



# ***Recent Developments in the Continuity of Proprietary Interest Requirement***

**District of Columbia Bar Association Taxation Section  
Corporate Tax Committee  
January 31, 2011**

**Speakers:**

*William Alexander, IRS Associate Chief Counsel (Corporate)*

*Robert Heller, Covington & Burling LLP*

*Scott Levine, Jones Day*

# Agenda

---

- Continuity of Interest
  - The Signing Date Rule
  - Collars (the Ceiling and Floor Rules)
  - Average Pricing
  - Contingent Consideration
- Reorganization Characterization Issues (Revisited)
  - P.L.R. 201150021 and Rev. Rul. 78-130

# Continuity of Proprietary Interest Requirement

---

- The continuity of proprietary interest (“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. Treas. Reg. section 1.368-1(e)(1).
- A substantial part of the proprietary interests in T is preserved, and the COI requirement generally is satisfied, where as little as 40 percent of the value of the T stock is exchanged for issuing corporation (“P”) stock.
  - Temp. Treas. Reg. section 1.368-1T(e)(2)(v) (Ex. 1) (2007) and Treas. Reg. section 1.368-1(e)(2)(v) (Ex. 1) (as amended in 2005) (40 percent P stock is sufficient to satisfy the COI requirement).
  - *John C. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (approximately 38 percent P stock is sufficient to satisfy the COI requirement).

# The Signing Date Rule

---

# Reason for Signing Date Rule

---

- Prior to the Signing Date Rule, T stock surrendered for P stock and P stock received by T shareholders was valued on the closing date.
- If P stock was publicly traded and declined in value between the signing date and the closing date, there was no guarantee that COI was satisfied (absent protective closing date adjustments).

# Signing Date Rule History

---

- Final regulations relating to the Signing Date Rule were initially published on September 16, 2005 (the “Old Regulations”).
- Temporary and proposed regulations modifying the Signing Date Rule were published on March 20, 2007 (the “Temporary Regulations”).
- Notice 2010-25 allowing taxpayers to rely on the Temporary Regulations if certain requirements are satisfied.
- Final regulations relating to the Signing Date Rule were published on December 19, 2011 (the “Final Regulations”).

# Signing Date Rule

---

- If a “binding contract” provides for “fixed consideration,” for purposes of determining whether COI is satisfied, P stock “shall be valued on the last business day before the first date such contract is a binding contract....” (Emphasis added).
  - Such date is referred to as the “Pre-Signing Date.” *See* Treas. Reg. section 1.368-1(e)(2)(i).
- Thus, if a “binding contract” provides for “fixed consideration”:
  - P stock must be valued on the signing date, and
  - P stock may not be valued on the closing date.
- If there is “fixed consideration” and COI is failed using the Signing Date Rule, it is irrelevant whether COI is satisfied on the closing date using the closing date value of the P stock.

# What is a “Binding Contract”?

---

- “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.”
- The definition of “binding contract” is the same under the Old, Temporary and Final Regulations.

# “Modification” to a “Binding Contract”

---

- Treas. Reg. section 1.368-1(e)(2)(ii)(B) provides:

“If a term in a binding contract that relates to the amount or type of consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, the date of the modification shall be treated as the first date there is a binding contract.” (Emphasis added).

# Permitted Modifications

---

- If the contract provides for fixed consideration and COI is satisfied on the Signing Date, the issuance of the following will not be treated as a modification:
  - Additional P stock;
  - Less boot; or
  - Additional P stock and less boot.
- If the contract provides for fixed consideration and COI is not satisfied on the Signing Date, the issuance of the following will not be treated as a modification:
  - Less P stock;
  - More boot; or
  - Less P stock and more boot.

# Issues Relating to Modifications to a Binding Contract

---

- Not a modification to a binding contract if not a modification to “amount” or “type” of consideration.
- Not always clear whether a modification is a modification to the “amount” or “type” of consideration.
  - Boot to be received is changed from cash to U.S. Treasury bills?
  - Stock to be received is changed from voting stock to nonvoting stock?
  - Stock to be received is changed from registered shares to unregistered shares?
  - Changes to escrow allocation among T shareholders?

# “Fixed Consideration”

---

- The binding contract must provide for “fixed consideration” in order for the Signing Date Rule to apply.
- Certain contracts that provided for “fixed consideration” under the Old Regulations will not provide for “fixed consideration” under the Temporary and Final Regulations.

# Old Regulations: General Rule for Fixed Consideration

---

- A contract provided for “fixed consideration” if it provided for one of the following:
  1. The number of shares of P stock and amount of money and other property exchanged for all of the T stock;
  2. The number of shares of P stock and amount of money and other property exchanged for each share of T stock;
  3. The percentage of T stock exchanged for P stock and the percentage of T stock exchanged for money and other property; or
  4. The percentage of each share of T stock exchanged for P stock and the percentage of each share of T stock exchanged for money and other property. Items (3) and (4) are referred to as the “Percentage Exchange Tests.”
- To qualify as “fixed consideration,” the stock-for-stock exchange and stock-for-cash/property exchange described in (3) and (4), above, each had to be independently “economically reasonable.”

# Purpose of Signing Date Rule

---

- The stated purpose of the Signing Date Rule is to allow taxpayers to test COI prior to the closing date of a reorganization (i.e., the signing date) where the T shareholders “generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date.” (Emphasis added).
- The preamble to the Temporary Regulations concludes that Treas. Reg. sections 1.368-1(e)(2)(iii)(A)(3) and (4) of the Old Regulations are inconsistent with this purpose.

# Final (and Former Temporary) Regulations: General Rule for Fixed Consideration

---

- A contract provides for “fixed consideration” if it provides for:
  1. The number of shares of P stock and the amount of money and other property to be exchanged for all of the T stock; or
  2. The number of shares of P stock and the amount of money and other property to be exchanged for each share of T stock.
- The Final Regulations do not contain the Old Regulations’ Percentage Exchange Tests (and related “economically reasonable” requirements).

# Example 1

---

- Facts
  - T merges with and into P whereby the sole T shareholder (who owns two identical shares of T stock) surrenders:
    - 1 share of T stock for \$400 cash, and
    - 1 share of T stock for \$400 of P stock based upon the P stock price on the closing date.
  - Pre-Signing Date price is \$100/share
  - Closing Date price is \$50/share
- Conclusion under Old Regulations
  - Contract provides for fixed consideration.
  - COI is satisfied (8 P shares x \$100 = \$800 worth of P stock and \$400 in cash, i.e., 67% COI)
- Conclusion under Final Regulations
  - Contract does not provide for fixed consideration because the number of P shares was not specified on the Pre-Signing Date.
  - COI is satisfied using closing date price (8 P shares x \$50 = \$400 worth of P stock and \$400 in cash, i.e., 50% COI)

# Example 2

---

- Facts
  - T merges with and into P whereby the sole T shareholder (who owns two identical shares of T stock) surrenders:
    - 1 share of T stock for \$400 cash, and
    - 1 share of T stock for \$400 of P stock based upon the P stock price on the closing date.
  - Pre-Signing Date price is \$100/share
  - Closing Date price is \$400/share
- Conclusion under Old Regulations
  - Contract provides for fixed consideration.
  - COI is not satisfied (1 P share x \$100 = \$100 worth of P stock and \$400 in cash, i.e., 20% COI)
- Conclusion under Final (and Temporary) Regulations
  - Contract does not provide for fixed consideration because the number of P shares was not specified on the Pre-Signing Date.
  - COI is satisfied using Closing Date Price (1 P share x \$400 = \$400 worth of P stock and \$400 in cash, i.e., 50% COI)

# “Contingent Adjustments”

---

- Old Regulations
  - The term “contingent adjustments” is not used.
  - Arguably, with respect to the stock-for-stock exchange, there was no need for a “contingent adjustment” provision because the Percentage Exchange Tests permitted contingent adjustments.
  - Thus, as a result of the Percentage Exchange Tests, a contract arguably provided for fixed consideration where the P stock to be issued to the T shareholders was subject to a “collar” (i.e., a type of contingent adjustment). *See* Slides 28-36 for a more detailed discussion about collars.
- Final (and Temporary) Regulations
  - The Percentage Exchange Tests are eliminated.
  - Certain “contingent adjustments” are permitted. *See* Slides 18-23.

# The Final Regulations & Contingent Adjustments

---

- General Rule: A contract that provides for “contingent adjustments” to the T shareholders’ consideration may still provide for fixed consideration.
- Exceptions: “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 [T] shareholders from being subject to the *economic benefits and burdens* of ownership of [P] stock after the [Signing Date].” (Emphasis added).
- Exception Examples: Contingent adjustments based on any of the following do not provide for fixed consideration:
  - The value of the P stock on any date after the Signing Date;
  - The value of any surrogate for the value of the P stock or the value of the P assets.

# Contingent Adjustments: Example 11 of the Final Regulations

---

- Facts
  - P and T sign a binding contract on January 3, Year 1, in 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, respectively.
  - 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% of the outstanding T stock.
  - 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 the per share T stock price.
  - On June 1, Year 1, the value of the T stock is \$1.40 per share and the value of the P stock is \$0.75 per share.
  - In determining whether COI is satisfied, the P stock price on the Signing Date must be used.
- Conclusion: 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.” (Emphasis added).

# Contingent Adjustments: Example 12 of the Final Regulations

---

- Facts
  - P and T sign a binding contract on January 3, Year 1, in 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, respectively.
  - 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% of the outstanding T stock.
  - If the value of the T stock *decreases* in value, the T shareholders (in the aggregate) will receive \$0.40 less P stock and \$0.60 less cash for every \$0.01 decrease in value of the per share T stock price on the closing date.
  - On June 1, Year 1, the value of the T stock is \$.70 per share and the value of the P stock is \$0.75 per share.
  - In determining whether COI is satisfied, the P stock price on the Signing Date must be used.
- Conclusion: The contract provides for fixed consideration “because 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.” (Emphasis added).

# Contingent Adjustments: Analysis of Examples 11 and 12 of the Final Regulations

---

- If P and T are publicly traded, the value of the T stock after the transaction is signed may correlate with the value of the P stock. The examples, however, conclude that T is not a “surrogate” for P stock.
- In the public context, a contract with terms similar to those in the examples may not be commercial. Under such a contract, the T shareholders would receive fewer P shares if:
  - The value of T’s assets remained constant, and
  - The value of the P stock declined after the Signing Date.
- Examples 11 and 12 may have utility where P and T are privately held.
- Assuming T is not a “surrogate” for P stock for purposes of the Final Regulations, does a contractual provision providing that the T shareholders receive less P stock as T’s value (post-signing) increases and more P stock as T’s value decreases provide for fixed consideration?

# Contingent Adjustments: Extension of Example 11 and 12 Reasoning

---

- Facts
  - 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, respectively.
  - Pursuant to 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:
    - (i) *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;
    - (ii) *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.
- Does the reasoning behind Examples 11 and 12 or the operative rule under the Final Regulations control?

# Shareholder Election Provisions: Old Regulations

---

- Fixed Consideration requirement satisfied notwithstanding presence of shareholder election if contract provides for:
  1. Minimum number of shares of P stock and maximum amount of money and other property that can be received in exchange for all of the T stock; or
  2. Minimum percentage of T shares that must be exchanged for P stock and maximum percentage of T stock exchanged for money and other property provided stock-for-stock exchange and stock-for-cash and other property exchange are “economically reasonable.”
- Shareholder Election Rule only applies if:
  - General Rule does not apply; and
  - A T shareholder has an election to receive P stock and/or money and other property in exchange for T stock.

# Shareholder Election Provisions: Final Regulations

---

- Fixed Consideration requirement satisfied notwithstanding presence of shareholder election if contract provides for:
  - The number of P shares to be issued is based upon the P stock value on the Signing Date.
- Eliminates maximum/minimum rule.
- Eliminates percentage exchange test.

# “Economic Reality”

---

- Old Regulations had “economically reasonable” requirement in Percentage Exchange Tests.
- Final Regulations eliminate “economically reasonable” requirement in definition of fixed consideration.
- Final Regulations, however, provide following example (Example 7):
  - P and T sign a binding contract on January 3, Year 1, in which T will be merged with and into P on June 1, Year 1.
  - Pursuant to 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.
- Example 7 concludes that:
  - Signing Date Rule applies to the transaction; but
  - COI not satisfied because, based on the “economic realities” of the exchange, only 20% 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.

## “Economic Reality” (Cont’d.)

---

- Facts
  - T has two shareholders (A and B), each holding two identical shares of the sole outstanding class of T stock.
  - A is the CEO of T and B is solely an outside investor.
  - T merges with and into P whereby A surrenders:
    - 1 share of T stock for \$200 cash, and
    - 1 share of T stock for \$200 (signing date value) of P restricted stock.and B surrenders:
    - 1 share of T stock for \$200 cash, and
    - 1 share of T stock for \$200 (signing date value) of P unrestricted stock.
  - The restrictions on A’s restricted P stock lapse provided A remains in the employ of P for two years and is not terminated for cause.
  - Does the exchange have “economic reality” for purposes of the Final Regulations?

# Expansion of Signing Date Rule?

---

- Time for valuation is relevant to more than COI determinations.
  - Section 368(a)(2)(E)
  - Section 368(a)(1)(C)/(a)(2)(B)
  - Section 382
  - Section 355(g)
  - Treas. Reg. section 1.367(a)-3(c)(3)(iii) (substantiality test)
- Are statutory changes necessary to expand Signing Date principles in some cases?

# Section 368(a)(2)(E) Example

---

- Facts
  - P and T sign a binding contract on January 3, 2012, in which a subsidiary of P (Merger Sub) will merge with and into T with T surviving.
  - In the merger, each T shareholder will receive 8 shares of P stock and \$2 of cash for each T share outstanding.
  - On January 2, 2012, each P share is worth \$1.
  - On the Closing Date, each P share is worth \$0.80.
- Conclusion: The transaction would not satisfy the section 368(a)(2)(E) requirement that P acquire stock in T representing section 368(c) control in exchange for P voting stock.
  - The control requirement would have been satisfied if the P stock were permitted to be valued on the Pre-Signing Date.
  - Note that COI would be satisfied regardless of the magnitude of the drop in the value of P stock under the Signing Date Rule.

# The Proposed Collar Rules

---

# Collars and the Preamble to the Old Regulations

---

- The preamble to the Old Regulations states that:

“The 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.”

# Collars and Example 9 of the Old Regulations

---

- T shareholders, in exchange for each share of T stock, are to receive, at their election, either:
  - \$1; or
  - P stock, the number of shares to be determined as follows:
    - \$1 worth of P stock if P stock is worth between \$0.80 and \$1.20 on the Signing Date; or
    - 1.25 shares of P stock if P stock is worth less than \$0.80 on the Signing Date; or
    - 0.83 shares of P stock if P stock is worth more than \$1.20 on the Signing Date.
- The terms provide for a proration mechanism to ensure that exactly 50% of T shares are exchanged for cash and 50% of T shares are exchanged for P stock (without any specificity as to how many shares of P stock will be issued for the T shares).
- The fixed consideration requirement is satisfied because:
  - 50% of the value of the T equity is exchanged for P stock; and
  - 50% of the value of the T equity is exchanged for cash.

# The Proposed Regulations

---

- Proposed Regulations provide for “special rules” to determine, under certain circumstances, the appropriate value of P stock when the Signing Date Rule does not apply.
- These special rules include:
  - Rules when T shareholder consideration is subject to a floor (“Floor Rule”);
  - Rules when T shareholder consideration is subject to a ceiling (“Ceiling Rule”); and
  - Rules when T shareholder consideration is determined based upon a multi-day average price of P stock (“Average Price Rule”).

# The Floor Rule

---

- The Floor Rule applies if:
  - Transaction is pursuant to a binding contract; and
  - The amount of “an item of consideration” to be exchanged for T stock “changes as the value of a [P share] varies above a specified price (Floor Price), but does not vary below the Floor Price.”
- If:
  - The Floor Rule applies, and
  - The FMV of a P share is greater than or equal to the Floor Price on the Pre-Signing Date; and
  - The FMV of a P share is below the Floor Price on the Closing Date,
- Then
  - P stock value is deemed to be the Floor Price for COI purposes.

# The Ceiling Rule

---

- The Ceiling Rule applies if:
  - Transaction is pursuant to a binding contract; and
  - The amount of “an item of consideration” to be exchanged for T stock “changes as the value of a [P share] varies below a specified price (Ceiling Price), but does not vary above the Ceiling Price.”
- If:
  - The Ceiling Rule applies, and
  - The FMV of a P share is less than or equal to the Ceiling Price on the Pre-Signing Date; and
  - The FMV of a P share is above the Ceiling Price on the Closing Date,
- Then
  - P stock value is deemed to be the Ceiling Price for COI purposes.

# Example 1: Collar (Floor and Ceiling)

---

- Facts
  - January 3, Yr 1, P and T sign a binding contract to merge T into P, with the T shareholders receiving 50 P shares and \$50 cash, subject to a price adjustment based on the average price of P stock over the five-day period prior to closing (the “AP”):
    - If AP is more than \$1, the cash consideration is reduced by 50 times the excess of the AP over \$1, and
    - If AP is less than \$1, the cash consideration is increased by 50 times the excess of \$1 over the AP,
    - However, in no event, will P deliver cash that is less than \$40 or more than \$60.
  - The adjustment ensures the receipt of aggregate consideration with a value of \$100 if the AP is between:
    - \$0.80 “Floor Price” (\$60 of cash ( $\$50 + ((\$1.00 - \$0.80) \times 50)$ ) and
    - \$1.20 “Ceiling Price” ( $\$40$  of cash ( $\$50 - ((\$1.20 - \$1.00) \times 50)$ )).
  - June 1, Yr 1, T merges into P, when the AP is \$0.25 per share, whereby the T shareholders receive \$60 cash and 50 P shares with a value of \$12.50.

# Example 1: Collar (Floor and Ceiling)

---

- Conclusion
  - COI is determined as if the AP was the Floor Price (\$60 of cash and \$40 of P stock) because:
    - the cash consideration did not vary below the Floor Price (\$.80);
    - the Pre-Signing Date value exceeded the Floor Price; and
    - the value on the Closing Date is less than the Floor Price.

## Example 2: No Floor Price

---

- The facts are the same as in Example 1, except:
  - the Pre-Signing Date value is \$0.50,
  - the Closing Date value is \$1.50, and
  - there is no Floor Price.
- COI is satisfied, determined as if the AP was the Ceiling Price (\$40 of cash and \$60 of P stock) because:
  - cash did not vary above the Ceiling Price (\$1.20),
  - the Pre-Signing Date value is less than the Ceiling Price, and
  - the value on the Closing Date exceeds the Ceiling Price.
- Example demonstrates that the Ceiling Rule and the Floor Rule apply independently.

# Average Price Rule

---

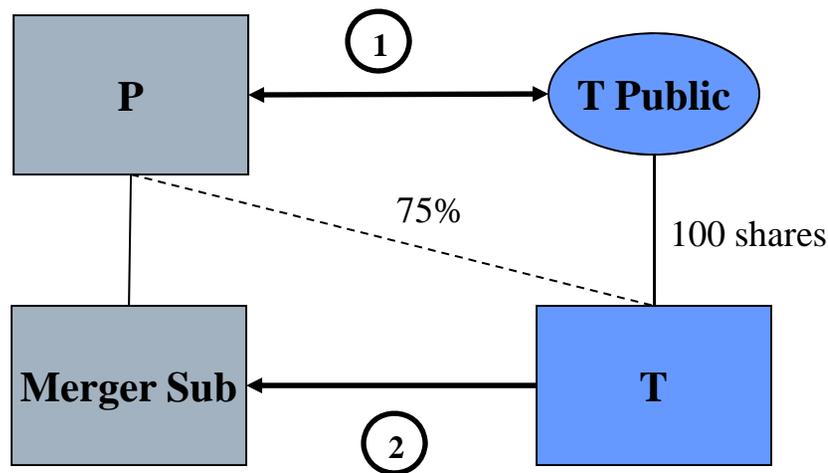
- Prop. Treas. Reg. section 1.368-1(e)(2)(vi)(C) provides that for purposes of determining whether COI is preserved, an average of prices *may* be used in lieu of the Closing Date price if—
  - The average price is based upon prices of P stock occurring after the Signing Date and before the Closing Date, and
  - The binding contract utilizes the average price, so computed, in determining the number of shares of each class of P stock and the boot to be exchanged for all the T stock, or to be exchanged for each share of T stock.
- Is the Average Price Rule elective?
  - Average Price Rule uses “may” while Floor and Ceiling Rules provide that each rule “applies if....”
- Should the Closing Date and dates on or before the Signing Date be included in the definition?

# Closing Date

---

- The date upon which the exchange of consideration in the potential reorganization occurs. Prop. Treas. Reg. section 1.368-1(e)(2)(vi)(D).
- When is the Closing Date in a multi-step transaction?
  - Tender offer followed by reverse subsidiary merger (Rev. Rul. 2001-26)
  - Reverse subsidiary merger followed by upstream merger (Rev. Rul. 2001-46)
  - Stock acquisition followed by upstream merger (Rev. Rul. 67-274)

# Closing Date & Multi-Step Transactions



- **Date 1 Tender Offer.** P acquires 75% of T stock in a tender offer for \$90 of cash and one share of P voting stock per T share surrendered, at a time when the FMV of a share of P stock is \$10.
- **Date 2 Squeeze-out Merger.** T merges with and into Merger Sub with Merger Sub surviving whereby each T shareholder that did participate in the Date 1 tender offer receives one share of P voting stock per T share surrendered, at a time when the FMV of a share of P stock is \$100.
- Is the value of P's stock on Date 1, Date 2 or both the closing date value for COI purposes?
- If Date 1: Approximately 13% of the consideration COI satisfying.
- If Date 2: Approximately 60% of the consideration COI satisfying.
- If each date: 32.5% of the consideration COI satisfying.

# Closing Date Definition Limitation

---

- Why isn't the definition of "closing date" applicable throughout Treas. Reg. section 1.368-1(e)?
- With respect to the Signing Date regulations, the term is relevant with respect to:
  - Contract modifications
  - Shareholder elections
- When the Signing Date Rule, the collar-related rules and the average pricing rule do not apply, the term "closing date" remains relevant, for example, when the T shareholders receive consideration in a purported reorganization on more than one date.

# Effective Date

---

- Final Regulations apply to transactions occurring pursuant to binding contracts entered into after December 19, 2011.
- For transactions entered into after March 19, 2010 and occurring pursuant to binding contracts entered into on or before December 19, 2011, the parties to the transaction may elect to apply the Temporary Regulations. Although no formal election must be made, in order for the Temporary Regulations to apply to a transaction:
  - “[T]he 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, may not elect to apply the provisions of [the Temporary Regulations], unless all such taxpayers elect to apply the provisions of such regulations. This election requirement will be satisfied if none of the specified parties adopts inconsistent treatment.”

# Post-Closing Contingent Consideration

---

- A transaction provides for post-closing contingent consideration when additional stock and/or boot may be received by T shareholders or T shareholders may forfeit previously received stock and/or boot upon the occurrence of one or more contingencies.
  - Includes escrow or holdback arrangements.

# What are the Issues?

---

- What is a contingent right to receive more P stock?
- When do you determine if there has been a qualifying section 368 reorganization?
  - At signing?
  - Closing?
  - After all possible payments have been made?
- What is the relevant P stock value to use in a COI determination?
  - Signing Date Rule?
  - Closing Date values?
  - Values when shares are issued?
  - Something else?

# Current Law

---

- *Carlberg*
  - T shareholders received freely transferable certificates that entitled them to additional stock upon satisfaction of contingent liabilities.
  - Certificates had a 10-year term.
  - Court held the certificates were stock and not boot.
- *Hamrick*
  - Section 351 exchange where transferor received stock and an earn-out payable in additional stock.
  - Earn-out had a 7-year term.
  - Citing *Carlberg*, court held that the right to receive solely P stock constituted stock.

# Current Law

---

- Rev. Proc. 84-42 follows the *Carlberg* and *Hamrick* decisions with modifications (significant ones listed):
  - Only related to stock consideration
  - Five-year requirement
  - At least 50% of maximum number of shares issued at closing
  - Non-assignable
- Rev. Proc. 84-42 also applies to escrowed stock.
  - Similar requirements but also requires T shareholders to have dividend and voting rights in P stock.
- COI regulations do not directly address post-closing contingencies.

# Questions

---

- Why is Rev. Proc. 84-42 more limiting than *Carlberg* and *Hamrick*?
  - Transferability
  - 50% requirement
  - Five-year maximum period
- Why don't the principles of these authorities apply where the contingent consideration is boot or a mixture of stock and boot?

# Continuity of Interest Issues

---

- Signing Date Rule may apply even to post-closing contingencies.
  - Treas. Reg. section 1.368-1(e)(2)(iii)(C) ignores contingencies in determining when there is “fixed consideration” under the Signing Date Rule if economic benefits and burdens of ownership of acquirer stock have passed.
  - Does not on its face distinguish between pre- and post-closing contingencies
- Examples in the Signing Date Rule regulations arguably confirm the application to post-closing contingencies.

# Signing Date Rule Examples 1 & 2

---

- Example 1
  - P and T sign contract pursuant to which T shareholders will receive 40 P shares and \$60 cash for their T stock.
  - Pre-Signing Date value of P shares is \$1/share.
  - 20 P shares are placed in escrow to secure customary reps and warranties (presumably between the Signing Date and Closing Date, but not stated)
  - At closing, each P share is worth \$0.25 and no escrowed stock is returned to P.
  - COI is satisfied based on Signing Date Rule
- Example 2
  - Same as Example 1 except the escrowed shares are returned to P.
  - Wait and see approach taken and COI not satisfied.
- Does the Signing Date Rule apply to post-closing contingencies?

# What Happens in Practice?

---

- Assume the worst; don't wait and see.
  - Assume the maximum amount of boot and the minimum amount of P stock will be issued.
  - Apply the Signing Date Rule where appropriate (e.g., when fixed number of shares are involved).
  - Use set values when provided (e.g., an earn-out paid in \$100 worth of P stock based on value when issued).
- Applications
  - Signing Date Rule Example 1 would not qualify as a reorganization because the worst case is Example 2.
  - To qualify, instead of an escrow of 20 P shares, provide for an escrow of 8 P shares and \$12 of cash.
  - Earn-outs can be paid in a mixture of stock and cash if in all circumstances, the total consideration paid will be at least 40% stock (based on appropriate values)

# What are the Alternatives?

---

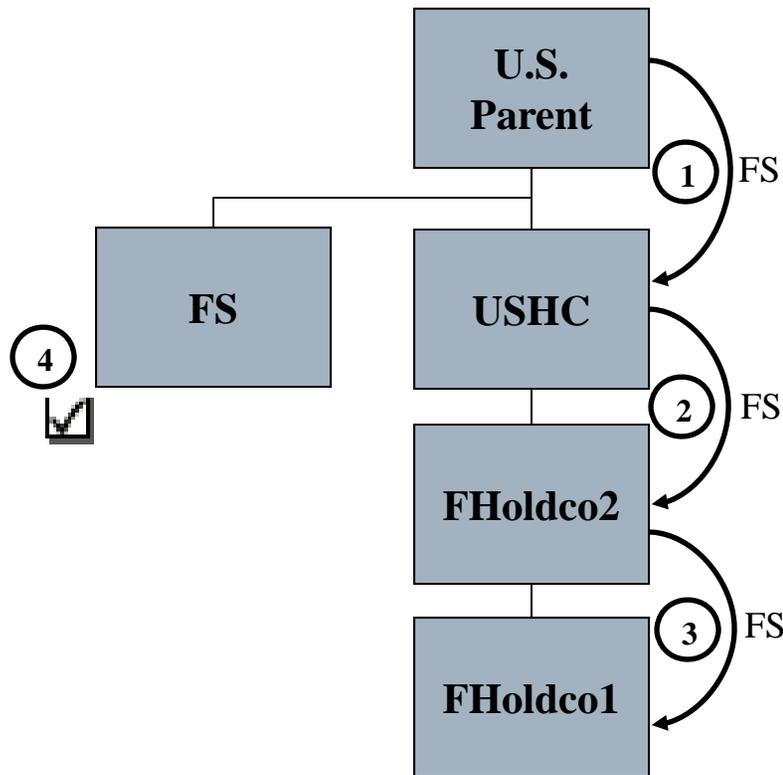
- Wait and See Approach
  - Pro: gives you the “correct” answer
  - Con: lack of certainty, statute of limitation issues
- Closing Determination Approach: At closing, treat the right to receive stock as stock and the right to receive boot as boot.
  - Pro: consistent with existing law for non-contingent reorganizations
  - Con: lack of certainty as to valuation
- Assume the Worst Approach
  - Pro: certainty
  - Con: “incorrect” answers, potential for abuse

# Other Possible Dates to Test COI?

---

# P.L.R. 201150021

---



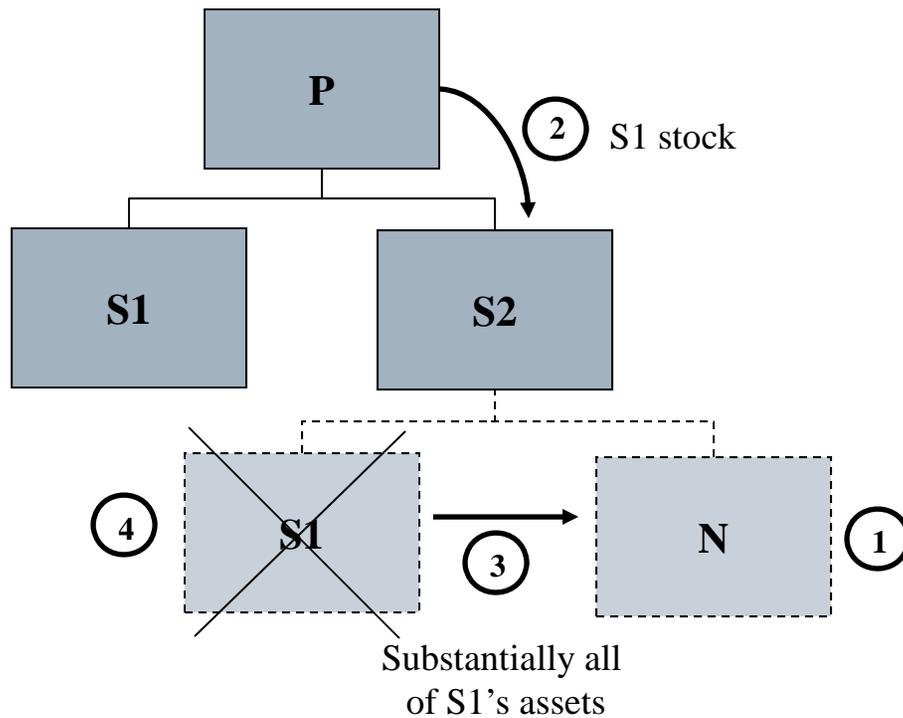
## FACTS

- U.S. Parent contributed the stock of FS to USHC (“Contribution 1”), which contributed it to FHoldco2 (“Contribution 2”), which contributed it to FHoldco1 (“Contribution 3”).
- Thereafter, FS elected to be treated as disregarded under Treas. Reg. section 301.7701-3 (“CTB Election”).

## CONCLUSION

- Contribution 1 and Contribution 2 qualify under section 351.
- Contribution 3 and CTB Election qualify as D reorganization.

# Rev. Rul. 78-130



## FACTS

1. S2 forms N.
2. P transfers all the stock of S1 to S2 for additional S2 voting stock.
3. S1 transfers substantially all of its assets to N in exchange for N shares.
4. S1 completely liquidates into S2.

## CONCLUSION

- No section 351 exchange.
- N viewed as directly acquiring S1 assets for S2 stock.
- No D reorganization because neither S1 nor P control N.
- Triangular C reorganization.

# Application of Rev. Rul. 78-130

---

- If the principles of Rev. Rul. 78-130 had been applied in PLR 201150021, FS would have been treated as transferring its assets directly to FHoldco1 in exchange for U.S. Parent stock.
- Policy concern of section 338 should not be violated because the T assets were transferred in a carryover basis transaction, i.e., an all boot D reorganization.
- Why didn't the IRS apply Rev. Rul. 78-130 to the facts in PLR 201150021?

# IRS Circular 230 Disclosure

---

To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein.