenue Ruling 2000-05</u>

As for appellants' contention that Revenue Ruling 2000-05 should not be given retroactive effect, revenue rulings and regulations are generally applied retroactively, unless provided otherwise. (IRC, § 7805(b)(8).) This is consistent with the general rule for court opinions. (See, e.g., *Harper v. Virginia Dept. of Taxation* (1993) 509 U.S. 86, 94 [stating that "the fundamental rule of 'retrospective operation' [] has governed '[j]udicial decisions . . . for near a thousand years,'" quoting *Kuhn v. Fairmont Coal Co*. (1910) 215 U.S. 349, 372].) To the extent a ruling interprets a statute, the ruling merely clarifies a meaning that has resided in the statute since the statute's enactment. If an interpretative ruling merely clarifies what the language of the statute was intended to convey, the ruling is no more retroactive in its operation than is a judicial determination construing and applying a statute to a case. (See *Anderson, Clayton & Co. v. U.S.* (5th Cir. 1977) 562 F.2d 972, 985 at fn. 30 (*Anderson*).)

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[18] Moreover, California courts as well as OTA's predecessor, the Board of Equalization, referenced the definition of merger provided in *Cortland* for California purposes in determining whether there was a reorganization for purposes of R&TC section 23251. (*Appeal of Heating Equipment Manufacturing Company* (60-SBE-027) 1960 WL 1405; *Heating Equipment Mfg. Co. v. Franchise Tax Bd*. (1964) 228 Cal.App.2d 290, citing *San Joaquin Ginning Co. v. McColgan* (1942) 20 Cal.2d 254.)

Revenue rulings and regulations are applied retroactively so long as such application is not an abuse of discretion. (*Redhouse v. Commissioner* (9th Cir. 1984) 728 F.2d 1249; *Manocchio v. Commissioner* (9th Cir. 1983) 710 F.2d 1400; *Automobile Club of Michigan v. Commissioner* (1957) 353 U.S. 180, 184-85. See *Appeal of BanCal Tri-State Corporation* (86-SBE-043) 1986 WL 22774.) In considering whether the IRS abused its discretion in issuing the regulation or ruling to prohibit a regulation or ruling from being given retroactive effect, courts have looked at the following factors: (1) whether or to what extent the taxpayer justifiably relied on settled prior law or policy and whether or to what extent the putatively retroactive regulation alters that law; (2) the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent [IRC] provisions; (3) whether retroactivity would advance or frustrate the interest in equality of treatment among similarly situated taxpayers; and (4) whether according retroactive effect would produce an inordinately harsh result. (*Anderson*, *supra*, 562 F.2d at p. 981.) This list of factors is neither exhaustive nor exclusive. Rather, the list is intended to serve as flexible guidance, not rigid requirements. (*Snap-Drape, Inc. v. Commissioner* (5th Cir. 1996) 98 F.3d 194, 202.) Of the four *Anderson* factors, courts tend to emphasize the first one most heavily. (*Ibid*.)

Appellants contend that the requirement that one of the corporations ceases to exist was not added until the issuance of Revenue Ruling 2000-05 and the IRS went beyond providing interpretative guidance. Thus, appellants assert that Revenue Ruling 2000-05 should not apply retroactively to this appeal. OTA disagrees.

As for the first factor, Revenue Ruling 2000-05 did not alter the law regarding what constitutes a statutory merger for purposes of whether a transaction satisfies the definition of reorganization in IRC section 368(a)(1)(A). Revenue Ruling 2000-05 merely interpreted existing law and applied it to transactions effected by the Texas corporation law that allowed for divisive mergers. Therefore, appellants have not shown that they justifiably relied on settled prior law or policy contrary to Revenue Ruling 2000-05. Appellants assert that the fact that the proposed Treasury Regulations and the final regulation applied prospectively supports finding that the IRS changed settled law. However, the IRS did not change settled law. Prior to the 1989 Texas corporation law, there was no other state corporation law that allowed divisive mergers. As discussed above, in 1934 when Congress revised the definition of reorganization to include a “statutory merger or consolidation,” the common meaning of merger contemplated one of the corporations to cease its existence in such a transaction. Furthermore, appellants have not provided any evidence suggesting that the IRS or Congress believed that a statutory merger could be divisive without qualifying under IRC section 355. In addition, appellants have not pointed to any case law to support that a "statutory merger" for purposes of IRC section 368 could be a divisive merger. (Cf. *Klamath Strategic Inv. Fund, LLC ex rel St. Croix Ventures, LLC v. U.S.* (E.D.Tex. 2006) 440 F.Supp.2d 608, 623 (*Klamath*).) Therefore, this factor weighs in favor of retroactive application.

The second factor considers the extent, if any, to which the prior law or policy has been implicitly approved by Congress, as by legislative reenactment of the pertinent IRC provisions. Appellants contend that, since 1955 the definition of a Type A reorganization "statutory merger or consolidation" has been interpreted as "a merger or consolidation effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia." (Treas. Reg. § 1.368-2(b)(1).) Appellants assert that Congress failing to amend IRC section 368(a)(1)(A) supports finding that Congress approved of the Treasury Regulation section 1.368-2(b)(1) definition of statutory merger (i.e., so long as the merger or consolidation was effected by law in the specified jurisdictions, it is a valid statutory or merger for purposes of IRC section 368(a)(1)(A)). However, appellants' argument ignores the fact that divisive "mergers," such as the transaction allowed by the Texas corporation law, did not exist at the time the Revenue Act of 1934 was passed and at the time when the IRS promulgated Treasury Regulation section 1.368-2(b)(1). Further, appellants' argument ignores the fact that the Treasury Regulation did not define "merger" or "consolidation." Rather, Treasury Regulation section 1.368-2(b)(1) focused on defining "statutory" for purposes of Type A reorganizations. The regulation merely reflected the requirement that there be a merger or consolidation that occurs pursuant to law; it did not remove the requirement that a merger or consolidation must have occurred.

Appellants further note that when Congress added a liquidation requirement to Type C reorganizations, Congress did not do so for Type A reorganizations, which appellants assert is implicit Congressional approval of the existing definition of Type A reorganizations. In 1984, Congress enacted IRC section 368(a)(2)(G) which requires all assets to be liquidated in IRC section 368(a)(1)(C) or 368(a)(1)(D) reorganizations. This is consistent with Congress's intent that divisive transactions are governed by IRC section 355. Legislative history suggests that

Congress believed that an IRC section 368(a)(1)(C) reorganization needed an explicit statutory liquidation requirement, in contrast to IRC section 368(a)(1)(A) reorganizations, because in a "statutory merger or consolidation" the transferor corporation is liquidated by operation of law. (S. Rep. No. 1622, 83d Cong., 2d Sess. 274 (1954); S. Rep. No. 169, 98th Cong., 2d Sess. 204 (1984).) Therefore, contrary to appellants' assertion that this shows that Congress had to change the statute to add the liquidation requirement for purposes of Type A mergers, the evidence suggests that Congress consistently believed that statutory mergers resulted in one corporation ceasing to exist and therefore it was unnecessary for Congress to explicitly add a liquidation requirement for purposes of Type A mergers.[19] Therefore, this factor weighs in favor of retroactive application.

As for the third factor, there is nothing to suggest unequal treatment for similarly situated taxpayers (i.e., those taxpayers who entered into similar transactions prior to Revenue Ruling 2000-05). As for the fourth factor, whether retroactive effect would produce an inordinately harsh result, appellants contend that allowing retroactive application of Revenue Ruling 2000-05 would result in a large assessment of tax against appellants. However, appellants have not shown that it would be inordinately harsh to apply the ruling. Appellants contend that taxpayers engaged in Type A reorganizations after the IRS issued Revenue Ruling 2000-05 were on notice of the liquidation requirement and those taxpayers were able to restructure their transactions accordingly. Appellants argue that since their transaction occurred in 1999, they were unable to do the same.[20] Appellants have not shown that they were justified in believing there was any prior settled law that would support finding that a divisive merger qualifies as a "statutory merger" for purposes of IRC section 368. As previously discussed, the authorities suggest otherwise.[21] All Revenue Ruling 2000-05 did was confirm that a "statutory merger," as understood at the time Congress enacted the language, assumed that one of the corporations

[19] It is noted that Congress revised IRC section 368 several times after Texas enacted its divisive merger statute in 1989. (See Aug. 5, 1997, 111 Stat. 917; Pub.L. 105-206, Title VI,§ 6010(c)(3)(B), July 22, 1998, 112 Stat. 813; Pub.L. 105-277, Div. Title IV,§ 4003(t)(2), Oct. 21, 1998, 112 Stat. 2681-910; Pub.L. 106-36, J, Title III, § 300l(a)(3), June 25, 1999, 113 Stat. 182.) None of these revisions addressed IRC section 368(a)(1)(A).

[20] Appellants make this argument within the third factor; however, it is more appropriately addressed in the fourth factor. (See *Klamath*, *supra*, 440 F.Supp.2d at p. 624.)

[21] As noted in footnote 21 above, appellants are subject to the tax at issue regardless of whether Revenue Ruling 2000-05 applies retroactively, and therefore its retroactive application would categorically not result in a harsh result.

would cease to exist in such a transaction. Unlike in *Klamath*, appellants here have not cited any legal authorities in conflict with the interpretation in Revenue Ruling 2000-05. (*Klamath*, *supra*, 440 F.Supp.2d at p. 625.) Therefore, these factors weigh in favor of retroactive application of the ruling.

In weighing the above factors, appellants have not demonstrated that applying Revenue Ruling 2000-05 in this appeal is an abuse of discretion; therefore, Revenue Ruling 2000-05 accordingly applies to this appeal.

For all the foregoing reasons, since appellants' 1999 transaction did not result in one of the corporations ceasing to exist, the transaction did not qualify as a "statutory merger" under IRC section 368(a)(1)(A).

HOLDINGS

1. FTB timely issued the NPAs for the 1999 tax year.
2. Appellants' transaction did not constitute a "statutory merger" that qualifies as a tax-free reorganization under IRC section 368(a)(1)(A).

DISPOSITION

FTB's action is sustained.

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Andrea L.H. Long
Administrative Law Judge

We concur:

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John O Johnson
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John O. Johnson
Administrative Law Judge

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Andrew J. Kwee
Administrative Law Judge

Date Issued: 3/21/2023