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Regulations Narrow Continuity of Interest Signing Date Rule

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The IRS and Treasury recently issued temporary and proposed regulations addressing the appropriate date on which to measure the value of consideration received for purposes of determining whether the continuity of shareholder interest (COI) requirement has been satisfied in an otherwise qualifying reorganization under section 368(a).[1] Temp. reg. section 1.368-1T(e)(2) (the new regulations) retroactively replaces reg. section 1.368-1(e)(2) (the old regulations), unless specified persons collectively make an election to apply the old regulations to a transaction that is subject to a binding contract entered into after September 16, 2005, and before March 21, 2007.

I. The COI Requirement

A continuity of shareholder interest is required for a transaction to qualify as a reorganization under section 368(a).[2] The COI requirement is satisfied if a substantial part of the value of the proprietary interest in the target corporation (T) is preserved in the transaction. A substantial part of the proprietary interest in T is preserved, and the COI requirement generally is satisfied, when as little as 40 percent of the value of the T stock is exchanged for issuing corporation (P) stock having the same value.[3]

[1]T.D. 9316, 72 *Fed. Reg*. 12974 (Mar. 20, 2007).

[2]Reg. section 1.368-1(b).

[3]Temp. reg. section 1.368-1T(e)(2)(v) (Example 1) and reg. section 1.368-1(e)(2)(v) (Example 1). *See also John C. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (approximately 38 percent of P stock is sufficient to satisfy the COI requirement).

II. Overview of the Signing Date Rule

In determining whether the COI requirement was satisfied before the issuance of the old regulations, the T stock surrendered for P stock and the P stock thus received were both valued on the closing date of the transaction. If the P stock was publicly traded and declined in value between the date the parties agreed on the allocation of consideration (that is, the number of P shares to be issued for T shares) and the closing date, there could be no guarantee, absent protective closing date adjustments, that the COI requirement would be satisfied. The old regulations were issued principally to provide taxpayers with assurance in some circumstances that closing date adjustments to preserve COI were no longer necessary.

In general, the old regulations provided, and the new regulations continue to provide, that for purposes of testing COI, the value of the P stock received by T shareholders is valued on the last business day before the first day on which the contract to effect the proposed reorganization is binding (the signing date), provided the contract provides for "fixed consideration"[4] (the signing date rule).[5] Thus, if the contract provides for fixed consideration, the P stock must be valued on the signing date and may *not* be valued on the closing date. If there is fixed consideration, but the COI requirement is not satisfied using the signing date rule, it is irrelevant whether COI would be satisfied on the closing date based on that date's P stock value.[6] Although not stated in the old regulations, the apparent purpose of the signing date rule is to allow taxpayers to test COI before the closing date of a potential reorganization (that is, the signing date) only when the T shareholders "can be viewed as being *subject to the economic fortunes* of P as of the signing date."[7] That purpose is now clearly stated in the new regulations' definition of fixed consideration.[8]

[4]*See* "Definition of Fixed Consideration," *infra*.

[5]Temp. reg. section 1.368-1T(e)(2)(i) and reg. section 1.368-1(e)(2)(i).

[6]The parties could always avoid testing COI based on signing date values by modifying the amount or type of consideration, provided that modification falls outside specific safe harbors. *See* "Modifications to a Binding Contract," *infra*.

[7]T.D. 9225, 2005-2 C.B. 716 (preamble to reg. section 1.368-1(e)(2) (emphasis added)).

[8]Temp. reg. section 1.368-1T(e)(2)(iii)(B)(*2*). The description of when the IRS and Treasury believe it is appropriate for the signing date rule to apply was altered from requiring the T shareholders to be *generally* subject to the economic fortunes of P on and after the signing date to requiring the T shareholders to be *completely* subject to the "benefits and burdens" of P at all times after the signing date. *Compare* T.D. 9316, *supra* note 1, *with*

(Footnote continued on next page.)

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III. Changes to the Old Regulations

A. Modifications to a Binding Contract

The old regulations provided, and the new regulations continue to provide, the same definition of a binding contract,[9] and both allow certain modifications to the ''amount'' and ''type'' of consideration to be received by the T shareholders without establishing a new signing date.[10] Under the old regulations, however, the only modification to the consideration that did not result in a new signing date was a modification resulting solely from the issuance of additional shares of P stock, provided the initial contract would have satisfied the COI requirement without that additional issuance.[11] The new regulations provide additional circumstances that allow a change in amount or type of consideration while preserving the initial signing date. First, if the initial contract satisfies the COI requirement, the new regulations permit modifications that result in solely the issuance of additional shares of P stock, solely a reduction in the amount of money and other property (boot), or a reduction in the amount of boot coupled with an issuance of additional shares of P stock.[12] Second, if the initial contract does not satisfy the COI requirement, the new regulations permit modifications that result in solely the issuance of fewer shares of P stock, solely an increase in the amount of boot, or an increase in the amount of boot coupled with the issuance of fewer shares of P stock.[13]

Permitting contracts to be modified in the above situations is appropriate because in each case the number of P shares issued to the T shareholders may only increase the likelihood that when the COI requirement was initially satisfied, the COI requirement would be satisfied if the additional P shares were included in the initial contract, and when the COI requirement was not initially satisfied, the COI requirement would remain unsatisfied if fewer shares were to be issued in the initial contract. The new regulations should expand, however, the modification exceptions to include situations in which the number of P shares issued to the T shareholders increases or decreases on one or more dates after the signing date, provided the number of P shares never falls below the number of P shares to be issued on the signing date.[14]

Neither the old regulations nor the new regulations provide guidance concerning the meaning of the terms ''amount'' and ''type.'' It is not always clear whether a modification is of an amount or type of consideration. For example, it is unclear whether a change from cash to U.S. Treasury bills is a modification of the type of consideration to be issued in the transaction. Two more examples are a change from voting P stock to nonvoting P stock and a change from registered shares to unregistered shares,[15] when, in each case, the initial type of consideration has the same value as the modified type of consideration. The new regulations leave to the practitioner to decide whether those changes would be modifications of an amount or type. Because the COI requirement places emphasis on the value of the P shares received for a proprietary interest in T, the IRS and Treasury should issue guidance that allows for some qualitative modifications to the consideration, when those modifications do not materially affect the value of the P stock or boot received by the T shareholders.

B. Definition of Fixed Consideration

As stated above, for the signing date rule to apply, in addition to the binding contract requirement, the contract must provide for fixed consideration. Under the old regulations, a contract provided for fixed consideration if it provided for one of the following:

> 1. the number of shares of P stock and the amount of boot to be exchanged for all of the T stock;
>
> 2. the number of shares of P stock and the amount of boot to be exchanged for each share of T stock;

T.D. 9225, *supra* note 7. That change ultimately results in significantly reducing the number of circumstances to which the signing date rule would apply.

[9]Under temp. reg. section 1.368-1T(e)(2)(ii)(A), ''[a] binding contract is an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) shall not prevent an instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary closing conditions remain to be satisfied, shall not prevent an instrument from being a binding contract.''

[10]Reg. section 1.368-1(e)(2)(ii)(A) and temp. reg. section 1.368-1T(e)(2)(ii)(A).

[11]Reg. section 1.368-1(e)(2)(ii)(B)(*2*).

[12]Temp. reg. section 1.368-1T(e)(2)(ii)(B)(*2*).

[13]Temp. reg. section 1.368-1T(e)(2)(ii)(B)(*3*). The provision ensures that a transaction that fails the COI requirement on the initial signing date (using the signing date value of P stock) will not subsequently satisfy the COI requirement if, after the permitted modification, the value of the P stock rose sufficiently to satisfy the COI requirement on that later date.

[14]The following example illustrates the suggested additional modification exception. P and T enter into a binding contract on Jan. 3, year 1, providing that T will merge with and into P on June 1, year 1. On Jan. 2, year 1, T has 100 shares of stock outstanding and each share of P and T stock is worth $1. Under the binding contract, the T shareholders will receive 40 P shares and $60 in cash for all the outstanding stock of T. On Feb. 1, year 1, the parties modify the contract. Under the modified contract, which is a binding contract, the T shareholders will receive 60 P shares and $60 in cash for all the outstanding stock of T. On Mar. 1, year 1, the parties modify the contract again. Under the second modified contract, which is a binding contract, the T shareholders will now receive 50 P shares and $60 in cash for all the outstanding stock of T. Like the exceptions to the binding contract requirement under the new regulations, the second modification to the contract should not be treated as a modification under temp. reg. section 1.368-1T(e)(2)(ii)(B)(*1*) because the number of P shares never falls below the number of P shares to be initially issued under the Jan. 3, year 1 contract (that is, 40 shares).

[15]Such a contractual modification could occur when, after the initial signing date, P finds itself unable to file a registration statement with respect to the P shares to be issued in the transaction because T would not be able to provide the necessary financial statements at closing.

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3. the percentage of T stock to be exchanged for P stock and the percentage of T stock to be exchanged for boot; or

4. the percentage of each share of T stock to be exchanged for P stock and the percentage of each share of T stock exchanged for boot.[16]

To qualify as fixed consideration, the stock-for-stock exchange and stock-for-boot exchange described in 3 and 4 above must each have been ''economically reasonable.''[17] The new regulations removed requirements 3 and 4 because the IRS and Treasury believed they were inconsistent with the purpose of the signing date rule: to allow taxpayers to test satisfaction of the COI requirement on the signing date only when the T shareholders ''can generally be viewed as being subject to the economic fortunes of [P] as of the signing date.''[18] Under the new regulations, a contract provides for fixed consideration only if it provides for the number of P shares and the amount of boot to be exchanged for all of the T shares or for each T share.[19] The following examples illustrate situations in which the signing date rule applied under the old regulations but does not apply under the new regulations.

Example A. Under a binding contract, T merges with and into P whereby the sole T shareholder (who owns two identical shares of T stock) surrenders one share of T stock for $400 cash and one share of T stock for $400 worth of P stock based on the P stock price on the closing date. On the signing date, the P stock was trading at $100 per share (that is, absent any change in the value of the P stock, the T shareholder would have received four shares of P stock). On the closing date, the P stock is trading at $50 per share (that is, on the closing date the T shareholder receives eight shares of P stock). Under the old regulations,[20] the contract would have provided for fixed consideration on the signing date because the contract provided the percentage of T stock (50 percent) exchanged for P stock and the percentage of T stock (50 percent) exchanged for boot. Under the new regulations, however, the contract does not provide for fixed consideration, because the contract does not provide the number of P shares to be received by the T shareholder as of the signing date.[21]

[16]Reg. section 1.368-1(e)(2)(iii)(A)(*1*)-(*4*).

[17]Reg. section 1.368-1(e)(2)(iii)(A)(*3*) and (*4*).

[18]T.D. 9316, *supra* note 1, at 12974 (preamble to temp. reg. section 1.368-1T(e)(2)).

[19]Temp. reg. section 1.368-1T(e)(2)(iii)(A) (first sentence).

[20]Reg. section 1.368-1(e)(2)(iii)(A)(*3*).

[21]As a result, on the closing date the T shareholder receives eight P shares worth $400, which if valued on the signing date would constitute $800 of P stock. Under the old regulations, the merger would have satisfied the COI requirement because approximately 67 percent of the consideration received by the T shareholder in the merger consisted of P stock. Although under the new regulations the signing date rule does not apply, the merger still satisfies the COI requirement because, on the closing date, 50 percent of the consideration received in the merger consists of P stock.

Example B. The facts are the same as in Example A, except that on the closing date the P stock is trading at $400 per share (that is, on the closing date the T shareholder receives one share of P stock). Under the old regulations,[22] the contract would have provided for fixed consideration on the signing date because the contract provided the percentage of T stock (50 percent) exchanged for P stock and the percentage of T stock (50 percent) exchanged for boot. Under the new regulations, however, the contract does not provide for fixed consideration, because the contract does not provide the number of P shares to be received by the T shareholder on the signing date.[23]

As illustrated in examples A and B above, under the old regulations, the consideration provision of a merger agreement could be drafted so that a T shareholder was protected from fluctuations in the P stock price between the signing date and the closing date because that shareholder was guaranteed to receive $400 worth of P stock on the closing date regardless of the P stock's closing date price. The old regulations, therefore, seemingly permitted transactions that were inconsistent with the purpose of the regulations (that is, to require the T shareholders to be subject to the ''economic fortunes'' of the P stock on the signing date) to be structured using the signing date rule. The new regulations were issued to prohibit the application of the signing date rule to contracts containing those provisions.

C. Shareholder Elections

The old regulations provided a special rule for contracts that could not specify an exact amount of T shares that would be surrendered for P shares because the T shareholders were given an election to exchange their T stock for P stock or boot. Specifically, the old regulations provided that if the binding contract was not described in reg. section 1.368-1(e)(2)(iii)(A) (because neither the number of P shares to be received for T stock nor the percentage of T stock to be exchanged for P stock was known on the signing date) and a T shareholder had an election to receive P stock or boot, the contract was treated as providing for fixed consideration if it provided for either (1) the minimum number of P shares and the maximum amount of boot to be exchanged for T stock, or (2) the minimum percentage of T stock to be exchanged for P stock, and in each case, the percentage allocation was economically reasonable on the signing date. The new regulations eliminate both the maximum/minimum rule of (1) and the minimum percentage exchange rule of (2) above. The new regulations provide that if a T

[22]Reg. section 1.368-1(e)(2)(iii)(A)(*3*).

[23]As a result, on the closing date the T shareholder receives one P share worth $400 that had a value of $100 on the signing date. Under the old regulations, the merger would not have satisfied the COI requirement because 20 percent of the consideration received by the T shareholder in the merger, based on signing date values, consists of P stock. Although under the new regulations the signing date rule does not apply, the merger does satisfy the COI requirement because, on the closing date, 50 percent of the consideration received in the merger consists of P stock.

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shareholder has an election to receive P stock or boot, the contract provides for fixed consideration if the number of P shares to be issued is based on the P stock value on the signing date.[24] The removal of the percentage exchange test in T shareholder election situations was necessary because that rule did not require the T shareholders to be subject to the ''economic fortunes'' of P after the signing date.

Example 9 of the new regulations describes a situation in which T shareholders have such an election.[25] In the example, P and T sign a binding contract on January 3, year 1, under which T will merge with and into P on June 1, year 1. On January 2, year 1, the P and T stock are each worth $1 per share. Under the contract, on June 1, year 1, each T shareholder must elect to receive for each share of T stock surrendered either $1 in cash or $1 of P stock based on the P stock's value on January 2, year 1 (that is, $1). The example concludes that the contract provides for fixed consideration.

The example appears to be of limited import because third parties are not likely to negotiate a contract with those terms. The contract in Example 9, despite satisfying the fixed consideration requirement, gives no assurance to the parties that the COI requirement will be satisfied because the mix of consideration (the percentage of P stock and the percentage of boot to be received by the T shareholders for their T stock in the merger) will not be known until June 1, year 1. By fixing the number of shares of P stock that the T shareholders will ultimately receive, based on the P stock price on the signing date, each T shareholder will elect — with near certainty — to receive solely cash if the P stock declines in value. Likewise, each T shareholder will elect to receive solely P stock if the P stock increases in value. In other words, a T shareholder will have a simple decision to make at closing, to elect to receive $1 in cash if the P stock is trading below $1 per share or one share of P stock if the P stock is trading above $1 per share. Although not addressed in the new regulations, for the contract in Example 9 to have commercial value, the contract must contain a proration mechanism requiring that at least 40 percent of the total consideration be in the form of P stock to ensure that the COI requirement will be satisfied. Adding the proration mechanism to the contract does not alter the conclusion that the signing date rule still applies. However, the addition of the proration mechanism ensures that the COI requirement will be satisfied whether the signing date rule applies or not.

D. Contingent Adjustments

The old regulations did not have an express provision addressing contingent adjustments in the consideration to be issued in a purported reorganization. As discussed above, however, the old regulations implicitly permitted adjustments by permitting the number of P shares ultimately issued to T shareholders to be based on the P stock's closing date value. Also, Example 9 of the old regulations provided additional comfort that a contract provided for fixed consideration when the P stock was subject to a collar based on the P stock's closing date value.[26]

In general, under the new regulations, a contract that provides for contingent adjustments to the consideration to be received by the T shareholders may still provide for fixed consideration.[27] The new regulations, however, do not permit contingent adjustments to the number of shares of P stock to be received in the reorganization if the adjustments are based on the value of the P stock after the signing date.[28] More specifically, the new regulations address contingent adjustments as follows:

> A contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration that prevent (to any extent) the target corporation shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation stock after the last business day before the first date the contract is a binding contract. For example, a contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to consideration in the event that the value of the stock of the issuing corporation, or the value of any surrogate for either the value of the stock of the issuing corporation or the assets of the issuing corporation increase or decrease after the last business day before the first date there is a binding contract; or in the event the contract provides for contingent adjustments to the number of shares of the issuing corporation stock to be provided to the target corporation shareholders computed using any value of the issuing corporation shares after the last business day before the first date there is a binding contract.[29]

Under the new regulations, however, a contract may still provide for fixed consideration (at least under some circumstances) when the number of P shares to be received by T shareholders is linked to changes in the value of the T stock. Examples 11 and 12 of the new

[24]Temp. reg. section 1.368-1T(e)(2)(iii)(A).

[25]Temp. reg. section 1.368-1T(e)(2)(v) (Example 9).

[26]Reg. section 1.368-1(e)(2)(v) (Example 9). The preamble to the old regulations stated that ''[t]he IRS and Treasury Department continue to study whether other arrangements involving contingent consideration should be within the scope of the signing date rule. Among these arrangements are . . . cases in which the issuing corporation stock to be issued in respect of target corporation stock is determined pursuant to a collar.'' T.D. 9225, *supra* note 7 at 717. Despite that language, Example 9 of the old regulations and particularly reg. section 1.368-1(e)(2)(iii)(A)(*3*) and (*4*) probably were sufficient to give taxpayers comfort that a contract in which T shareholders received P stock subject to a collar based on the P stock's closing date price provided for fixed consideration.

[27]Temp. reg. section 1.368-1T(e)(2)(iii)(B)(*1*).

[28]*See, e.g.*, temp. reg. section 1.368-1T(e)(2)(v) (Example 10) (when contract provides that the number of P shares to be received by T shareholders will be increased if the *P stock price* is lower on the closing date than on the signing date, the contract does not provide for fixed consideration.).

[29]Temp. reg. section 1.368-1T(e)(2)(iii)(B)(*2*).

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regulations each describe such a situation.[30] In Example 11, P and T sign a binding contract on January 3, year 1, under which T will merge with and into P on June 1, year 1. On January 2, year 1, T has 100 shares of stock outstanding and each share of P and T stock is worth $1. Under the contract, if the T stock is worth $1 on June 1, year 1, the T shareholders will receive 40 P shares and $60 cash in exchange for 100 percent of the outstanding T stock. The contract also provides that if the T stock is worth more than $1 on June 1, year 1, $1 of additional cash will be paid to the T shareholders (in the aggregate) for every $0.01 increase in value of each T share. The example concludes that the contract provides for fixed consideration ''[b]ecause the contract provides [for] the number of shares of P stock and the amount of money to be exchanged for all the proprietary interests in T, and the contingent adjustment to the cash consideration is not based on changes in the value of the P stock, P assets, *or any surrogate thereof*, after January 2, year 1.''[31]

Example 12 is the same as Example 11 except that, regarding any contingent adjustment, if the value of the T stock *decreases* in value, the T shareholders (in the aggregate) will receive $0.40 less in P stock and $0.60 less in cash for every $0.01 decrease in value of each T share on the closing date. Example 12 concludes that:

> [B]ecause the contract provides for the number of shares of P stock and the amount of money to be exchanged for all of the proprietary interests in T, the contract does not provide for contingent adjustments to the consideration based on a change in value of the P stock, P assets, or any surrogate thereof, after January 2, Year 1, and the adjustment to the number of P shares the T shareholders receive is determined based on the value of the P shares on January 2, Year 1, there is a binding contract providing for ''fixed consideration'' as of January 3, Year 1.

First, both examples 11 and 12 conclude that when the number of P shares to be received by T shareholders is based on the *value* of T on the *closing* date, the value of T is not a ''surrogate'' for the value of the P stock ultimately issued. Thus, although the T shareholders are prohibited from ''hedging'' against fluctuations in P's stock price, P is permitted to hedge against fluctuations in T's stock price under the new regulations. Despite the IRS and Treasury's view that the T stock is not a surrogate for the value of the P stock, there may be some who believe that the value of post-signing-date T stock correlates with the value of the P stock.[32] If that's true, the T stock, at least to some extent, may be viewed as a ''surrogate'' for the value of P. In Example 12, P is protected from a decline in the value of T's assets because P will deliver fewer P shares at closing if T's value declines. What if, rather than a reduction in the value of T's assets, P's stock price declines because of a decline in P's assets (other than the T assets the market expects P to acquire at closing)? Surely one would expect P's stock price to decline. One would also expect T's stock price to decline because the P stock received by the T shareholders at closing will also be worth less. That decline in T's value is a direct result of a decline in P's value, yet Example 12 concludes that ''the contract does not provide for contingent adjustments to the consideration based on a change in value of P stock, P assets, or any surrogate thereof'' (that is, the T stock is not a surrogate for the value of the P stock).

If the T stock does not decline because of the value of its own assets (as opposed to the value of its stock), one would expect that P stock trading at $0.50 per share on the closing date (a decline of $0.50) would result in the T stock trading at $0.80 per share on the closing date (a decline of $0.20).[33] The facts of examples 11 and 12 leave one wondering whether either example has any practical application, and thus may leave some taxpayers wondering whether the two examples may be relied on for the proposition that T will not be treated as a surrogate for the value of P. The conclusory language in the examples appears to assume that fluctuations in the P stock price after the signing date have no effect on the ultimate amount of consideration to be received by the T shareholders. The statements in examples 11 and 12 that the T stock is not a surrogate for the value of the P stock reinforce that assumption. If so, that reasoning may permit a contractual provision providing that the T shareholders receive less P stock as T's value increases and more P stock as T's value decreases. The new regulations therefore create a conflict between the operative language of the new regulations[34] and the conclusory statements in examples 11 and 12. If the T stock value is not a surrogate for the value of the P stock in examples 11 and 12, it should not be a surrogate for the value of the P stock in the following example.

Example C. P and T sign a binding contract on January 3, year 1. On January 2, year 1, T has 100 shares of stock outstanding and each share of P stock and T stock is worth $1. Under the contract, if the value of the T stock does not increase or decrease after January 3, year 1, the T shareholders will receive 40 P shares and $60 cash in exchange for 100 percent of the outstanding T stock. The contract also provides that if the value of the T stock *increases* in value, one *less* share of P stock will be issued to the T shareholders (in the aggregate) for every $0.01 *increase* in value of the per-share T stock price, and if the value of the T stock *decreases* in value, one *more* share of P stock will be issued to the T shareholders (in the aggregate) for every $0.01 *decrease* in value of the per-share T stock price.

The contingent adjustments in Example C are based on the value of the T stock, not the value of the P stock.

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[30] Temp. reg. section 1.368-1T(e)(2)(v) (examples 11 and 12).

[31] Temp. reg. section 1.368-1T(e)(2)(v) (Example 11) (emphasis added).

[32] *See* Robert Willens, ''When Is Continuity of Interest Assessed?'' *Tax Notes*, Apr. 16, 2007, p. 259, *Doc 2007-7529, 2007 TNT 74-34*.

[33] The T stock per-share price would decline only $0.20 because only 40 percent of the T shareholders' consideration is in the form of P stock. Thus, one T share is exchanged for $0.60 in cash and 0.4 shares of P, worth $0.40 on Jan. 2, year 1, and currently worth $0.20.

[34] *See* temp. reg. section 1.368-1T(e)(2)(iii)(B)(2).

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On one hand, if one believes the T stock price is a partial or complete surrogate for the P stock price, the operative rule would prevent the contract in Example C from providing for fixed consideration on the signing date. On the other hand, if examples 11 and 12 may be relied on for the premise that the T stock price is not a surrogate for the P stock price, the contract described in Example C is a permissible hedge or collar whereby the number of P shares ultimately received by the T shareholders fluctuates based on the value of P. It is more likely that the conclusory statements in examples 11 and 12 are unintended and that the T stock operates as a surrogate for the value of P. Under that reasoning, temp. reg. section 1.368-1T(e)(2)(iii)(B)(*2*) should apply and the contract in Example C should not be viewed as providing for fixed consideration.

It's possible that the IRS and Treasury were merely trying to provide a mechanism to permit increases and decreases in the value of the T *business* between the signing date and the closing date, when that mechanism altered the number of P shares to be issued to the T shareholders while not violating the signing date rule. Such an adjustment is not inconsistent with the signing date rule. However, by linking the number of shares of P stock to be received to the T stock value rather than the T asset value (a benchmark whose value is not controlled by changes to the P stock trading price), the example appears to allow for a hedge. One way to correct for that unintended conflict is to change the benchmark from the T stock trading price to a valuation of the T business assets. Although that suggestion harmonizes the example with the purpose of the signing date rule, determination of the value of the T business assets in those cases will limit the usefulness of this permitted contingent adjustment because it would be administratively burdensome.

E. 'Economic Reality'

As stated above, the new regulations no longer include in the definition of fixed consideration situations in which the T shareholders exchange a percentage of their T stock for P stock and a percentage of their T stock for boot.[35] The new regulations also remove the related requirement that those exchanges be ''economically reasonable.''[36] The new regulations do, however, retain an example illustrating the general principle that, when allocating the amount of T stock exchanged for P stock and boot, the allocations must be based on the ''economic realities'' of the overall exchange on the signing date.[37] In Example 7 of the new regulations, P and T sign a binding contract on January 3, year 1, under which T will be merged with and into P on June 1, year 1. Under the contract the T shareholders will exchange 60 shares of T stock for $80 of cash and 40 shares of T stock for 20 shares of P stock. On January 2, year 1, each share of P stock is worth $1. The example concludes that the contract provides for fixed consideration and, therefore, the signing date rule applies to the transaction. The example ultimately concludes, however, that, ''based on the economic realities of the exchange,'' only 20 percent of the consideration received by the T shareholders (based on the signing date value of the P stock) is in the form of P stock and, therefore, the COI requirement has not been satisfied.[38]

The allocations in Example 7 are clearly not based on the ''economic realities of the exchange'' because the T stock surrendered for the P stock has a greater value than the P stock.[39] It is difficult to see the utility of this example because it illustrates only a seemingly obvious point: When the number of shares of P stock to be received for T stock is fixed on the signing date, COI is tested using the signing date value of the P stock. Whether or not the exchange is economic, the same test applies to determine if the COI requirement is satisfied. Example 7 is helpful, however, in at least one regard. When the exchanges lack economic reality because of a legitimate business concern, the fixed consideration requirement will nonetheless be satisfied and the determination of whether the COI requirement has been satisfied can be made on the signing date. Example D is one such situation.

Example D. T has two shareholders, X and Y, each holding two shares of the sole outstanding class of T stock. X is a valued T employee, and Y is purely a passive investor. On January 3, year 1, P and T sign a binding contract under which T will merge with and into P. On January 2, year 1, the value of the P stock is $1 per share. Under the contract, X surrenders one share of T stock for $1 cash and one share of T stock for one share of P *restricted* stock, and Y surrenders one share of T stock for $1 cash and one share of T stock for one share of P *unrestricted* stock. The restrictions on X's restricted P stock lapse if X remains in P's employ for the two-year period following the merger and is not terminated for cause.

It is quite possible that the restricted stock received by X is less valuable than the unrestricted stock received by Y. Nonetheless, X is willing to engage in the merger to ensure the merger is consummated. Likewise, P is not willing to consummate the merger unless X remains employed by the combined company for the two years following the merger. Example 7 ensures that the parties can test COI on the signing date. Despite the possibility that restricted and unrestricted stock may have different per-share values, the IRS and Treasury should issue specific guidance providing that exchanges similar to those described in Example D are based on the economic realities of the transaction and that, with regard to

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[35]*See* T.D. 9316, *supra* note 1, at 12975.

[36]*See id.* (discussing removal of reg. section 1.368-1(e)(2)(iii)(A)(*3*) and (*4*)).

[37]*See* temp. reg. section 1.368-1T(e)(2)(v) (Example 7) and reg. section 1.368-1(e)(2)(v) (Example 7).

[38]Temp. reg. section 1.368-1T(e)(2)(v) (Example 7).

[39]Also, the issue raised in the example appears misplaced because under the new regulations (unlike the old regulations), the definition of fixed consideration does not require some exchanges to be economically reasonable.

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situations like Example D, the restricted P stock has the same value as the unrestricted P stock for purposes of the COI requirement.[40]

IV. Effective Date

As stated above, the new regulations retroactively replace the old regulations unless an election is made to apply the old regulations to a transaction that was under a binding contract entered into after September 16, 2005, and before March 21, 2007.[41] Although no formal election must be made, for the old regulations to apply to a transaction "the target corporation, the issuing corporation, the controlling corporation of the acquiring corporation if stock thereof is provided as consideration in the transaction, and any direct or indirect transferee of transferred basis property from any of the foregoing" must all adopt consistent treatment.[42]

We understand that the new regulations are afforded retroactive effect in an effort to alleviate the unintended consequences of the old regulations — mainly to avoid the taxpayer unfavorable result in Example B above. That effect, however, may not be warmly received by all taxpayers.

First, the effective date provision appears to violate section 7805(b). Treasury has limited authority to promulgate regulations with retroactive effect. Before July 30, 1996, section 7805(b) authorized Treasury to prescribe "the extent, if any, to which any ruling or regulation, relating to the internal revenue laws, shall be applied without retroactive effect." Section 7805(b) was amended in 1996 to bar retroactive regulations in most situations.[43] Under the amended provision, a temporary regulation generally "shall [not] apply to any taxable period ending before the earliest of" the date on which the regulation is filed with the *Federal Register* or "the date on which any notice substantially describing the expected contents of [the regulation] is issued to the public." Thus, absent an exception described below, the new regulations should not apply to any agreement entered into before March 21, 2007, unless an affirmative election is made by the affected taxpayer to apply the new regulations. Treasury may issue a mandatory retroactive regulation if the regulation was issued within 18 months of the enactment of the related statute, issued to prevent abuse, issued to correct a procedural defect in the issuance of any prior regulation, issued to address internal Treasury Department policies, practices, or procedures, or issued with congressional authorization.[44] Also, section 7805(b)(7) provides that Treasury "may provide for any taxpayer to elect to apply any regulation" retroactively. The first five exceptions are not relevant to the new regulations.[45] Regarding section 7805(b)(7), reg. section 1.368-1(e)(8)(ii) does not permit taxpayers to elect to apply the new regulations retroactively. Rather, the new regulations apply by default unless all relevant taxpayers elect to apply the old regulations. That provision could be viewed as a direct violation of section 7805(b), and if it is a violation, the new regulations would have no retroactive effect.

Second, if the effective date language were valid, some taxpayers may not be in a position to elect to apply the old regulations. For example, assume that after a purported asset reorganization entered into after September 16, 2005, and before March 21, 2007, P transfers some or all of the T assets in a nonrecognition transaction to a partnership that P does not control (or P transfers a small portion of the T assets to a noncontrolled corporate transferee in a section 351 exchange). The T assets represent transferred-basis property received in the purported reorganization. For P to elect to apply the old regulations, the effective date language requires P, T, and the partnership (or noncontrolled corporation) to adopt consistent treatment. The partnership (or noncontrolled corporation) may prefer a stepped-up basis in the T assets and could refuse to adopt consistent treatment.

V. Conclusion

Although the new regulations correct many of the problems associated with the old regulations, a few problems remain, and in fact the new regulations create new uncertainties. Ultimately, because of the inherent conflict between the need for flexibility in structuring

[40]The IRS and Treasury have not yet provided guidance on the treatment of restricted stock for purposes of the COI requirement. *See* T.D. 9225, *supra* note 7, at 719. Regarding the issue of valuing the restricted P stock, Example D assumes that that stock is treated as a proprietary interest in P for purposes of the COI requirement.

[41]Reg. section 1.368-1(e)(8)(ii).

[42]*Id.* The inclusion of both the phrases "issuing corporation" and "controlling corporation of the acquiring corporation if stock thereof is provided as consideration in the transaction" appears to be redundant. Note that the T shareholders are not required to adopt consistent treatment in order for the old regulations to apply. Presumably such a requirement would be administratively impractical when T is a public company.

[43]P.L. 104-168, section 1101(a), 110 Stat. 1452, 1469.

[44]Section 7805(b)(2)-(6).

[45]First, the "promptly issued" exception does not apply because the origins of tax-free reorganizations predate the Internal Revenue Code of 1939 (*see, e.g.*, P.L. 254 section 202(b), 40 Stat. 1057) and the COI doctrine can be traced back to at least 1932 and the Second Circuit's decision in *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932). Second, neither the IRS nor Treasury has suggested that the new regulations have been issued to prevent abuse. In fact, the old regulations were initially issued to provide taxpayers assurance that transactions structured as tax-free reorganizations when signed would not later be rendered taxable. To the extent a taxpayer has relied on the old regulations, the IRS may not retroactively apply a new set of rules that renders the old regulations unavailable. *See Klamath Strategic Investment Fund, LLC v. United States*, 440 F. Supp.2d 608, 625, *Doc 2006-13753*, *2006 TNT 140-14* (E.D. Tex. 2006) (reg. section 1.752-6(d) may not be applied retroactively when taxpayers "that engaged in the conduct *before issuance of any notice* could justifiably rely on [then-current law]") (emphasis added). Third, the new regulations do not correct any procedural defect in the old regulations. In fact, the old regulations have no procedural rules. Fourth, the old regulations are not regulations relating to internal Treasury Department policies, practices, or procedures. Fifth, section 368 does not provide any legislative grant from Congress to Treasury to issue regulations relating to the COI requirement.

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public reorganizations and the compelling policy of requiring T shareholders to be subject to the ''economic benefits and burdens'' of P stock ownership, we believe there is a real possibility that the IRS and Treasury will abandon their attempt to draft a rule with broad application. We hope, however, the IRS and Treasury will not give up on this important project.

FIN 48 Considerations: Tax Attorneys' Perspective

By Roger A. Pies and Adam Gropper

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In June 2006 the Financial Accounting Standards Board issued Interpretation No. 48, dealing with the treatment of uncertain tax benefits. The new standards became effective for fiscal years beginning after December 31, 2006. There have been requests to delay the effectiveness of FIN 48, but it remains in effect at this time.

In this article we raise a number of questions regarding how FIN 48 should be applied in some situations. We believe that, to a surprising extent, FIN 48 either fails to answer some fundamental questions or relies on flawed premises.

We discuss the FIN 48 procedure for dealing with uncertain tax benefits, but only in a brief overview. We do not try to explain FIN 48 requirements in detail. It is assumed that the reader is familiar with FIN 48's provisions.

We also do not provide suggestions as to how FIN 48 should be interpreted, because the proper interpretation of FIN 48 is outside our area of expertise. Thus, the following discussion is from the perspective of a tax lawyer asked to provide guidance on uncertain tax benefits when that guidance will be used to meet FIN 48 requirements. We try to focus attention on issues that do not appear to have clear answers in FIN 48.[1]

I. The FIN 48 Process in Brief

The FIN 48 process begins with an identification of a company's uncertain tax position. The company must make a judgment regarding the appropriate ''unit of account.'' In an example involving research credits, FIN 48 describes the determination of the proper unit of account. The example involves four research projects. The company determines that each project should be viewed as a separate unit of account. That determination

[1]Other commentators have also raised questions about the effect of FIN 48 in various situations. *See, e.g.*, Neil D. Kimmelfield, ''FIN 48: Measuring Tax Benefits in the Real World,'' *Tax Notes*, Oct. 30, 2006, p. 501, *Doc 2006-21304*, *2006 TNT 210-26*; W. Scott Rogers and Raymond G. Andrews, ''FIN 48 and Interest Accruals — A Discussion With FASB,'' *Tax Notes*, Mar. 12, 2007, p. 1031, *Doc 2007-4979*, *2007 TNT 49-44*; Brian R. Lynn, ''Blame It on Transparency,'' *Tax Notes*, Mar. 5, 2007, p. 945, *Doc 2007-4514*, *2007 TNT 44-40*; Michael Urban and Tim Throndson, ''FIN 48: Potential Impact of Interest Computations and Penalties,'' *Tax Notes*, Feb. 19, 2007, p. 767, *Doc 2007-2909*, *2007 TNT 35-65*; Brett Cohen and Reto Micheluzzi, ''Lifting the Fog: Accounting for Uncertainty in Income Taxes,'' *Tax Notes*, Oct. 16, 2006, p. 233, *Doc 2006-20362*, *2006 TNT 200-33*.

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