NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON CONTINUITY OF INTEREST AND
PRE-CLOSING STOCK VALUE FLUCTUATION

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Report No. 1050

CONTINUITY OF INTEREST AND PRE-CLOSING STOCK VALUE FLUCTUATION

By The New York State Bar Association Tax Section*

I. Introduction

This report of the New York State Bar Association Tax Section offers recommendations regarding whether the continuity of interest requirement applicable to tax-free reorganizations under Section[1] 368 of the Internal Revenue Code (the "Code") should be determined based on stock values as of the date of the signing of a merger agreement or solely as of the date the merger closes.

An acquisitive reorganization qualifying for tax-free treatment under Section 368 must satisfy the continuity of interest requirement.[2] The applicable Treasury Regulations provide that "[c]ontinuity of interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization".[3] Shareholders of the target corporation (the "Target") must receive, in exchange for their proprietary interests in Target, a sufficient continuing interest (generally, an equity interest) in the acquiring corporation (the "Acquiror"). The current practice for determining whether a merger satisfies the continuity of interest requirement turns on the value of the Acquiror's stock

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

2 Treas. Reg. Section 1.368-1(e)(1).

3 *Id*.

on the date that the merger closes, rather than on the date that the merger agreement is signed.[4] Consequently, in a merger in which Target shareholders receive part-cash, part-Acquiror stock consideration, the transaction could fail to satisfy the continuity of interest requirement under current practice if the Acquiror's stock drops in value between the date of signing and closing. Such a scenario could occur even if the parties to the transaction fully intended to effect a tax-free reorganization when they signed the merger agreement.

The current practice of relying solely on closing date stock values has created considerable taxpayer uncertainty regarding whether a merger that is the subject of a binding written agreement (but that has not yet closed) will qualify as a tax-free reorganization. As a result, sophisticated taxpayers have developed mechanisms for dealing with post-signing stock value fluctuation that generally add complexity and inefficiency to the negotiation and execution of merger agreements. Conversely, unsophisticated parties enter into merger agreements lacking such mechanisms and may be disadvantaged by the current practice of determining continuity solely using closing date stock values. The U.S. Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") recently listed on their 2003-2004 Priority Guidance Plan a project regarding taxpayer guidance on "the effect of pre-closing changes of Acquiror stock value on continuity of interest". For the reasons discussed below, this report recommends that satisfaction of the continuity of interest requirement should be determined, subject to certain conditions, using stock values at signing.

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4 *See* Rev. Proc. 77-37; 1977-2 C.B. 568, section 3.02 (Continuity of interest measured "as of the effective date of the reorganization".)

II. Scope of Report and Summary of Recommendation

This report addresses the effect of pre-closing stock value fluctuations on a merger's satisfaction of the continuity of interest requirement applicable to tax-free reorganizations under Section 368. Specifically, this report examines whether the government should consider using stock values as of the date a merger agreement is signed or solely stock values as of the closing date.

Our principal recommendation is that continuity of interest be measured using signing date values (determined immediately prior to the public announcement of the merger agreement) provided that (a) the Acquiror and the Target have entered into a binding written contract subject to customary closing conditions and (b) the closing of the merger occurs within a commercially reasonable amount of time.

III. Continuity of Interest: Background and Rationale

The tax-free reorganization provisions under Section 368 exempt certain corporate combinations from gain recognition because such transactions "effect only a readjustment of continuing interest in property under modified corporate forms".[5] In order to qualify as a tax-free reorganization, the following requirements must be satisfied: (a) the Target shareholders must receive a continuing interest in the combined entity;[6] (b) the Acquiror must continue the Target's historic business or use a significant portion of the Target's historic business assets in its own business;[7] and (c) the transaction must be motivated by a legitimate business purpose. Qualification of a merger as a tax-free reorganization under Section 368

[5] Treas. Reg. Section 1.368-1(b).

[6] Treas. Reg. Section 1.368-1(e).

[7] Treas. Reg. Section 1.368-1(d)(1); *see also* Rev. Rul. 81-25; 1981-1 C.B. 132 (continuity of business enterprise requirement applies only to transferor corporation).

results in deferral of gain recognition for the former Target shareholders on their Acquiror stock received and for the Target on the consideration received from the Acquiror and distributed to Target shareholders or creditors.[8]

The continuity of interest requirement provides that, in exchange for their Target shares, Target shareholders must receive a definite, material and substantial proprietary interest in the Acquiror. The general purpose of the requirement is to prevent transactions that are, in substance, sales from receiving treatment as mere alterations of business form.[9] The continuity of interest requirement emerged from judicial doctrine.[10] The U.S. Supreme Court has held that a part-cash, part-stock merger satisfied the continuity of interest requirement where Target shareholders received Acquiror stock equal to as little as 38.5 percent of the aggregate consideration received.[11] The judicial doctrine regarding continuity of interest has historically been flexible and lacking clear parameters. The Service's private letter ruling policy regarding tax-free reorganizations requires that the Target shareholders receive a continuing stock interest

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8 Sections 354, 356, 361. A Target shareholder's basis in the Acquiror stock received will be the same as the shareholder's basis in the Target stock surrendered (reduced by the sum of cash and other property received and increased by any gain recognized). Section 358(a). The shareholder's holding period in the Target stock will tack onto its holding period in the Acquiror stock received. Section 1223(1). The Target generally will not recognize gain on the property transferred or liabilities assumed. The Acquiror will generally have a carryover basis in such property received. Section 362(b).

9 Treas. Reg. 1.368-1(e).

10 The courts developed the current requirement in interpreting a provision of the Revenue Act of 1926 under which a merger could qualify as a tax-free reorganization if the Acquiror received "substantially all of the properties of another corporation". *See, e.g*., Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932) (distribution of cash and promissory notes did not create sufficient continuity); *interpreting* Revenue Act of 1926, ch. 27, section 203(h), 44 Stat. 14 (1926). Based upon a literal reading of the statute, a sale of assets for cash and notes could arguably have qualified as a tax-free reorganization under the applicable provision. The courts held that Congress intended that, in order for a merger to qualify for tax-free treatment, the Target's former shareholders must maintain some continuing equity interest in the surviving entity. *See id*.

11 *See* John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935) (Target shareholders receiving 38.5 percent stock interest in the Acquiror received sufficient continuity). There appears to be an inconsistency between the Supreme Court opinion, which tested continuity based on an issuance of 12,500 shares of preferred stock, and the Tax Court opinion, which tested continuity based on 14,060 shares. John A. Nelson Co., v. Helvering, 24 B.T.A. 1031 (1931). The latter decision would imply a continuity percentage of 41.3 percent.

in the Acquiror with a value equal to 50 percent of the value of all formerly outstanding Target stock as of the effective date of the reorganization.[12] For ruling purposes, continuity of interest has been measured using the value of Acquiror stock as of the closing date.[13]

In 1998, the Treasury issued regulations providing that sales of Target stock occurring prior to a reorganization and sales of Acquiror stock by Target shareholders after a reorganization, in each case to parties unrelated to the Acquiror, are disregarded for continuity of interest purposes.[14] Prior to the issuance of those regulations, post-reorganization dispositions of Acquiror stock could cause a merger to fail the continuity of interest requirement.[15] Those regulations thus represent an attempt by the Treasury to quell taxpayer uncertainty regarding whether a transaction will satisfy the continuity of interest requirement. Further, the 1998 regulations articulate the principle that whether a merger should qualify as a reorganization depends upon the deal struck between the Acquiror and the Target (or Target shareholders) and not on market activity that occurs before or after the merger closes.

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12 Rev. Proc. 77-37; 1977-2 C.B. 568, section 7.01(2).

13 *Id*.

14 Treas. Reg. 1.368-1(e)(1998).

15 Prior to the issuance of the 1998 regulations, some courts premised decisions based on the assumption that such sales may result in mergers failing to satisfy the continuity requirement. *See* Treasury Decision 8760 ("Based on an intensive inquiry into nearly identical facts, some of these cases held that as a result of the subsequent sale the potential reorganization did not satisfy the COI requirement; others held that satisfaction of the COI requirement was not adversely affected by the subsequent sale"); *see, e.g.,* McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982); Penrod v. Commissioner, 88 T.C. 1415 (1987); Heintz v. Commissioner, 25 T.C. 132 (1955) (Sales of Acquiror stock received in exchange for Target stock in the potential reorganization may cause the COI requirement to fail to be satisfied).

IV. Stock Value Fluctuation between Signing and Closing

As continuity of interest for purposes of Section 368 has, under current practice, been determined using closing date stock values,[16] changes in the price of Acquiror stock that occur after the signing of a merger agreement may jeopardize a merger that would otherwise have satisfied continuity. Parties to a merger agreement may intend to effect a tax-free reorganization by negotiating and signing an agreement in which Target shareholders will receive Acquiror stock sufficient to satisfy the continuity of interest requirement. Significant time, however, may elapse between the signing date and the closing date. For example, mergers that are subject to antitrust or other regulatory review and approvals may take months or longer to close. During this time, the value of Acquiror stock may fluctuate dramatically as a result of market conditions over which the parties to the merger agreement have little control.[17] An example of the effect of such stock price fluctuation is illustrated below:

Example. On June 1, 2004, after lengthy negotiations, Target, a publicly traded corporation, and Acquiror, also a publicly traded corporation, sign a binding written contract under which Target will be merged into Acquiror, with Acquiror surviving the merger. In the agreement, the parties state their intent that the merger is to be characterized for U.S. federal income tax purposes as a tax-free reorganization under Section 368(a)(1)(A). Under the agreement, in exchange for all outstanding Target shares, Target shareholders will receive (in the aggregate) 50 Acquiror shares (each of which is worth $1 on June 1, 2004) and $50 cash. The agreement contains no provision that would readjust the merger consideration in the event that

[16] Support exists under *current* law for determining continuity using signing date values. Such support is discussed in detail in Part VI of this report. No court has squarely ruled on whether, under current law, continuity of proprietary interest may be satisfied based on signing date values.

the continuity requirement would not otherwise be satisfied. Measured at signing, Target shareholders, therefore, will receive a mix of 50 percent Acquiror stock and 50 percent cash consideration in the merger. The merger agreement provides for customary closing conditions, including a condition that the parties must each receive an opinion of counsel to the effect that the merger will qualify as a reorganization under Section 368. During the late summer of 2004, trading prices on the stock market on which Acquiror stock is traded fluctuate wildly as a result of a national emergency or the upcoming Presidential election (it cannot be determined to which event the market swings are attributable). On the date of the merger closing, October 1, 2004, the value of Acquiror stock has fallen from \$1 per share on June 1st to \$.25 per share. In exchange for their Target shares, consequently, Target shareholders will receive (in aggregate) \$50 cash and 50 Acquiror shares worth \$.25 each (equal to \$12.50 in total stock consideration). Target shareholders thus will receive a mix of 80 percent cash and 20 percent Acquiror stock (valued at the closing date). This mix is likely insufficient to satisfy the continuity of interest requirement if continuity of interest must be measured based on stock values at closing.

The parties in this example are left with few options. Either party in this example may refuse to close the transaction because, in the absence of the guidance recommended by this report, counsel would be unable to opine that the merger will qualify as a reorganization. Both parties have a right to "walk away" from the transaction for tax reasons deriving from the drop in the Acquiror's stock price. Continuity concerns thus could benefit one party's strategic negotiating position. The Target (or Target shareholders) could exploit this event to renege on

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(footnote continued)

[17] The value of Acquiror stock often declines after a proposed merger is publicly announced, which is generally at the time the merger agreement is signed.

the deal made with the Acquiror, or vice versa. The tax rule in this situation alters one party's relative bargaining power, interfering with the business deal originally reached by the parties. In order for the transaction to proceed, the parties must reach a new agreement. The parties could agree to proceed with the merger as originally structured, in which case the transaction will be treated as a taxable event requiring gain or loss recognition by the Target shareholders and the Target, an extremely undesirable result. Alternatively, the parties may, if both agree, restructure the transaction to provide more tax-efficient results.[18] The outcome in this example, thus, is either non-consummation or renegotiation, neither of which was the result intended by the parties at the time they signed the merger agreement. In a merger involving unsophisticated parties, the parties may not even be aware of the potential restructurings that could ameliorate the problem.

V. Alternative Approaches to Pre-Closing Stock Value Fluctuation

The danger that post-signing stock value fluctuation poses to proposed tax-free reorganizations causes many parties to provide in the merger agreement for one of several complicated mechanisms that activate in the event that the merger does not satisfy the continuity of interest requirement on the date of closing.[19]

A. Additional Stock Consideration or Reduced Cash Consideration

Parties to a part-cash, part-stock merger may avoid the dilemma of post-signing stock value fluctuation by negotiating in the merger agreement a formula under which the Acquiror must provide additional shares of its stock to the consideration mix, or reduce the amount of cash that the Acquiror would provide (or both), as the price of its stock declines below

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[18] Alternative transaction structures are discussed in greater detail in Part V of this report.

[19] For a discussion of some of the potential mechanisms, *see* Craig M. Wasserman, *et al*., *New Strategies for Financial Institutions in the E-Commerce Economy 2000*, PRACTISING LAW INSTITUTE CORPORATE LAW AND

(footnote continued)

a certain level prior to the closing date. This mechanism is designed to provide Target shareholders with stock consideration the value of which exceeds the necessary threshold to satisfy the continuity of interest requirement. Such a solution is, at a minimum, complicated, requiring the parties to focus on tax-driven mechanics and formulas that go to the heart of the transaction—the amount the Acquiror will pay—but, at the same time, applies only in the event of a contingency. The tax formula for revising the consideration bears no relation to the financial rationale of the transaction. It tampers with the parties' fundamental agreement on price. Indeed, agreement on a formula for rejiggering the pool of consideration may not even be possible in the pressurized environment in which acquisition negotiations take place.

B. Taxable Reverse Subsidiary Merger

Another method employed by parties is a provision in the merger agreement requiring that, in the event that sufficient continuity would not be provided as a result of pre-closing changes in Acquiror stock value, the direction of the merger would automatically reverse. Under this provision, an Acquiror subsidiary would merge into the Target in a reverse subsidiary merger. Such a mechanism would result in a taxable transaction for Target shareholders. But, because the transaction would be changed from a transfer of Target assets to a transfer of Target shares, there would be no corporate-level gain and thus Acquiror would not inherit any corporate-level tax liability. The parties may not be able to agree to this provision if the Target shareholders demand assurance that their exchange of Target stock for Acquiror stock will be tax-free.

(footnote continued)

PRACTICE HANDBOOK SERIES, 1206 PLI/CORP 145 (September 2000); Victor I. Lewkow, *Allocating Market Risk in Stock-for-Stock Acquisitions*, 8 NO. 9 INSIGHTS 15 (September 1994).

C. Holding Company Section 351 Transaction

The parties could provide that if continuity is not satisfied, the transaction would be restructured in a manner designed to satisfy Section 351, rather than Section 368. Under this alternative, a new holding company would be formed. The new holding company would form two merger subsidiaries, one of which would merge into Acquiror and the other of which would merge into Target. As a result, the new holding company would own all the stock of Acquiror and all the stock of Target. In the Acquiror merger, the Acquiror shareholders would receive holding company stock, and in the Target merger, the Target shareholders would receive holding company stock and cash in the amounts originally intended by the parties. The transaction would qualify under Section 351, because property transferors (*i.e.*, the former Target shareholders and former Acquiror shareholders) transfer property (*i.e.*, the stock in Target and the stock in Acquiror) to a transferee corporation (*i.e.*, the new holding company) in exchange for stock of the transferee corporation, and, in the case of the Target shareholders, boot.[20] The continuity of interest doctrine does not apply to Section 351 transactions,[21] because Section 351 protects incorporations of property and is therefore not limited to readjustments of corporate form. Accordingly, decreases in the value of Acquiror stock after signing do not affect the qualification of a transaction as a Section 351 transaction.

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20 *Cf.* Priv. Ltr. Rul. 8822062 (March 7, 1988). In that private letter ruling, the Service stated that if the Target shareholders' exchange of Target stock for cash and new holding company stock had qualified as a reorganization under Section 368(a)(2)(E), the Target shareholders would not be treated as transferors of property for Section 351 purposes. Consequently, the Target shareholders' receipt of new holding company stock would not be counted in determining whether the Acquiror shareholders would be entitled to Section 351 nonrecognition treatment. The Service subsequently abandoned this position in Priv. Ltr. Rul. 9143025 (July 24, 1991), ruling that stock of the new holding company received by Target shareholders in a Section 368(a)(2)(E) reorganization would be taken into account in determining whether Acquiror shareholders were entitled to Section 351 nonrecognition treatment.

21 *See* Rev. Rul. 84-71; 1984-1 C.B. 106.

In many cases, a transaction that is structured as a merger intended to qualify as a reorganization could, at least in theory, be restructured as a holding company transaction intended to qualify under Section 351. However, a holding company structure is not always practical. If the Acquiror is much larger than the Target, for example, the Acquiror may not want to readjust its own corporate structure in order to make the acquisition. Depending upon the Acquiror's state of incorporation, a holding company structure may require a vote of the shareholders of the Acquiror that would not otherwise be required. Although Section 251(g) of the General Corporation Law of the Sate of Delaware would generally permit the holding company structure without an Acquiror shareholder vote if the Acquiror is incorporated in Delaware, many other states would not. Imposing a holding company on top of the Acquiror may also have implications with respect to debt issued by the Acquiror, because the creditors would no longer have recourse to the top-tier company in the corporate chain. Further, if numerous acquisitions are contemplated, it would be unwieldy to create a new holding company for each acquisition. Thus, Acquiror often will not agree to a holding company structure.

D. All-Stock or All-Cash Merger

The merger agreement could also provide that, in the event that a change in Acquiror stock price would prevent satisfaction of the continuity requirement at closing, the structure of the transaction will remain unchanged, but Target shareholders will receive consideration consisting of all Acquiror stock. If the transaction reverts to an all-stock deal, the continuity requirement will be satisfied. Alternatively, the merger agreement could provide that in the event that the continuity requirement cannot be satisfied at closing, the transaction could be structured as a reverse subsidiary merger and the Target shareholders would receive consideration consisting of all cash. These types of provisions are often the least feasible of the available options as a result of the dramatic change in consideration required.

In all of these cases, the mechanisms are provided solely as a result of tax considerations regarding the continuity of interest requirement and arise from the non-tax motivated delay between the signing and closing dates.

VI. Measuring Continuity of Interest at Signing vs. Closing

The current practice of determining whether a transaction satisfies the continuity of interest requirement solely using closing date stock values results in taxpayer uncertainty, transactional inefficiency and unfair outcomes. The common justification for the current practice is that Target shareholders actually receive the merger consideration on the closing date and that tax consequences of a merger generally are determined at the time the merger occurs. The continuity of interest doctrine, however, does not depend on the timing of the Target shareholders' realization of gain. Rather, it is a qualitative test that addresses whether the transaction as a whole satisfies a long-standing judicial policy against imposing tax on readjustments of corporate forms.[22] Indeed, from the time of signing, the Target shareholders generally benefit or suffer economically with changes in the Acquiror stock value. After signing, the higher the value of the Acquiror stock, the better off the Target shareholders are, and vice versa. The value of the Target stock rises and falls with changes in the value of the Acquiror stock. In that sense, the Target shareholders acquire an equity interest economically in the Acquiror at the time of signing, bolstering the rationale for testing continuity at that point.

As discussed below, the Service has applied numerous other qualitative tests based on the facts as they existed when the parties struck the deal, as distinguished from the time the transaction was effected. Those authorities support a flexible approach to continuity that

[22] *See* discussion of background and rationale of the continuity requirement in Part III of this report.

would permit relying on stock values at the time the parties enter into a merger agreement to determine whether the continuity requirement has been satisfied.

A. Precedent for Using Signing Date Stock Values

In the context of analyzing qualitative tests, the Service has placed emphasis on the facts that existed when the parties struck a deal in order to determine whether a qualitative requirement was satisfied.

In a pair of related revenue rulings regarding the amount of redemption premium that may be provided on preferred stock without triggering a deemed distribution under Section 305(c), the Service relied upon the value of the preferred stock at the time the agreement regarding the redemption premium was signed, rather than at the time the transaction was consummated.[23] Although the applicable Section 305 Treasury Regulations were revised in December 1995, the reasoning of the Service in those rulings supports measuring continuity of interest at signing. The former Treasury Regulations under Section 305 generally provided that if a corporation issued preferred shares that could be redeemed at anything other than a "reasonable redemption premium", the premium would be taxable to recipient shareholders as a deemed distribution.[24]

Under the former regulations, a call premium not in excess of 10 percent of the issue price of the preferred stock was considered reasonable.[25] In Revenue Ruling 75-468,[26]

[23] *See* Rev. Rul. 75-468; 1975-2 C.B. 115; Rev. Rul. 81-190; 1981-2 C.B. 84 (Deemed distribution under Section 305(c) did not occur because premium would not have exceeded 10 percent threshold using signing, rather than consummation, date values). As described in n. 16 *supra*, these rulings support an argument that, under current law, continuity is measured at signing.

[24] *See* former Treas. Reg. 1.305-5(b)(2).

[25] *Id*.

[26] Rev. Rul. 75-468; 1975-2 C.B. 115.

parties to a merger signed an agreement under which each share of outstanding Target stock, which was trading at $20 per share at the signing date, would be exchanged for one share of Acquiror preferred stock that could be redeemed for $21 per share. Between the date of the signing of the agreement and the date of consummation of the reorganization, the value of the outstanding Target shares dropped to $18 per share. Consequently, the redemption premium at the time of the issuance of the preferred shares was approximately 16 percent. However, the reason for the change in the percentage represented by the redemption premium was solely the result of "market conditions that caused the fair market value of Y stock to be less at the date of the exchange for the X preferred stock than it was at the date the exchange ratio was agreed to".[27] The ruling emphasizes that a premium in excess of 10 percent "was not bargained for nor was it intended".[28] Accordingly, the Service held that Section 305(c) should not apply because at the time of the signing of the agreement, the parties agreed to issue stock with a redemption premium of only five percent. Revenue Ruling 81-190[29] reaches a similar conclusion regarding a parallel set of facts.

The government has placed emphasis on signing date values in other contexts where the test, like the "reasonable redemption premium" test, is qualitative in nature. A recent Technical Advice Memorandum,[30] for example, involved the issue of whether warrants received by a corporation from a sibling corporation were acquired in a bargain sale that would have required a reallocation of income under Section 482. The Service held that no bargain sale

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27 *Id*.

28 *Id*. *See also* Rev. Rul. 2003-55; 2003-22 I.R.B. 961 (May 12, 2003) (Business purpose requirement of Treas. Reg. Section 1.355-2(b)(1) is satisfied even though, as a result of "unexpected deterioration in market conditions", plan for public stock offering of subsidiary stock is cancelled).

29 Rev. Rul. 81-190; 1981-2 C.B. 84.

occurred because at the time the parties entered into the relevant written agreement, the warrants contained no bargain element.[31] Again, the holding turned on the facts at the time the parties entered into the written agreement, rather than at the point at which the transaction was executed. The proper time for determining whether a bargain sale had occurred was when the parties struck the deal.[32]

A common thread runs through these rulings: the parties in these transactions (a) would have complied with a qualitative requirement based on the facts at the time they entered into a written agreement to effect the transaction at issue, but (b) could not satisfy the requirement at the consummation of the transaction as a result of unexpected or unforeseen market conditions.[33] These authorities support the proposal that the stock values as of the date the parties entered into a written merger agreement should be permitted to be used to satisfy continuity. Changes in stock price occurring after the signing date should not cause a merger to fail to satisfy the continuity of interest requirement.

(footnote continued)

30 Technical Advice Memorandum 200334001 (August 22, 2003).

31 *Id*.

32 *See also* Treas. Reg. Section 1.988-2(a)(2)(ii)(C), Example (no gain is recognized as a result of a bargain sale arising from an increase in the value of the underlying property between the date of signing a purchase contract with an unrelated party and the date the sale occurs).

33 *See* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933), in which the U.S. Supreme Court affirmed the Fifth Circuit's decision that merger consideration consisting of cash and short-term notes issued by the Acquiror did not constitute sufficient continuity. In its decision, the Fifth Circuit emphasized the intent of the parties at the time they signed the merger agreement. The Fifth Circuit stated "[t]here is no doubt that the written agreement of November 4, 1926, for the disposition of petitioner's property to a new corporation, contemplated an outright sale and not an exchange or reorganization". Pinellas Ice & Cold Storage Co. v. Commissioner, 57 F.2d 188 (5th Cir. 1932). By looking to the type of transaction "contemplated" by the parties at the signing, the Fifth Circuit decision, and the U.S. Supreme Court decision affirming it, support the proposal that continuity of interest should be tested by reference to circumstances at signing, and accordingly should be measured using signing date stock values.

The 1998 continuity of interest regulations also support using signing date values to measure continuity of interest. As discussed above in Part III, those regulations permit sales by Target shareholders before a potential tax-free reorganization and sales by former Target shareholders of the Acquiror stock they receive in the potential tax-free reorganization so long as those sales are not made to Acquiror or a person related to Acquiror. The Treasury stated in the preamble to those regulations that "the final regulations focus the COI requirement generally on exchanges between the [Target] shareholders and [the Acquiror]".[34]

The government's decision in the 1998 regulations to disregard pre- and post-merger sales to third parties for purposes of continuity of interest was a larger step than the government would be required to take in disregarding post-signing changes in stock value. In an outright sale to a third party, a Target shareholder disposes of his equity in the Acquiror. A mere change in Acquiror stock value is a much more benign change in position from a continuity of interest perspective. The Target shareholders continue to be entitled to the same number of Acquiror shares. The 1998 continuity regulations disregard sales of Target shares before the merger and Acquiror shares after the merger; our proposal would disregard changes in Acquiror stock value—which are caused or evidenced by sales of Acquiror shares—that occur between signing and closing. Further, there is no concern regarding a disposition funded by the Acquiror, which was the primary concern underlying the 1998 regulations.

B. Reducing Uncertainty, Inefficiency and Unfairness

The current method of measuring continuity of interest using closing date values creates considerable uncertainty regarding the outcome of an executed merger agreement.

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[34] Treasury Decision 8760.

Parties to a merger may not know whether a proposed tax-free reorganization will satisfy the continuity of interest requirement at closing. Further, Target shareholders may not know the type or amount of stock and/or cash consideration they will receive (and the Acquiror may not know the type and amount of consideration it will be required to pay) in the event that a mechanism described in Part V of this report is triggered. If continuity of interest were determined using signing date values, the parties to a merger would have a substantially greater degree of certainty regarding whether the transaction will satisfy the requirement.

The Treasury and the Service have taken steps in recent years to add certainty to the continuity of interest doctrine. As described in Part III of this report, the Treasury issued regulations regarding pre- and post-reorganization dispositions of Target or Acquiror stock because the inconsistent case law on these issues "[did] not further principles of reorganization treatment and [was] difficult for both taxpayers and the Service to apply consistently".[35] Measuring continuity using signing date values would provide similar clarity.

The increased certainty that would result from a clear rule would improve contractual efficiency. The current practice of using closing date values requires taxpayers to include complicated mechanisms that address pre-closing changes in Acquiror stock value. These mechanisms require time-consuming and costly negotiation. Testing continuity at signing would make these provisions unnecessary.

The current practice of measuring continuity at closing also creates problems in the case of a transaction subject to the federal securities laws. In the case of a merger involving a

[35] *Id*. The Service further clarified the continuity doctrine in 1999 by ruling that an Acquiror's open market repurchases of its own shares through a broker subsequent to the closing of a merger agreement (even if the Acquiror repurchased shares from former Target shareholders) were disregarded for continuity of interest purposes. Rev. Rul. 99-58; 1999-52 I.R.B. 701.

publicly traded Target, the proxy statement describing the transaction to Target shareholders and soliciting the Target shareholders' vote is typically reviewed by the Securities and Exchange Commission (the "SEC") for compliance with SEC requirements. Among other things, the proxy statement must describe the expected federal income tax consequences. If those consequences hinge on the value of the Acquiror stock at closing, the consequences cannot be described with any certainty. The SEC's current approach to the tax disclosure compounds the problem. The SEC in recent years has requested, and often insisted, that the proxy statement include or reflect a legal opinion, given at the time the proxy statement is finalized, as to federal income tax consequences. Providing an opinion as of the proxy statement date regarding tax consequences that depend on facts at closing is problematic. The situation can be addressed to a degree by including a provision in the agreement along the lines described in Part V. A. above. The situation would be ameliorated if a key fact—the value of Acquiror stock—were settled as of signing.

Measuring continuity at signing would also be more equitable than using solely closing date stock values. It is unfair to penalize parties that fully intended to comply with the continuity of interest requirement at the time they signed the merger agreement (when they had control over the relative values of stock and cash in the consideration mix) as a result of changes in Acquiror stock value occurring after the signing and over which they have little control. It is also harsh to penalize unsophisticated taxpayers that are unaware of the danger that pre-closing stock price fluctuation poses to reorganization treatment or are unfamiliar with techniques to address it. It may also be unfair to permit tax-free treatment to parties that are willing and able to structure their transaction as a holding company Section 351 transaction and deny tax-free treatment to parties that, for non-tax reasons, are not willing to undergo the inconvenience and impracticality of a holding company structure or are simply not able to use that structure.[36]

VII. Recommendations

As this report demonstrates, we agree with the Treasury and the Service that the current practice of measuring continuity of interest solely using closing date values should be reconsidered. Accordingly, we make the following recommendation:

A. Recommendation Regarding Measurement of Continuity Using Signing Date Values

We recommend that continuity of interest may be measured using signing date values (determined immediately prior to the public announcement of the merger agreement) provided that (a) the parties to a merger have entered into a binding written contract subject to customary closing conditions and (b) the closing of the merger occurs within a commercially reasonable amount of time.

Our recommendation requires that the parties enter into a binding written contract subject to customary closing conditions.[37] A mere non-binding term sheet, letter of intent or option should not be sufficient. Also, because a merger must close within a commercially reasonable amount of time under our recommendation, an Acquiror would be unable to delay the closing date unreasonably.

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[36] *See* Part V of this report for further discussion of the holding company Section 351 transaction structure alternative.

[37] It could be argued that a merger agreement is not binding until any required shareholder vote in favor of the merger is obtained. A shareholder vote of approval, however, is a customary closing condition. Merger agreements submitted to a shareholder vote are routinely approved. While a shareholder vote is not a "rubber stamp", it is the rare case that a merger agreement is turned down by shareholders. Further, measuring continuity as of the date of the shareholder vote would undercut the certainty that measuring at signing would achieve and would encourage the use of adjustment formulas that measuring at signing would eliminate.

Our recommendation would use signing date values as determined immediately prior to the public announcement of a merger agreement. Taxpayers usually anticipate that, immediately after the public announcement of a merger agreement, *some* degree of change, upward or downward, to the price of the Acquiror's stock will occur. The extent of those changes is unpredictable and often not within the control of the parties. In order to achieve the clarity that our proposal seeks, decreases in stock value resulting from a merger announcement should not be taken into account.

Our recommendation leaves little room for taxpayer abuse. It is unlikely that an Acquiror would deliberately cause its own stock price (and market capitalization) to plummet. Our proposal may encourage an Acquiror to enter into a merger agreement prior to an anticipated drop in the Acquiror's stock price. However, the securities laws, state fiduciary laws and a successful plaintiffs' bar provide significant constraints on management behavior in relation to stock price. We do not believe that the incentive that may be created to enter into a merger agreement prior to an anticipated drop in Acquiror stock price requires additional tax-based safeguards.

B. Measurement of Continuity of Interest Using Signing Date Values is Independent of Minimum Percentages of Acquiror Stock Required and Does Not Affect the Date of Realization

Our recommendation is not intended to affect the minimum percentage of Acquiror stock required in the mix of consideration to be transferred to Target shareholders. The minimum percentage guidelines have emerged from a judicial doctrine nearly 70 years old. Whatever percentage the courts or the Service choose to apply for purposes of deciding cases, issuing rulings or otherwise, our recommendation clarifies *when* these ratios should be measured.[38]

Our proposal also does not affect the date on which realization occurs and the date on which the amount of gain recognized by Target shareholders is determined. That date would continue to be the closing date of the transaction. On that date, a Target shareholder would measure the shareholder's amount realized by valuing the total consideration received, deduct basis to determine gain realized, measure the value of the boot received and recognize gain equal to the lesser of the gain realized and boot received. Thus, under our recommendation, although continuity would be measured based on signing date values, gain recognized would be based on closing date values.[39] We believe this approach is rational. For the reasons described above, continuity is appropriately a holistic and qualitative test based on circumstances at signing, while the tax accounting for each shareholder's gain recognized (and the Target's gain recognized, if any) should be based on values on the date that the transaction is effected.[40]

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[38] Therefore, the use of signing date values should not implicate judicial decisions regarding the relationship between the step transaction doctrine and continuity of proprietary interest. *See, e.g.,* Yoc Heating Corp. v. Commissioner, 61 T.C. 168 (1973). In that case, the Acquiror purchased approximately 85 percent of the stock of Target in exchange for cash and notes. Acquiror then caused the assets of Target to be acquired by Acquiror's wholly-owned subsidiary. The court treated these two steps as an integrated transaction, and consequently, the acquisition failed to satisfy the continuity requirement. *See also* Kass v. Commissioner, 60 T.C. 218 (1973), *aff'd* 491 F.2d 749 (3d Cir. 1974), in which the Court integrated Acquiror's purchase of approximately 84 percent of Target stock for cash with the subsequent merger of Target into Acquiror, holding that the merger failed the continuity requirement. Acquiror in these instances was able to obtain a step-up in basis in the Target assets without making a Section 338 election. In response, the Treasury issued regulations that treat stock acquired in a qualified stock purchase as counting favorably towards continuity of interest. See Treas. Reg. Section 1.338-3(d)(2).

[39] Under general U.S. tax principles, in order for tax to be imposed, a realization event must occur. Signing a merger agreement generally is not such an event.

[40] *See* Amerada Hess Corp. v. Commissioner, 517 F.2d 75, 78 (3d Cir. 1975) (In a taxable exchange, for purposes of determining Acquiror's basis in property received and seller's amount realized, court required parties to value Acquiror shares using closing date fair market value of such shares rather than pre-signing date value of Acquiror shares used in the acquisition agreement).

See also Treas. Reg. Section 1.1060-1(a) (referencing Treas. Reg. Section 1.338-6). In the context of "applicable asset acquisitions", subject to certain exceptions, parties may not allocate purchase price to any asset in

(footnote continued)

C. Special Cases

Our recommendation should generally apply to special cases, using signing date values where applicable.

1. Collars and Other Formulas that Depend on Acquiror Stock Price

The discussion above has argued that in a typical merger, where the pool of consideration consists of a fixed number of Acquiror shares and a fixed amount of cash, continuity should be tested at signing. Many merger agreements provide, however, that the number of Acquiror shares or the amount of cash to be paid depends on the value of Acquiror stock. The most common example, often referred to as a "collar", is designed to guarantee that Target shareholders receive a fixed value per share of Target stock so long as the Acquiror stock price remains within a specified band. Under a collar, the Acquiror pays additional Acquiror shares (up to a limit) if the Acquiror stock price declines and fewer Acquiror shares (but no less than a minimum) if the Acquiror stock price increases.[41] Suppose that the Acquiror stock price is trading at $1 per share. A merger agreement could provide that each Target share will be entitled to (a) $1 of cash and (b) either (i) Acquiror stock worth $1 provided that a share of

(footnote continued)

an amount exceeding the fair market value of that asset as of the beginning of the day after the closing date. The relative fair market values of the assets to be acquired, however, may fluctuate between the date that the parties sign the purchase agreement and the day after the closing date. As a result of these fluctuations, the parties ultimately may be required to reallocate the purchase price. *See* Michael L. Schler, *Sales of Assets After Tax Reform: Section 1060, Section 338(h)(10), and More*, 43 TAX L. REV. 605 (1988) (the requirement to allocate based on values on the day after the closing date "interfer[es] with the parties' expected allocations"). It could be argued that this provision, which focuses on the day after the closing date as the proper time for valuation, should apply by analogy to the measurement of continuity. The purpose of the purchase price allocation provision, however, is to ensure that the seller's gain is properly measured, and the acquiror's basis is determined, as of the time of realization. As this report demonstrates, the continuity doctrine does not tum on the timing of Target shareholders' realization of gain.

[41] For a description of typical commercial collars, *see* Edward D. Herlihy *et al*, *Dealing with Market Risks in Stock Mergers: Collars and Walk-aways*, INSIGHTS, VOL. 6, NO. 7 (July 1992).

Acquiror stock is worth at least $0.85 and no more than $1.15, (ii) 1.18 shares of Acquiror stock if Acquiror stock is worth less than $0.85 per share or (iii) 0.87 shares of Acquiror stock if Acquiror stock is worth more than $1.15 per share. Such collars provide price protection to Target shareholders by ensuring that, within a range of Acquiror stock values, the value of the consideration paid to Target shareholders is fixed. The parties should not be disadvantaged, under the tax rules, by reason of choosing a formula to protect Target shareholder value within a band, instead of choosing a fixed pool of stock and cash consideration. Transactions involving the type of collar described above are common commercial arrangements, and the tax law should not make Target shareholders choose between a degree of price protection and relative certainty of tax result. Thus, "collars" should be tested for continuity at signing by applying the formula contemplated in the merger agreement using the signing date Acquiror stock value.

Another type of pricing formula—a "cash top-up" formula—also aims to protect Target shareholders against declines in Acquiror stock prices. This type of formula does so by adding cash to the pool of consideration up to a limit. For example, suppose the Acquiror stock price is trading at $1 per share. A merger agreement could provide that each Target share will be entitled to (a) $1 of cash, (b) 1 share of Acquiror stock and (c) if the Acquiror's stock price is less than $1 per share, cash (up to a maximum of $0.10) equal to the excess of $1 over the value of the Acquiror's stock price. This type of formula, like the collar described in the preceding paragraph, derives from business negotiations relating to the extent to which Target shareholders are willing to suffer decreases in Acquiror stock value and the extent of earnings dilution from the issuance of additional shares that the Acquiror is willing to bear. Like the "collar" formula in the preceding paragraph, the "cash top-up" also represents an attempt by the parties to offer Target shareholders a degree of price protection. This formula arguably should also be tested at signing. Under that approach, the continuity test would be met in the example, because the mix of consideration, assuming a stock value of $1, would be 50 percent stock and 50 percent cash (i.e., $1 of cash and 1 share of Acquiror stock worth $1 for each Target share). The formula in this paragraph is arguably not as sympathetic a case from a continuity perspective as the collar, because price protection for Target shareholders is achieved by adding cash to the pool of consideration if the Acquiror's stock price declines. Nevertheless, because a cash top-up is a common commercial arrangement involving a relatively small amount of cash top-up (a maximum of $0.10 in this example), it should be tested for continuity by applying the formula contemplated in the merger agreement using the signing date Acquiror stock value.

Although neither the "collar" nor the "cash top-up" formulas above are abusive, there may be rare cases in which a transaction involving a formula dependent on Acquiror stock price could be abusive. For example, suppose that, at the time an agreement is entered into, the Acquiror stock price is $1 per share and the agreement provides that if the stock price at closing is exactly $1 per share, then the consideration will be all stock, but if the Acquiror stock price is any other amount, the consideration will be 90 cents cash and 10 cents' worth of Acquiror stock. That transaction should not be protected. Measured at signing, the consideration is all stock, but in all likelihood, the Acquiror's stock price will not be exactly $1 at closing and the consideration will be 90 percent cash and 10 percent Acquiror stock. The formula in this example is not commercial in light of the dramatic change in the type of consideration. We believe that commercial formulas stemming from business negotiations on price, such as the "collar" and the "cash top-up" should be protected, while formulas such as the one in this paragraph should not be protected.

2. Private Transactions

Private transactions raise valuation issues regardless of when continuity is measured. The concerns raised in this report regarding decreases in Acquiror stock value stem from the public markets, because the public markets provide daily evidence of value. The value of the stock of a privately-held Acquiror, and changes in that value between signing and closing, are harder to judge. Nevertheless, the same type of problem could arise in the private context as arises in the public context. Dramatic changes in Acquiror stock value could occur after signing. The rationale for measuring continuity at signing would appear to apply equally in the private context.

Of course, if Acquiror is privately held and Target is publicly traded, the post-announcement value of Target stock will provide a good (but not perfect) indication of the value of Acquiror stock. The Target stock will adjust to reflect the anticipated consideration, including Acquiror stock, but will also reflect the risk that the merger will not occur and may reflect the impact of the announcement itself on the value of Acquiror stock as well as anticipation of a possible topping bid.

3. Two-Step Transactions

A two-step acquisition generally consists of (a) a tender or exchange offer followed by (b) a reverse subsidiary merger intended to qualify under Section 368(a)(2)(E)[42] or a forward subsidiary merger intended to qualify under Section 368(a)(2)(D). The Service recently issued published rulings confirming that, so long as the two steps are part of a plan, they will be

[42] Because Section 368(a)(2)(E) requires an acquisition of "control" (80 percent of the voting stock and 80 percent of each class of non-voting stock) in exchange for Acquiror voting stock, continuity of proprietary interest is rarely a problem in transactions that are intended to qualify under Section 368(a)(2)(E).

integrated and tested for reorganization status as a single overall transaction.[43] Traditionally, two-step transactions have been tested for continuity of interest at the time of the second step, the merger.[44]

Most two-step acquisitions begin with the signing of an agreement between the Acquiror and the Target. Our proposal to measure continuity at signing would apply to two-step acquisitions that involve agreements between the Acquiror and the Target.

Some two-step acquisitions do not involve any signed agreement between the Acquiror and the Target. Consistent with our proposal and the published rulings treating two-step acquisitions as a single overall transaction, in the case of two-step acquisitions that do not involve a signed agreement between the Target and the Acquiror, it may be appropriate to test for continuity of interest at the time the tender offer or exchange offer is initially made to the Target shareholders.[45]

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[43] Rev. Rul. 2001-26; 2001-1 C.B. 1297; Rev. Rul. 2001-46; 2001-2 C.B. 321.

[44] The Service's ruling guidelines appear to mandate that the test compare the value of the Acquiror stock owned by the former Target shareholders with the value of all the outstanding Target stock immediately prior to the merger. Rev. Proc. 77-37; 1977-2 C.B. 568, section 7.01(2), requires a representation that there is no plan on the part of Target shareholders to sell Acquiror shares "that would reduce the target shareholders' ownership of acquiring stock to a number of shares having a value, as of the date of the transaction, of less than 50 percent of the value of all of the formerly outstanding stock of target as of the same date". Thus, suppose that in the first step, Acquiror acquires 50 percent of the Target stock for $50 cash in the aggregate, and in the second step, Target merges into Acquiror with the remaining Target shareholders receiving only stock. Arguably, under the ruling guidelines, whatever the value of the Acquiror stock on the date of the merger, continuity of interest is satisfied in that example, because the value, on that date, of the Acquiror stock issued in the merger is 50 percent of the value of all the Target stock. The value of 100 percent of the Target stock immediately before the merger is twice the value on that date of the consideration being paid on that date for 50 percent of the Target stock.

[45] For analogous authority supporting this position, *see* Rev. Rul. 72-354; 1972-2 C.B. 216. In that ruling, Acquiror purged itself of previously acquired Target stock by selling such stock in order to acquire Target in a subsequent stock-for-stock reorganization qualifying under Section 368(a)(1)(B). The Service respected the sale of the previously purchased Target stock as an independent transaction because it occurred prior to the date the exchange offer was made to the Target shareholders (as distinguished from the date such offer closed). Thus, the Service looked to the offer date as the point at which the stock-for-stock reorganization commenced.

4. Contingent Stock and Escrowed Stock

Contingent stock and escrowed stock should also be subject to our recommendation. The New York State Bar Association Tax Section is contemporaneously submitting a separate report, *Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganization Transactions*, addressing the treatment of consideration payable in shares of Acquiror stock the receipt of which is contingent on events that occur after the closing of the transaction. That report generally recommends that such contingent stock or escrowed stock be treated as proprietary consideration based on the fair market values of such rights on the closing date of the transaction. That report assumes that continuity must be measured at closing. If our recommendation in this report regarding signing date is adopted, then contingent stock and escrowed stock should be valued at signing.

D. Corollary Issues

This report focuses on acquisitive transactions. Continuity of interest is also a requirement for divisive transactions under Section 355.[46] Authorities on continuity of interest under Section 355 are scarce. Further, divisive transactions are not generally jeopardized by pre-closing changes in stock value. Nevertheless, in the unusual event that stock values were relevant to satisfaction of continuity of interest in the divisive context, the principles applicable to acquisitive transactions ought to apply to divisive transactions.

Another set of corollary issues revolves around the timing for testing statutory reorganization rules that turn on value. The most significant of these is the "control" test under

[46] *See* Treas. Reg. Section 1.355-2(c) ("section 355 requires that one or more persons who, directly or indirectly, were the owners of the enterprise prior to the distribution or exchange own, in the aggregate, an amount of stock establishing a continuity of interest in each of the modified corporate forms in which the enterprise is conducted after the separation").

Section 368(a)(2)(E). That test requires that at least 80 percent of the voting power and at least 80 percent of all other classes of stock of the Target be acquired by the Acquiror in the transaction in exchange for Acquiror voting stock. Thus, a part-cash/part-stock transaction designed to qualify under Section 368(a)(2)(E) is vulnerable to changes in stock value after signing and before closing. The same types of awkward mechanics discussed in Part V of this report can be built into an agreement to address the problem, but those mechanics are undesirable. They have the effect that tax concerns, rather than business economics, drive the amount and type of consideration paid. Restructurings involving a forward subsidiary merger intended to qualify under Section 368(a)(2)(D) or involving a holding company intended to qualify under Section 351 are sometimes, but not always, possible.

It is more difficult to conclude that the Section 368(a)(2)(E) “control” test should be measured at signing than it is to conclude that continuity of interest should be measured at signing. Continuity is inherently a flexible judicial doctrine, while the “control” test is a statutory bright-line rule. Yet, that difficulty should not be overstated. The statute does not mandate timing for the “control” test, and it is possible that the Service could interpret the test to be satisfied at signing. Because this issue is not listed on the Priority Guidance Plan, we are not presently making any recommendation with regard to it.

The Treasury should also consider whether a transaction that does not satisfy the continuity of interest requirement using signing date values should be retested for continuity using closing date values. In other words, if a merger does not satisfy the continuity of interest requirement using signing date stock values, but does satisfy the requirement using closing date stock values, should the merger be considered to have satisfied the continuity of interest requirement? Such scenarios should be rare under our recommendation as parties intending to effect reorganizations would most likely structure merger consideration to satisfy continuity at signing.

The Service may wish to consider whether to provide guidance regarding precisely which Acquiror stock values contemporaneous with signing should be used for purposes of continuity of proprietary interest. One approach may be to use the average of the high and low value on the relevant date. Another would be to permit parties to use a trailing average (*e.g.*, the average closing price over the preceding 20 days) if a trailing average is used by the parties in setting the merger consideration. There are many possible approaches that would be practical. Whatever approach is adopted, we recommend that the parties be able to determine whether continuity of proprietary interest is satisfied when they sign a merger agreement.

VIII. Conclusion

Measuring satisfaction of the continuity of interest requirement under Section 368 solely based on stock values as of the closing date results in uncertainty, inefficiency and unfairness that is not required by underlying doctrine. In accordance with the recommendation of this report, the continuity of interest requirement should be tested using signing date stock values (as an alternative to closing date stock values), provided that the conditions described above are fulfilled.