NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON TREATMENT OF VARIABLE STOCK CONSIDERATION IN TAX-FREE CORPORATE REORGANIZATIONS

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REPORT ON TREATMENT OF VARIABLE STOCK CONSIDERATION IN TAX-FREE CORPORATE REORGANIZATIONS[1]

This New York State Bar Association Tax Section report (the "Report") recommends an approach to the problem of characterizing corporate transactions where a portion of the consideration payable in shares of acquirer stock is subject to arrangements that render its receipt contingent upon events that occur only after the transaction's effective date (referred to generically in this Report as "Variable Stock Consideration"). This Report focuses exclusively on Variable Stock Consideration issued in corporate transactions that qualify, or are intended to qualify as tax-free reorganizations under section 368 of the Internal Revenue Code (the "Code") and concentrates on the continuity of proprietary interest requirement.

Part I of the Report briefly describes common legal arrangements involving Variable Stock Consideration. Part II provides a general overview of Variable Stock Consideration arrangements under current tax law. Part III evaluates the policy and technical merits of alternative approaches to Variable Stock Consideration and Part IV makes specific recommendations about the approach we suggest be adopted and appropriate form of the related guidance.

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[1] This Report was drafted by Andrew Walker with substantial assistance from Karen Gilbreath, John Barrie, Kimberly Blanchard, Patrick Browne, Kathleen Ferrell, Robert Jacobs, Jay Milkes, Michael Schler and Linda Swartz. Helpful comments were also received from Andrew Berg, Dickson Brown, Deborah Paul and Willard Taylor.

The Report makes the following recommendations:

1. We generally recommend that the continuity of interest test apply consistently to Variable Stock Consideration regardless of the legal form of arrangement by which it is provided (*i.e.*, whether it is provided through an escrow, through the issuance of stock to target shareholders subject to a "claw-back" obligation or through contingent stock rights), although we recommend certain specific exceptions discussed below.

2. We generally recommend that a "closed transaction" approach be adopted to the receipt of Variable Stock Consideration so that taxpayers can determine no later than the date they agree to enter into the reorganization whether the reorganization qualifies as tax-free.[2]

3. We generally recommend that this "closed transaction" approach measure the fair market value of the Variable Stock Consideration (thereby taking into account the probability that target shareholders will or will not ultimately receive the underlying stock) and treat the Variable Stock Consideration, to the extent of this value, as a proprietary interest that counts favorably towards satisfying the continuity of interest test, provided that the target shareholders also have received a substantial current stock ownership interest in the acquiring corporation.

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[2] Under current law, while not entirely clear, continuity of interest and the other requirements for reorganization treatment generally are tested on the effective date of the reorganization. We have recently submitted a report that advocates measuring continuity of interest on the signing date subject to certain requirements. *See* New York State Bar Tax Section Report No. 1050 on Continuity of Interest and Pre-Closing Stock Value Fluctuations (Jan. 23, 2004). Consistent with that recommendation, in this Report we assume the signing date to be the relevant testing date for continuity of interest purposes.

4. We recommend that receipt of escrowed stock be treated as satisfying this further requirement that target shareholders receive a substantial current stock ownership interest if, based on the terms of the escrow agreement, the target shareholders are appropriately treated as owners of the underlying stock for federal income tax purposes. Where that is not the case (*e.g.*, in the case of contingent stock rights or escrowed stock that is not appropriately treated as owned by the target shareholders), the target shareholders would be required to receive, in addition to Variable Stock Consideration, a substantial non-contingent stock interest.

5. We support an exception to the above "fair market valuation" approach for traditional stock escrow arrangements that secure customary representations and warranties. For this particular type of stock escrow, we believe it appropriate to treat the underlying stock as issued and outstanding for purposes of the continuity of interest requirement and other reorganization provisions.

I. Background – Common Variable Stock Consideration Arrangements

Typical reasons for entering into contingent consideration arrangements include: (1) to provide security for the selling shareholders' liability for a breach of representations and warranties made in connection with the reorganization, (2) to allocate all or a portion of the risk of a contingent liability of the target corporation to the target shareholders and (3) to provide a mechanism to address fundamental disagreements about the value of the target corporation's business (or sometimes, the value of the acquirer's

stock).[3] Variable Stock Consideration arrangements provide a legal mechanism to resolve these business uncertainties by appropriately adjusting the purchase price that ultimately will be received by the target shareholders.

The legal forms of arrangement by which Variable Stock Consideration is provided vary, but generally fall into three categories:

1. The acquirer may issue a convertible instrument (usually preferred stock) the conversion price of which adjusts based on factors such as performance of the target business or resolution of contingent liabilities (an "Adjustable Conversion Ratio Instrument").

2. The acquirer may convey rights to acquire an amount of its stock that is contingent on the post-closing performance of the target's business or the value of the acquirer's stock ("Contingent Stock Rights"). These rights may be embedded in the reorganization agreement or a separate agreement. Contingent Stock Rights typically convey rights to a variable number of shares that are not issued and outstanding as a state law matter and that convey no current entitlement to dividends or ability to exercise voting power.

3. The acquirer may issue a portion of the stock consideration into an escrow that will release the stock to the target shareholders only when specified performance

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[3] The acquiring corporation may, of course, issue contingent rights to acquire its stock for other reasons. For example, the acquirer may issue warrants to acquire its stock to replace outstanding warrants of the target corporation. Or, the acquiring corporation may issue options with respect to its stock to give target shareholders a vested interest in the acquiring corporation's business only if the stock price exceeds certain thresholds, for example in the reorganization of a financially troubled business.

measures are met or if no breach of representations and warranties has occurred during a specified period ("Escrowed Stock").[4] An Escrowed Stock arrangement often conveys a current entitlement to any dividends declared on the Escrowed Stock and the right to currently exercise the voting power of the Escrowed Stock, and the Escrowed Stock is issued and outstanding for state law and accounting purposes.

II. Background - Current Law

a. General requirements for tax-free reorganizations

The corporate reorganization provisions except from the general rule of gain recognition certain described transactions that represent a mere readjustment of continuing interests in business property in modified corporate form.[5] If the requirements for qualification as a tax-free reorganization are satisfied, the target shareholders will recognize gain only if money or property other than stock of the acquiring corporation is received by them in the reorganization transaction.[6] The target shareholders' tax basis in the acquirer stock they receive in the transaction will be the same as the basis in the target stock surrendered, and the holding period for the acquirer stock will include the holding

[4] In certain cases, the contingent stock is not issued into an escrow but is issued outright to the target shareholders subject to a contractual or legal obligation to return the stock contingent upon certain later events. This type of claw-back arrangement may be very similar in effect to a typical stock escrow, the primary difference being that the target shareholders' obligation to return the stock is not secured. Because we believe these arrangements are analytically indistinguishable from a stock escrow for relevant purposes of this Report, we have not discussed these arrangements separately.

[5] Treas. Reg. § 1.368-1.

[6] I.R.C. §§ 354 and 356. However, the receipt of non-stock consideration that qualifies as a security in exchange for an existing security is taxable only to the extent that its principal amount exceeds the principal amount of the security that is surrendered in the exchange.

period of the target stock surrendered in the exchange.[7] The target corporation will not recognize gain or loss on the transfer of its assets in an asset reorganization and generally will not recognize gain as a result of the acquiring corporation's assumption of its liabilities,[8] and the acquiring corporation will have a carryover basis in the assets it acquires from the target corporation.[9] A reorganization must meet a number of statutory, regulatory and judicial requirements to qualify as tax-free. Of these requirements, the following, in particular, may be implicated by the use of Variable Stock Consideration:

Continuity of Interest. Necessary for acquisitive reorganizations described in Code section 368 is that "in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization" (the "continuity of interest" requirement).[10] In general, a proprietary interest in the target corporation is preserved if it is exchanged for a proprietary interest in the acquiring corporation. While "proprietary interest" is not specifically defined in the regulations, the term generally is understood to require receipt of the acquiring corporation's stock. Post-reorganization dispositions of the acquirer stock by the former target shareholders generally are ignored in measuring continuity, unless the acquired stock is sold to, or redeemed by, the issuing

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[7] I.R.C. §§ 358 and 1223.

[8] I.R.C. §§ 357 and 361.

[9] I.R.C. § 362.

[10] Treas. Reg. §1.368-1(e). The Internal Revenue Service (the "Service") generally interprets this "substantial part" for ruling purposes as requiring that at least 50% of the value of the target be exchanged for equity of the acquiring corporation. *See* Rev. Proc. 77-37, 1977-2 C.B. 568 and Rev. Proc. 86-42, 1986-2 C.B. 722. However, cases have found continuity to have been preserved where stock represents a smaller percentage of the consideration. *See, e.g., John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (38% stock preserved continuity). Divisive reorganizations (spin-offs, split-offs and split-ups) also have a continuity of interest requirement.

corporation (or a related person) "in connection with the reorganization."[11] Presumably, a redemption that is planned or contemplated, or occurs pursuant to the legal arrangements entered into at closing, is "in connection with" the reorganization. Prior law was generally understood to permit a contemplated sale or redemption of acquirer stock after five years (*i.e.,* to require unrestricted ownership only for a definite and substantial period).[12]

Qualifying Consideration v. Boot. Section 354 provides that no gain or loss is recognized by a shareholder who exchanges stock in the target corporation for stock in the acquiring corporation in a transaction described in section 368. Under section 356, the receipt of money or property other than stock ("boot") in exchange for stock will cause gain to be recognized by the recipient.

Solely for Voting Stock. Certain acquisitive reorganization forms require that the acquiring corporation acquire stock or assets of the target corporation "solely in exchange for voting stock."

Control. Certain forms of acquisitive reorganization require that "control" be acquired in the transaction. For example, in a section 368(a)(1)(B) stock acquisition, the acquiring corporation must control the target corporation after the reorganization. In a "reverse triangular merger" under section 368(a)(2)(E), the acquiring corporation must acquire a controlling interest in the target corporation solely in exchange for acquiring's voting stock.

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[11] Treas. Reg. § 1.368-1(e).

[12] See, e.g., Rev. Rul. 66-23, 1966-1 C.B. 67 (Service will ordinarily treat five years of ownership as sufficient); *Nelson v. Helvering*, 296 U.S. 374 (1935) (callable preferred stock acceptable).

b. General Treatment of Rights to Acquire Stock

As the above discussion illustrates, the federal income tax classification of an instrument issued or received in a reorganization can be important. If an instrument is classified as stock, it generally may be received by a target shareholder without gain recognition,[13] and it would be taken into account favorably for purposes of satisfying the statutory requirements as well as the continuity of interest requirement. Conversely, if the instrument is not classified as stock, its receipt generally results in gain recognition and it is unfavorably treated in determining whether the reorganization requirements have been met.

If an instrument is not characterized as stock under general federal income tax principles, it does not receive the generally favorable treatment accorded stock under the reorganization provisions, even if it has economically significant equity indicia. *Helvering v. Southwest Consolidated*[14] involved the treatment of stock warrants issued in a reorganization of a financially troubled company to former shareholders. The relevant provision of the Revenue Act then in effect required that the successor corporation acquire the assets of the predecessor corporation "solely" for voting stock of the transferee. The U.S. Supreme Court held that the warrants were not voting stock. It reasoned that a warrant holder's right to stock are wholly contractual and entitle the holder to money damages rather than specific performance. The court stated that the holder "does not have, and may never acquire, any legal or equitable rights in shares of

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[13] Certain debt-like "non-qualified" preferred stock is treated like "boot" for this purpose. *See* I.R.C. §§ 354(a)(2)(C) and 351(g); Treas. Reg. §§ 1.356-6, 1.356-7 and 1.351-2(e).

[14] *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942).

stock. . . . And he cannot assert the rights of a shareholder." It is clear under current law that, except where the right to acquire equity is in substance equity (for example, because the exercise price is insubstantial), rights to acquire stock, such as warrants, may be securities but are not stock.[15]

Recent Treasury regulations clarify the treatment of rights to acquire stock, such as warrants.[16] The regulations treat rights to acquire stock as zero principal amount securities for purposes of the reorganization rules, with the result that warrants generally may be received without gain recognition.[17] However, the Service apparently does not view rights to acquire stock as continuity-preserving instruments.[18] It is unclear whether the Variable Stock Consideration arrangements that are the focus of this Report were specifically considered by the Service when these regulation were drafted or are within the intended scope of these regulations.

c. Current Law Treatment of Adjustable Conversion Ratio Instruments

The treatment in reorganizations of Adjustable Conversion Ratio Instruments is generally clear. When, as is typical, the convertible instrument is convertible preferred stock, it generally is not boot and may be received tax-free, and it counts favorably towards the satisfaction of the continuity of proprietary interest test and other

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[15] *See Gordon v. Commissioner*, 424 F.2d 378 (2d Cir. 1970), *cert. denied* 400 U.S. 848 (1970); *Bateman v. Commissioner*, 40 T.C. 408 (1963).

[16] Treas. Reg. § 1.356-3 (amendments of January 5, 1998).

[17] *See* T.D. 8752 (Jan. 5, 1998).

[18] *See* 61 F.R. 67508, Notice of Proposed Rulemaking, (December 23, 1996) ("[t]he proposed rules do not permit rights to acquire stock to be taken into account in determining continuity of shareholder interest.").

requirements necessary to be tax-free reorganization.[19] Conversely, when the convertible instrument is convertible debt, it would constitute boot, would not count favorably towards satisfaction of the continuity of proprietary interest test and would not count favorably towards satisfying the other requirements necessary to be a tax-free reorganization.

d. Current Law Treatment of Contingent Stock Rights

It is clear under current law that Contingent Stock Rights are not "boot" for purposes of the reorganization provisions. The original authority for this conclusion is found in two seminal cases addressing the treatment of Contingent Stock Rights.

Carlberg v. United States [20] involved a merger in which shareholders of two target corporations received common shares of the acquirer and a negotiable "certificate of contingent interest" in acquirer shares that were authorized and reserved but not issued. As specified litigation and tax liabilities of the target corporations were resolved, the number of reserved shares was to be adjusted based on a prescribed formula and reserved shares ultimately remaining after these adjustments were to be issued to the target shareholders. The certificates were transferable and entitled the holders to a cash payment in lieu of any dividends declared on shares of the class reserved when the shares

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[19] A portion of the stock into which the instrument is converted arguably could be viewed as a payment of imputed interest. We believe no interest should be imputed. In general, financial instruments are not bifurcated for tax purposes. While section 305 generally requires inclusion of amounts that constitute deemed dividends (including as a result of changes in the proportionate interest of shareholders through adjustments to conversion ratios), an exception applies where this represents a purchase price adjustment. *See* Treas. Reg. § 1.305-1(c). We believe taxability of the return on contingent convertible preferred stock is best addressed under section 305.

[20] *Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960) (*nonacq.*).

were ultimately distributed. The government argued that the certificates were boot, rather than stock. Because the certificates were transferable, the government argued the certificates had an intrinsic value separate and distinct from the underlying common stock. The court held the certificates were not boot, based on the underlying purposes of the reorganization provisions, the economic substance of the interests conveyed and the business exigencies that led to the issuance of contingent stock rights.

Hamrick v. Commissioner[21] involved the formation of a new corporation and transfer to it of patent rights by two inventors and cash by a group of financial investors. Both sets of transferors received stock of the new corporation in the exchange. In addition to stock of the new corporation, the inventors also received rights to receive additional shares contingent upon the earnings of the transferee corporation during the seven years following the transfer until their interest in the new company represented two-thirds of the then outstanding shares of the new corporation. The inventors claimed that their receipt of stock— both in the original transfer and in subsequent years— under the terms of the earn-out arrangement was non-taxable because it was a transfer of property for stock in a transaction described in section 351. The government argued the contingent rights were not stock but boot. The Tax Court held that the rights to receive additional stock were not boot. The court's primary rationale was that the owner of the rights could never have received anything other than stock.[22]

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[21] *Hamrick v. Commissioner*, 43 T.C. 21 (1964).

[22] The government also contended that the potential ownership changes resulting from the contingent stock rights prevented the transaction from qualifying under section 351 because the required "control" of the corporation following the exchange could not be established with certainty at the time of the transfer. The court rejected this argument noting, correctly, that the initial control group satisfied the control requirement at the time of transfer and the issuance of

The Service subsequently acquiesced in the *Hamrick* result and ruled that the contingent right to stock was not boot and did not destroy an otherwise qualifying reorganization under section 368(a)(1)(B).[23] For private ruling purposes, the Service stated in Revenue Procedure 84-42[24] that it will rule favorably on reorganizations involving contingent stock rights where certain additional conditions are met.[25]

It is also clear under current law that, unless separate provision for interest is made, receipt of a portion of the underlying shares will be treated as a payment of imputed interest representing compensation for the deferred receipt of the shares.[26] The expiration or lapse of the Contingent Stock Rights is not a taxable event. The target shareholders' basis in their target shares is initially allocated among the maximum number of acquirer shares that could be issued and reallocated among all the acquirer

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additional stock to certain members of that group could never divest that transferor group of control.

[23] *See* Rev. Rul. 66-112, 1966-1 C.B. 68; Rev. Rul. 67-90, 1967-1 C.B. 79 (same result where number of additional shares was contingent on value of acquirer stock).

[24] Rev. Proc. 84-42, 1984-1 C.B. 581.

[25] The additional conditions imposed for ruling purposes are that: (1) there be a valid business purpose for the arrangement, (2) the contingency that determines whether the shares are issued is not the reorganization-related federal income tax liabilities of the parties, (3) all stock is issued within five years (unless there is a bona fide dispute as to the arrangement), (4) the rights are not negotiable or readily marketable, (5) the rights can be satisfied only with shares, (6) there is a maximum number of shares that may be contingently issued and at least 50% of the shares issued in the transaction are not subject to the contingent arrangements, (7) the contingent event that determines the number of shares to be issued is not within the control of either party and (8) the mechanism for calculating the number of shares to be returned is objective and readily ascertainable.

[26] *See Fox v. United States*, 510 F.2d 1330 (3d Cir. 1974); Rev. Rul. 70-300, 1970-1 C.B. 125; Rev. Rul. 72-35, 1972-1 C.B. 139; Rev. Rul. 72-32, 1972-1 C.B. 48; Rev. Rul. 73-298, 1973-2 C.B. 173. Treas. Reg. § 1.483-4(b), Ex. 2. The enactment of section 163(l) has created an issue as to whether the imputed interest is deductible by the acquirer, the answer to which depends on whether the obligation that gives rise to the imputed interest is deemed to be debt. Service or Treasury Department clarification that the imputed interest is deductible would be helpful.

shares when the contingency is finally resolved and the contingent shares are actually received.[27]

It is not clear under current law how Contingent Stock Rights should be treated for purposes of the continuity of interest test. *Carlberg* and *Hamrick* appear to treat Contingent Stock Rights as stock equivalents. However, it is questionable whether the rationale in those cases could be extended to justify treatment of Contingent Stock Rights as continuity-preserving instruments. Where target shareholders can receive only more or less voting stock, it is clear the transaction would always result in receipt of voting stock and, therefore, that the Contingent Stock Rights should not adversely affect the treatment of the reorganization provided the rights are not viewed as separate and distinct from the underlying stock. However, it is unclear whether the cases hold that Contingent Stock Rights are equivalent to current ownership of voting stock or, instead, reached the result they did by applying a type of "open transaction" approach to the particular facts in those cases.[28] Accordingly, where this distinction matters-- as it does if boot also is issued in the exchange-- neither case law nor Treasury Department directives provide a clear answer regarding the treatment of the Contingent Stock Rights for continuity of interest purposes.

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[27] Prop. Reg. § 1.453-1(f)(2), Ex. (4); PLR 8938062 (June 29, 1989); Rev. Rul. 76-334, 1976-2 C.B. 108.

[28] Knowing that only more or less voting stock will be received and the amount of tax would be zero in any event, the courts may have concluded it does not make sense to actually wait and see how much stock is issued because the characterization is known prospectively.

e. Current Law Treatment of Escrowed Stock

Escrowed Stock generally is not boot for purposes of the reorganization provisions.[29] Where dividends and voting power on the underlying stock pass through to the target shareholders under the terms of an escrow, absent other unusual facts, practitioners conclude that the target shareholders should be treated as the tax "owners" of the Escrowed Stock. This conclusion is consistent with authorities addressing "ownership" of property for tax purposes and various administrative pronouncements.[30] While the ownership indicia of Escrowed Stock typically do not point unambiguously to either party as the owner, where dividends and voting power pass through to the target shareholders, treating the target shareholders as owners, and the stock as issued and outstanding for tax purposes, appears justified.[31] Determining the tax owner of the

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[29] *See Feifer v. United States*, 500 F. Supp. 102 (N.D. Ga., 1980); *McAbee v. Commissioner*, 5 T.C. 1130 (1945) (concluding that shareholders acquired equitable title to stock placed in escrow against liabilities and the escrow arrangement was simply a security device).

[30] *See* Rev. Rul. 72-256, Rev. Rul. 76-334, 78-376; Rev. Rul. 70-120; pre-1994 Treas. Reg. Section 1.483-1(b)(6), Ex. 8; I.R.C. § 468B(g); *Feifer, supra n.* 29; *McAbee, supra n.* 29 (concluding that shareholders acquired equitable title to stock placed in escrow against liabilities and the escrow arrangement was simply a security device).

[31] The primary indicia of stock ownership are (1) formalities of title (although these are given limited weight), (2) right to dividends, (3) ability to exercise voting power, (4) power to dispose of the stock, (5) opportunity for gain and (6) risk of loss. That escrowed stock is issued and outstanding for state law and accounting purposes tends to suggest that it is owned by the shareholders, although this factor is formalistic. That escrowed stock may be voted by the shareholders or their authorized agents and the shareholders are entitled to receive the dividends on the stock is highly indicative of current ownership. The opportunity to capture appreciation on the stock depends on whether the stock is ultimately released to the shareholders or returned to the issuer. This is indeterminate prior to termination of the escrow or, at best, can be measured only by taking into account the likelihood of release to the shareholders (which will rarely point unambiguously to either party). To the extent the target shareholders surrendered some portion of the value of the target company stock with the expectation that they would receive the escrowed shares in exchange, the risk of loss on the escrowed shares should be viewed as theirs. An escrow generally will not permit the target shareholders to dispose of their interests in the escrowed stock. On the other hand, the issuing corporation cannot dispose of the stock either. In some cases target shareholders may be permitted to substitute other property and withdraw the escrowed stock. This should be treated as a power to dispose of the stock and buttresses the

escrowed stock may be more difficult if, for example, dividends or voting power during the escrow period do not pass through to the target shareholders.

Revenue Procedure 84-42 sets out the Service's position for granting private rulings on reorganizations, including where a portion of the stock consideration will be placed in escrow.[32] The Revenue Procedure states that, where certain conditions are met, that stock is issued into escrow or otherwise subject to conditional return to the issuer will not prevent the Service from ruling favorably on the proffered reorganization plan.[33]

To the extent target shareholders are entitled to current receipt of any dividends paid on Escrowed Stock, it is also clear under current law that no imputed interest arises under section 483 when the escrowed shares ultimately are distributed.[34] This is a logical extension of the technical conclusion that the target shareholders own the escrowed shares for federal income tax purposes immediately following the effective date of the reorganization.

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conclusion that the target shareholders own the stock. Alternatively, the claim to the escrowed stock may be negotiable. This feature also suggests the target shareholders should be treated as having a power effectively to dispose of the escrowed stock.

[32] Rev. Proc. 84-42, 1984-1 C.B. 581.

[33] The additional conditions imposed for ruling purposes are: (1) there be a valid business reason for the escrow arrangement, (2) the stock is issued and outstanding on the corporate balance sheet and for state law purposes, (3) all dividends declared, if any, will be distributed currently, (4) all voting rights of the stock, if any, are exercisable by the shareholders or their authorized agents, (5) the shares are not subject to return based on death, termination of employment or similar circumstances, (6) all stock will be released within five years (unless there is a bona fide dispute as to the release), (7) at least 50% of the shares issued in the transaction are not subject to the escrow arrangement, (8) the contingency that determines release or return of the shares is not within the exclusive control of either party, (9) the return of the escrowed shares is not contingent on tax results upon audit of the reorganization in which the escrowed stock is issued, and (10) the mechanism for calculating the number of shares to be returned is objective and readily ascertainable.

[34] Rev. Rul. 76-334, 1976-2 C.B. 108; Rev. Rul. 72, 256, 1972-1 C.B. 222; Rev. Rul. 70-120, 1970-1 C.B. 124; prior law Treas. Reg. §1.483-1(b)(6), Ex. 8 (1983).

The treatment of Escrowed Stock in determining whether continuity of proprietary interest is preserved in a reorganization is not entirely clear. A determination that the Escrowed Stock is issued and outstanding, and that the target shareholders own it for tax purposes, would suggest that the Escrowed Stock should be treated no differently for continuity purposes than stock that is not held in escrow and therefore is not subject to forfeiture. That conclusion may be intuitively troubling, however, unless forfeiture is unlikely.[35] Indeed, certain commentators have raised the technical concern that the regulations on shareholder continuity applicable to post-1998 transactions call this result into question.[36] Those regulations generally ignore post-reorganization dispositions in measuring continuity unless the acquiring company's stock is "redeemed" by the acquiring company or a related party "in connection with" the reorganization. The regulations could conceivably be read to encompass a return of Variable Stock Consideration to the acquiring corporation. While the meaning of "redeemed" admittedly may be subject to varying interpretations, the regulations apparently presume that the redemption is in lieu of disqualified non-proprietary consideration. The regulations appear to treat the cash received from the stock redemption as boot in the reorganization for continuity purposes.[37] We question whether a return of stock to the acquirer from escrow necessarily should be viewed as the equivalent of a cash redemption for this purpose. The regulation generally is consistent with step transaction principles

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[35] *Cf.* Rev. Rul. 66-23, *supra n.* 12.

[36] *See, e.g.*, Ginsberg & Levin, Mergers, Acquisitions and Buyouts ¶ 6.10.2.3 (2002).

[37] The examples in the regulations do not make this entirely clear because they do not address a situation where treating the redeemed stock adversely rather than ignoring it would change the outcome. However, it appears that, were the acquiring company to issue $100 of stock and $100 cash and then redeem $20 of the stock for cash, the continuity percentage would be 40% ($80 / $200) not 44% ($80 / $180).

(applicable under prior law) that treated an acquiring corporation as issuing cash if stock issued in the reorganization was redeemed for cash or other property pursuant to a plan in effect at the time of the original stock issuance. Those same principles suggest that a preplanned "redemption" for no consideration should, at worst, result in the shares being ignored in measuring continuity. In the absence of direct authority on point, however, the treatment of Escrowed Stock for continuity purposes may not be entirely clear.

III. Evaluation of Alternative Approaches to Variable Stock Consideration

As discussed above, we find considerable uncertainty under current law addressing the appropriate treatment of Variable Stock Consideration received in a reorganization, particularly its treatment under the continuity of interest test. There is also considerable inconsistency in treatment depending on the legal form of arrangement by which Variable Stock Consideration is conveyed. This uncertainty arises from the tension between the need to characterize the transaction on the effective date of the reorganization for administrative and equitable reasons and the fact that the ultimate outcome of the contingent stock arrangement will not be known until a later date.

The issue is often moot, because the value of stock unqualifiedly issued in the reorganization relative to the boot issued is sufficient to satisfy the continuity of interest requirement. However, in other cases, the Variable Stock Consideration's treatment may be determinative.

> Example 1. B owns all the corporation T stock. T merges into corporation P in a state law merger otherwise described in section 368(a)(1)(A) and P issues in the exchange (i) 100 shares of unrestricted voting common stock worth $3.60 per share (or $360 in aggregate), (ii) cash of $600 and (iii) contingent rights to an additional 70 shares of voting

> common stock subject to satisfaction of performance measures by the target business. If the 70 contingent shares were valued at $3.60 per share, they would have a total value of $252, increasing the overall equity consideration to $612.

Most practitioners would probably advise that, under current law, continuity of interest is not satisfied or, at best, substantial doubt exists as to whether the reorganization qualifies as tax-free. If tax-free treatment is sufficiently important, the parties could restructure the transaction. For example, the parties could (1) issue, in lieu of a like amount of the cash, $120 worth of nonqualified preferred stock or (2) issue, in lieu of contingent stock rights and a portion of the other consideration, debt-like preferred stock convertible into common stock with an adjustable conversion ratio.[38] In any case, the business deal the parties would otherwise have struck will have to be meaningfully revised to ensure tax-free reorganization treatment. The transaction, restructured as suggested above, does not however clearly result in an inherently more "proprietary" stake in the acquirer being conveyed to target shareholders.

It is our experience that the lack of clarity under current law does not prevent taxpayers from structuring reorganizations involving Variable Stock Consideration to satisfy the continuity of interest requirement. As the discussion above illustrates, changes in transaction structure necessitated by the parties' tax objectives often do not meaningfully further the purposes of the continuity of interest doctrine by forcing the target shareholders to accept a more substantial proprietary stake in the acquirer. The

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[38] The government has regulatory authority to preclude the use of nonqualified preferred stock for this purpose, but so far has not exercised this authority. *See* I.R.C. § 351(g)(4). Even if it did, however, the latter solution would quite possibly survive as legislative history implies that, in contrast to section 305, a sufficiently substantial conversion right should be treated as participation in profits and prevent treatment as nonqualified preferred stock. *See* H.R. Rep. No. 105-220, at 545 (1997).

current uncertainty simply fosters remedial tax planning by sophisticated taxpayers while unduly hindering negotiation of desired commercial terms of the transaction.

These opportunities for tax planning are facilitated by the inconsistent treatment of different legal Variable Stock Consideration arrangements under current law. We question whether the differences between forms of arrangement like Escrowed Stock and Contingent Stock rights generally are sufficiently substantive to justify fundamentally different treatment, other than in certain limited respects discussed below. Accordingly, as discussed more fully below, we generally suggest that Escrowed Stock be treated comparably to Contingent Stock Rights in determining whether the continuity of interest requirement is satisfied.

How might Variable Stock Consideration be treated in measuring continuity? In theory, there are at least five general approaches that could be adopted: (1) a "wait and see" or "open transaction" approach where satisfaction of the continuity requirement remains uncertain until the amount of stock actually issued becomes fixed, (2) a "closed transaction approach" that treats the Variable Stock Consideration as a separate right received in the initial exchange that is distinct from the underlying stock, is inherently non-proprietary and counts adversely under the continuity of interest test based on the fair market value of the right, (3) a "closed transaction approach" that treats the Variable Stock Consideration as indistinguishable from the underlying stock (*i.e.*, as a current ownership interest in the underlying stock) that therefore counts favorably towards satisfying the continuity of interest test to the same extent as if the underlying stock were issued and outstanding, (4) a "closed transaction approach" that ignores Variable Stock

Consideration in measuring continuity (*i.e.*, treats it as consideration that is deemed to have zero value, as warrants are now treated for purposes of other reorganization requirements) or (5) a "closed transaction" approach that treats the Variable Stock Consideration as a separate right issued in the exchange that is distinct from the underlying stock, is inherently proprietary and counts favorably towards satisfaction of the continuity requirement based on the fair market value of the right at the time of the reorganization. We consider below the relative merits of each approach as a technical and policy matter and also consider those circumstances in which different treatment of Escrowed Stock and Contingent Stock Rights may be justified.

Open Transaction Approach. Under an open transaction approach, the result in Example 1 above would be uncertain until the amount of stock actually issued under the Contingent Stock Rights arrangement becomes known. The primary policy advantage of an "open transaction" approach is that it generally avoids the risk of abusive transactions designed selectively to achieve or to avoid tax-free treatment at the option of the taxpayer. However, there are other ways to limit this type of abuse, for example by requiring that there be a valid business purpose for the contingent stock consideration arrangement or by discounting the Contingent Stock Rights in measuring continuity by the likelihood the stock will ultimately be issued.

The primary disadvantages of an open transaction approach are its lack of administrability and its fundamental unfairness to taxpayers. Our tax system assumes an annual accounting, rather than a transactional approach, to measuring income.[39] While

[39] *See Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931).

there are rare and unusual exceptions, the tax law strongly disfavors open transaction approaches.[40] We do not think an income tax system in which the fundamental characterization of a transaction remains uncertain for a number of years after the tax return on which it must be reported has been filed is readily administrable.

Nor do we think it efficient or fair to taxpayers to adopt an approach that leaves them in a quandary about the fundamental tax consequences of the business deal they have struck.[41] The inequity of an open transaction approach is exacerbated in the context of corporate reorganizations by the corporate-level tax, because a disqualified transaction may result in a tax on gain at both the target corporation and target shareholder level. If taxpayers are unable to determine the characterization of the reorganization at the time they strike the deal, they may lose the opportunity to avoid multiple levels of tax, for example, by structuring the transaction as a stock transfer rather than an asset transfer. This strikes us as fundamentally unfair as well as inefficient.

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[40] *See* Treas. Reg. §1.1001-1(g) (requiring valuation of contingent instruments for purposes of determining the amount realized from a transaction); Installment Sales Act of 1980 (expanding the statutorily deferred payment option to all forms of deferred payment sales with the effect that the open transaction doctrine allowing for cost recovery, as sanctioned by *Burnet v. Logan*, 283 U.S. 404 (1931), would be available only for "rare and extraordinary" cases); T.D. 8858 (2000) (eliminating the open transaction regime that had been allowed for section 338 elections since its enactment in 1982); H.R. 5662, the Community Renewal Tax Relief Act of 2000, enacting section 358(h) (requiring the valuation of contingent liabilities assumed in section 351 exchanges); Notice 2001-17 (Service's position that the assumption of contingent liabilities may be subject to section 357(b)(1), and thus, that liability must be valued); Treas. Reg. §1.197-2(k), Ex. 6 (allowing the valuation of a covenant not to compete at the date of the sale).

[41] In general, the "open transaction doctrine" has been applied in situations where the characterization of a transaction as a taxable exchange is clear and the only question is when to measure the value of the amount realized when property received in inherently difficult to value. There is no question in those circumstances that gain recognition at the time of the exchange is the theoretically preferable approach but is arguably precluded by practical and administrative considerations.

Aside from its doubtful practicality as an administrative matter and its fundamental unfairness, we do not think the "open transaction" approach is necessarily even theoretically preferable in principle to a "closed transaction" approach. Consider a variation on Example 1 above:

> Example 2. B owns all the T stock. T has a potential liability of $200 that is the subject of litigation. The litigation is expected to be resolved by February 2004. In December 2003, T merges into P in a state law merger otherwise described in section 368(a)(1)(A). Were it not for the liability, the parties agree that the target business is worth $1212. Assume the parties can agree that T's likelihood of prevailing in litigation is at least 95% and value the liability at $10 and conclude that the target corporation is therefore worth $1202.

Assume first that P issues in the exchange (i) 167 shares of unrestricted voting common stock worth $3.60 per share at the time of the exchange (or approximately $602 in aggregate) and (ii) cash of $600. If, contrary to the parties' expectations, the litigation is unsuccessful, the P corporation stock will be worth less than expected. Nevertheless, it is clear that this dilution in the value of P stock owned by B has no impact on the characterization of the reorganization.

Now assume, instead, that P issues in the exchange, as in Example 1 above, (i) 100 shares of unrestricted voting common stock worth $3.60 per share (or $360 in aggregate), (ii) cash of $600 and (iii) contingent rights to an additional 70 shares of voting common stock subject to T prevailing in the litigation. Under an "open transaction" approach, the characterization of the transaction would depend on the outcome of the litigation. If T does not prevail, the transaction will be taxable. If T does prevail, the transaction will qualify as a tax free reorganization. We do not see why the subsequent event should affect the characterization of the reorganization merely because the parties chose to allocate this risk entirely to the T shareholders, rather than have both

the P and T shareholders bear the risk of dilution in the value of their P stock. At the time of the exchange, the parties' reasonable expectations suggest that the contingent right has a value of approximately $240 ([70 x $3.60] x 95%).[42]

Accordingly, we believe there are significant and insurmountable problems with adopting an open transaction approach. The theoretical justification for such an approach is, at best, questionable and it raises substantial administrative, fairness and efficiency concerns.

Closed Transaction -- Non-Proprietary Interest Approach. Under a closed transaction- non-proprietary interest approach, Variable Stock Consideration would be treated as non-stock consideration separate and distinct from the underlying stock that does not convey a proprietary interest.

> Example 3. B owns all the corporation T stock. T merges into corporation P in a state law merger otherwise described in section 368(a)(1)(A) and P issues in the exchange (i) 200 shares of unrestricted voting common stock worth $3.60 per share (or $720 in aggregate), (ii) cash of $600 and (iii) assignable contingent rights to an additional 333 shares of voting common stock subject to satisfaction of performance measures by the target business. Assume the likelihood the contingent shares will be issued is 90% and the value of the contingent rights on the date received is $1,079.

Under this approach, continuity would not be satisfied in Example 3 above because the value of the cash and contingent stock rights represents approximately 70% of the aggregate consideration.

[42] We recognize that the assumption made in discussing various Examples in the Report – that the value of contingent consideration is the value of the underlying consideration discounted by the probability of receipt – is overly simplistic. However, we do not believe making this simplifying assumption fundamentally affects the analysis.

Receipt of Contingent Stock Rights and even Escrowed Stock admittedly is substantively and economically different from outright receipt of the underlying stock because of the risk that the underlying stock will ultimately be forfeited under the terms of the arrangement. Treatment of Variable Stock Consideration as a separate and distinct interest is plausible, particularly when the contingent rights are assignable and negotiable.

However, underlying the proposition that Variable Stock Consideration be treated unfavorably for continuity purposes-- because it conveys different economic and substantive rights than the underlying stock-- is a presumption that only stock can count as a proprietary interest. We recognize that this presumption is arguably consistent with current law as a technical matter. However, the authority to this effect is limited. The case usually cited for the proposition that only stock can constitute a proprietary interest is *Southwest Consolidated* discussed above.[43] At issue in *Southwest Consolidated* was whether warrants are voting stock for purposes of the reorganization provisions and any comments in the decision regarding the status of warrants as a proprietary interest are dicta. *Carlberg* appears to suggest that Contingent Stock Rights are treated like stock. The technical basis for treating Escrowed Stock as a proprietary interest because it is

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[43] *Southwest Consolidated* does, if carefully parsed, provide some support for this proposition. The Court expressly stated that "Under the statute involved in *Helvering v. Alabama Asphaltic Limestone Co.,* 42-1 USTC ¶9245, decided this day, there would have been a "reorganization" here. For the creditors of the old company had acquired substantially the entire proprietary interest of the old stockholders." The former shareholders received 18,445 Class B warrants which the Board of Tax Appeals found, and the Court recited, had a value of $25 on the date received (*i.e.*, an aggregate value of approximately 26% of the gross asset value of the company on the reorganization date). The statement that the creditors had received the entire proprietary interest could therefore be understood to imply that the warrants received by the former shareholders were not a proprietary interest. On the other hand, that implication was irrelevant to the decision and mentioned only in passing.

owned for tax purposes by the target shareholders is also strong. Certain cases could even be read to imply that warrants are a proprietary interest.[44]

There is apparent inconsistency in treating Variable Stock Consideration like boot for this purpose when it is not boot for other reorganization purposes. Moreover, Variable Stock Consideration more closely resembles stock than boot as a substantive matter, because the value of the rights it conveys is closely tied to the performance of the continuing corporate business. Unlike boot, Variable Stock Consideration generally does not give target taxpayers the opportunity to extract untaxed assets from corporate solution.[45] Receipt of Variable Stock Consideration therefore is not comparable to receipt of cash or debt from the acquiring corporation and target shareholders who receive Variable Stock Consideration have not "cashed out" their investment in the combined business. As a substantive matter, Variable Stock Consideration represents an interest whose value is closely tied to the performance of the continuing combined corporate business, albeit a contingent interest whose value will be realized only if the business performance exceeds certain thresholds or other requirements are met.[46]

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[44] *See, e.g., Bateman v. Commissioner*, 40 T.C. 408 (1963), *non-acq.* 1965-2 C.B. 7 and *E.P. Raymond v. Commissioner,* 37 B.T.A. 423 (1938).

[45] For example, receipt of debt entitles the holder to payment of interest out of pre-tax earnings and tax-free repayment of principal. Redemption of contingent stock rights or the stock will be non-deductible by the acquiring corporation under section 1032 and may be taxable to the target shareholder as a dividend under section 302.

[46] In certain instances, Contingent Stock Rights may resemble warrants, particularly where they are tradable. For example, a contingent stock right where the contingency is based on the value of the acquirer's stock, rather than the target's business performance, somewhat resembles a European-style option with an automatic cashless exercise. The Service has indicated that it is reluctant to treat warrants as counting favorably towards satisfying the continuity of interest requirement. *See* n.18, *supra*. We do not think the possible inconsistency with the treatment of warrants justifies treating Contingent Stock Rights as non-proprietary. In most cases, contingent stock arrangements and warrants are economically distinguishable. Whatever the appropriate

Closed Transaction -- Undiscounted Proprietary Interest Approach. An alternative closed-transaction approach would be to treat Variable Stock Consideration as if the underlying stock were issued and outstanding for continuity purposes.

> Example 4. B owns all the corporation T stock. T merges into corporation P in a state law merger otherwise described in section 368(a)(1)(A) and P issues in the exchange (i) 100 shares of unrestricted voting common stock worth $3.60 per share (or $360 in aggregate), (ii) cash of $600 and (iii) contingent rights to an additional 67 shares of voting common stock subject to satisfaction of business performance measures by the target business. The value of stock underlying the contingent right is $241.

Under this approach, continuity would be satisfied in Example 4, because the value of the stock issued outright and the stock underlying the contingent rights together represents more than 50% of the aggregate consideration.

The primary objection to this approach, regardless of the legal form of the Variable Stock Consideration arrangement, is that it gives the taxpayer undue credit towards satisfying the continuity requirement relative to the value of the proprietary interest being conveyed. The central problem is that the stock may never be unqualifiedly issued to the target shareholders. Failing to discount Variable Stock Consideration for purposes of the continuity test to reflect this risk of forfeiture creates opportunities for abuse. For example, taxpayers could seek to satisfy continuity by

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treatment of warrants, we therefore believe treating Contingent Stock Rights as a non-proprietary interest generally is inappropriate. Moreover, the policy argument against treating warrants as proprietary interests, itself, is far from compelling. Like Contingent Stock Rights, warrants convey a significant economic stake in the performance of the combined businesses and it is hard to see why they are adversely treated when non-voting preferred stock counts favorably towards satisfaction of the continuity of interest requirement. We therefore believe the Service's decision to treat warrants as non-proprietary also may merit reconsideration.

escrowing substantial amounts of stock consideration that is unlikely ever to be released to the target shareholders.

As a general matter, this policy concern applies with equal force to Contingent Stock Rights and Escrowed Stock where the contingency involves an "earn out" dependent on future business performance. We do not think the result in Example 4 should be different merely because the Variable Stock Consideration is in the form of an Escrowed Stock arrangement that passes through any dividends and voting power to the target shareholders. In these circumstances, the importance to the target shareholders of the (potentially temporary) right to participate in dividends or control may be relatively insignificant compared to the potential risk of forfeiture. That target shareholders may have rights to specific performance and not merely money damages if the acquirer breaches the terms of the arrangement is, for this purpose, a meaningless distinction. Nor do we believe the state law or accounting status of Escrowed Stock as issued and outstanding to be relevant as a tax policy matter. "Tax ownership" is fact specific, malleable and difficult to administer and we are concerned that an inconsistent valuation rule for Contingent Stock Rights and Escrowed Stock may foster the use of escrow arrangements and create client pressure for aggressive "tax ownership" opinions. We therefore generally do not support treating Variable Stock Consideration as if the underlying stock were issued and outstanding for purposes of the continuity of interest requirement merely based on the application of "tax ownership" principles in all circumstances.

We note that this conclusion may appear inconsistent with the approach we recommended for compensatory restricted stock arrangements in our recent Report on the Treatment of Restricted Stock in Corporate Reorganization Transactions.[47] In that report, we recommended treating restricted stock as issued and outstanding. We believe that this approach is appropriate in that context where the likelihood of forfeiture is largely within the control of the employee and subject to that individual's decision to continue in employment, making objective valuation difficult or impossible. Moreover, the likelihood of abusive use of compensatory restricted stock to achieve tax-free treatment seems quite remote. For most types of Variable Stock Consideration arrangements addressed in this Report, where the contingency generally is objectively determinable and the likelihood of abuse by taxpayers is greater, we have concluded that the valuation approach discussed below is generally preferable.

There is, however, at least one situation in which we believe treating Variable Stock Consideration as if the underlying stock were issued and outstanding is justified—typical Escrowed Stock arrangements in which the escrow arrangement secures customary target representations and warranties if the terms of the escrow arrangements permit the conclusion that the target shareholders own the stock. It is our experience that the likelihood that target shareholders will receive the underlying stock where the escrow secures customary representations and warranties is high and the risk of abuse low. We therefore believe that, as in the case of compensatory restricted stock, it would make sense for reasons of administrative simplicity to avoid the need to value the Escrowed Stock separately in these circumstances and, instead, to treat the underlying stock as

[47] *See* New York State Bar Association, Tax Section, Report on the Treatment of Restricted Stock in Corporate Reorganization Transactions, Report No. 1042 (Oct. 23, 2003).

issued and outstanding. Other than in these circumstances, we believe that treating Variable Stock Consideration as if the underlying stock were issued and outstanding (with no discount to reflect the possibility of forfeiture) is unduly subject to manipulation by taxpayers.

Closed-Transaction -- Zero Value Approach. A closed transaction approach that ignores Variable Stock Consideration represents another possible approach.

> Example 5. B owns all the corporation T stock. T merges into corporation P in a state law merger otherwise described in section 368(a)(1)(A) and P issues in the exchange (i) 100 shares of unrestricted voting common stock worth $3.60 per share (or $360 in aggregate), (ii) cash of $600 and (iii) contingent rights to an additional 67 shares of voting common stock subject to satisfaction of performance measures by the target business. The value of stock underlying the contingent right is $241. Assume there is a 60% likelihood the underlying stock will be issued and the value of the contingent right is $144.60.

Under this approach, continuity likely would not be satisfied in Example 5 because the Variable Stock Consideration would be excluded from both the numerator and denominator.

A closed transaction approach that simply ignores Variable Stock Consideration in measuring continuity has considerable intuitive appeal. It would avoid the difficult task of valuing the contingent stock consideration to prevent overstating or understating the relative value of the proprietary interest being conveyed by the acquirer in the reorganization. It would also be relatively simple and administrable. However, this approach understates the relative value of the proprietary interest received by the target shareholders, albeit less significantly than an approach that would treat contingent stock

as a non-proprietary interest. In addition, this approach would suggest that contingent non-stock consideration should be similarly ignored.[48]

Accordingly, while we believe simply ignoring Variable Stock Consideration in measuring continuity has many advantages, on balance, we prefer the "fair market value" approach recommended below. If the "fair market value" approach is not acceptable, however, the "zero value" approach is a viable and practical alternative.

Closed Transaction – Fair Market Value Approach. Finally, the contingent right to Variable Stock Consideration could be treated as a proprietary interest based on the fair market value of that right on the date the parties agree to the terms of the reorganization. In other words, the Variable Stock Consideration would be treated as proprietary based on the nature and value of the contingent rights conveyed and it would be irrelevant that the Variable Stock Consideration is not considered to be stock or to be a "tax ownership" interest in stock. Under this approach, continuity in Example 5 above would be satisfied because the value of the non-contingent stock and fair market value of the Variable Stock Consideration together represents more than 50% of the aggregate consideration.

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[48] We do not focus in this Report on the treatment of contingent rights to receive non-stock consideration such as an escrow of cash or property. In general, however, we believe that receipt of contingent rights to receive non-stock consideration should be treated as boot. For the reasons above, we do not support an open transaction approach that would potentially recharacterize the transaction at a later date if the underlying boot is ultimately issued. Ignoring this contingent consideration merely because the right to receive it is contingent is similarly inappropriate and creates potential for abuse. Treating the consideration as boot without any discount for the likelihood the non-stock consideration will be issued and received is unduly unfavorable to taxpayers. Accordingly, we think that contingent rights to receive non-stock consideration represent a non-proprietary interest that should constitute boot based on the fair market value of the rights on the closing date.

This closed transaction approach appropriately reflects the inherently proprietary nature of Variable Stock Consideration and avoids significantly overstating or understating the relative value of the proprietary interest being conveyed by the acquirer to the target shareholders. There are, however, two policy concerns with this approach, one practical and one theoretical. Valuation of Variable Stock Consideration requires an evaluation of, among other factors, the likelihood the stock ultimately will be issued rather than returned to the issuer. The value therefore may not be readily determinable. The use of Variable Stock Consideration may suggest that the parties at armslength were unable to agree on a fixed value. The valuation is therefore likely to be less than precise, and susceptible at the margins to taxpayer manipulation.

Nevertheless, we do not view this as a reason to reject this approach. First, the continuity requirement itself is inherently factual and imprecise. For example, while the Service requires 50% of the consideration to be in the form of proprietary interests for advance private letter ruling purposes, case law supports substantially lower thresholds, *e.g.*, 38%.[49] Accordingly, that the "true" value of the contingent stock consideration may vary somewhat from the asserted value is not a compelling concern.[50] Further, such valuation problems are unavoidable in the context of corporate reorganizations. Variable Stock Consideration is particularly prevalent in reorganizations involving private, rather than public, companies. Valuation of non-contingent stock being issued in those contexts is itself subject to similar difficulties.

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[49] *See* n. 10, *supra*.

[50] This conclusion rests upon the judicial origin of the continuity of proprietary interest as a fact-specific "backstop" to the formal statutory requirements for reorganization treatment. For that reason, as discussed further below, we do not suggest extending this approach to the formal statutory requirements for reorganization treatment.

The theoretical objection to this approach, at least in its extreme form, is that it permits a tax-free reorganization where target shareholders receive no current voting power or interest in the earnings of the combined business and may never receive stock in the combined corporation.

> Example 6. B owns all the corporation T stock. T merges into corporation P in a state law merger otherwise described in section 368(a)(1)(A) and P issues in the exchange (i) cash of $600 and (iii) contingent rights to 850 shares of P voting common stock that is trading at $3.60 per share at the time of the exchange, subject to satisfaction of performance measures by the target business. Assume that the likelihood that the performance measures will be met and the stock issued is 20% and the fair market value of the contingent rights to P stock are worth $600.

B has no current interest in voting power or earnings, and depending on the term of the arrangement may not receive such an interest. There is only a 20% likelihood that B will ever receive any P stock. In these circumstances, despite the theoretical argument that the rights are themselves inherently proprietary, treating continuity of interest as satisfied is intuitively troubling. While the proprietary nature of contingent rights justifies their generally favorable treatment for continuity purposes, continuity of interest arguably also requires some substantial current right to participate in the earnings and/or control of the combined business. We believe this objection can be addressed by the additional requirement that target shareholders receive a "substantial" current stock ownership interest. We believe that this modified approach to continuity of interest best reconciles the competing policy and technical consideration discussed above, although we recognize that it results in additional complexity as compared to current law or the "zero value" approach discussed above.

IV. Specific Recommendations

a. Adopt a Closed-Transaction-- Fair Market Value Approach in Measuring Continuity of Interest

For the reasons discussed above, we generally recommend the adoption of a closed transaction approach to measuring continuity of interest in reorganizations involving Variable Stock Consideration. We generally recommend that Variable Stock Consideration be treated as proprietary consideration based on the fair market value of the Contingent Stock Rights or Escrowed Stock on the closing date. While we recognize that this approach may raise difficult valuation questions, in the case of "earn out" arrangements we believe these valuation difficulties generally are no more pronounced than difficulties in valuing the underlying stock itself. We have concluded, however, that it would be inappropriate to permit a tax-free reorganization in which the target shareholders do not receive any substantial current right to participate in the control of, or earnings of, the combined business. Therefore, we support this approach, subject to the additional requirement that the consideration received in the reorganization includes a substantial current stock ownership interest.

We believe the nature and amount of the current stock interest necessary for the interest to be considered "substantial" should depend on all of the facts and circumstances. The continuity of interest requirement evolved to measure whether a transaction more closely resembles a sale than a reorganization in modified corporate form based on the totality of the facts and circumstances. However, to provide certainty to taxpayers, we support a safe harbor, as discussed more fully below. We believe a threshold-- such as 20% of the aggregate consideration-- would represent a substantial

interest. Alternatively, the Service could base the threshold on current Revenue Procedure 84-42, which permits no more than half of the equity consideration to be in the form of contingent stock consideration. In that event, given a safe harbor requirement for satisfaction of continuity of interest of 50% of the aggregate consideration, the substantial current stock ownership required would be 25% of the aggregate consideration (*i.e.*, 50% of 50%).

b. Treatment of Different Legal Forms of Variable Stock Consideration in Measuring Continuity of Interest

As discussed above, we believe inconsistent treatment of substantively similar Variable Stock Consideration arrangements is a trap for the unwary, fosters inefficient tax planning by sophisticated, well-advised taxpayers and is therefore generally undesirable as a policy matter. There are, however, certain substantive differences between some Escrowed Stock arrangements and Contingent Stock Rights. While we therefore recommend that the approach above generally apply to all forms of Variable Stock Consideration without regard to the legal form of arrangement by which it is provided, we believe two qualifications to this general approach are appropriate:

We support an approach that treats Variable Stock Consideration as if the underlying stock were issued and outstanding for typical Escrowed Stock arrangements in which the contingency involves satisfaction of customary representations and warranties and the terms of the arrangement permit the conclusion that the target shareholders own the underlying stock for tax purposes. In these limited circumstances, the likelihood the stock will issue is typically high, the risk of abuse is low and the benefits of administrative simplicity outweigh any risk of abuse.

In other situations, we believe separate valuation of the Variable Stock Consideration should be required and, in addition, target shareholders should be required to receive a substantial current stock ownership interest. In the case of Contingent Stock Rights, this would require the target shareholders also to receive a substantial amount of non-contingent stock. We believe the government could reasonably conclude that this additional current stock ownership requirement is satisfied in situations involving Escrowed Stock where the target shareholders are treated as tax owners of the underlying stock (whether such Escrowed Stock is counted at face value or only at discounted value) and therefore continue to distinguish, to this extent, between Escrowed Stock and Contingent Stock Rights. Treating Escrowed Stock that is "owned" by the target shareholders for tax purposes as satisfying this additional requirement would be consistent with current law and, as a policy matter, would give due effect to the current interest in earnings and voting power that generally is necessary to reach the conclusion that the target shareholders own the Escrowed Stock. The requirement that the interest in Escrowed Stock be separately valued would give due weight to the risk of forfeiture in determining whether continuity of interest has been satisfied.

Our recommended approach—treating Variable Stock Consideration as a proprietary interest based on the fair market value of the consideration when it is received but also requiring a substantial current stock ownership interest—appropriately furthers consistent treatment of different forms of Variable Stock Consideration by treating not only Escrowed Stock and Contingent Stock Rights, but also Adjustable Conversion Ratio Instruments, similarly for continuity of interest purposes. For example, receipt of (i) preferred stock convertible into common based on an adjustable conversion ratio and (ii)

a substantial amount of preferred stock and separate Contingent Stock Rights will, in each case, result in the same treatment, as is appropriate given the substantial economic equivalence of the interest in the combined business conveyed thereby.

c. Collateral Recommendations

Use of Variable Stock Consideration also may implicate satisfaction of various requirements other than continuity of interest, for example statutory requirements under section 368(a)(2)(E) (which requires that the acquiring corporation acquire "control" of the target corporation in exchange for its voting stock). Upon considering these other requirements, we have concluded that the technical and policy basis for applying the approach described above to bright-line statutory rules rather than an amorphous judicial doctrine like continuity is questionable. Moreover, in our experience these issues arise far less frequently in practice and are adequately addressed by current law. Accordingly, we believe the approach we recommend above should apply solely in measuring whether the continuity of interest requirement is satisfied. We do not generally recommend its extension to other statutory requirements for tax-free reorganization treatment or propose any change in current law in that regard.[51] However, we do request clarification of current law in certain related respects.

As discussed above, it is settled law that Variable Stock Consideration generally does not constitute boot. Accordingly, even in a form of reorganization that mandates

[51] The Report also does not address how Variable Stock Consideration is to be treated for a number of collateral purposes, for example, under Treas. Reg. § 1.367(a)-3 (which requires that less than 50 percent in voting power and value of the stock of a foreign acquiring corporation be acquired in the acquisition by U.S. shareholders of the target) or Code section 355 (where measurement of what was issued in the reorganization is relevant for purposes other than determining whether continuity of interest is satisfied).

receipt solely of voting stock, such as a "B" reorganization, Variable Stock Consideration does not disqualify the reorganization.

Notwithstanding *Carlberg*, which involved assignable Contingent Stock Rights, the Service conditions its favorable treatment for advance ruling purposes on the Contingent Stock Rights being non-assignable. The Service's technical concern, we assume, is that freely assignable rights are property that has a separate value and is inherently distinct from the underlying stock. We do not believe the ability to assign Contingent Stock Rights generally should cause the rights to be treated as boot, however. Whatever the original source of concern, regulations have since adopted an approach that effectively treats the receipt of a warrant in exchange for stock as non-taxable in most circumstances (by treating the warrant technically as a zero principal amount security). We see no policy reason Contingent Stock Rights or other Variable Stock Consideration should be less favorably treated than warrants for this purpose. The Service's position is also contrary to relevant judicial authority. Accordingly, we recommend that guidance clarify that Variable Stock Consideration does not constitute boot even if the relevant rights representing the Variable Stock Consideration are assignable.

Consistent with the closed transaction approach we recommend above, we also believe that unplanned or unforeseen intervening transactions occurring after closing, but prior to final resolution of the Variable Stock Consideration arrangement, should not affect the tax characterization of the original reorganization. For example, issues arise if during the term of an Escrowed Stock arrangement or pendency of Contingent Stock Rights, the original acquiring corporation is itself acquired and the stock of the second

acquirer is substituted for stock of the original acquirer. The Service has issued a private ruling concluding that the issuance of stock of a "successor" in this situation will not cause target shareholders to be treated as having received stock of a corporation that is not a party to the reorganization (*i.e.*, boot) provided that the second transaction was not contemplated at the time of the first.[52] However, the ruling involved a subsequent reorganization in which the second acquiring corporation was clearly a "successor." If that is a requirement, a subsequent transaction involving, for example, a "B" reorganization or triangular reorganization (where the second acquirer whose stock replaces the original acquirer stock is not technically a successor) would not qualify. We commend the result reached by the Service and believe it should be extended to all intervening transactions on the grounds that the first reorganization is a closed transaction as of the effective date of the first reorganization. Provided the subsequent transaction was not planned at the time of the original reorganization, we are unable to identify any risk of abuse or other substantive policy concern with this approach. Confirmation of this conclusion by the Treasury or Service in published guidance would be helpful and desirable.

d. Form of Guidance Requested

i. Regulatory Guidance

We request that the Treasury and the Service issue regulations, or amend the existing regulations under section 368 and other relevant Code provisions, to adopt the

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[52] PLR 9838007 (June 16, 1998). *Cf.* Rev.. Rul. 75-456, 1975-2 C.B. 128 (addressing a subsequent "F" reorganization of the acquirer).

substantive proposals above. We recognize that a fact dependent approach like the one we propose above is difficult to articulate as a clear legal rule. We therefore suggest that the regulation simply clarify that satisfaction of the continuity of interest requirement depends on the surrounding facts and circumstances and that, where the target shareholders receive a substantial current stock ownership interest, their receipt of additional rights to acquire stock (for example, pursuant to Escrowed Stock or Contingent Stock Rights arrangements) may be taken into account as a proprietary interest in measuring whether continuity is met based on the fair market value of those contingent rights. The amended regulations could also provide an example that would reach results consistent with the safe harbor we recommend below. If the Service is interested in pursuing the approach we recommend, we would be pleased to provide a suggested draft of amended regulations to the extent this would be helpful.

ii. Changes to Revenue Procedure 84-42

We recommend that the Service issue a Revenue Procedure, or amend Revenue Procedure 84-42, to clarify that it generally will treat continuity as satisfied if (i) at least a specified percentage of the aggregate consideration (for example, 20 percent) is in the form of acquiring stock that is owned by the target shareholders on the date of the reorganization, and (ii) the value of any non-contingent stock consideration, together with the fair market value of any Variable Stock Consideration provided to target shareholders in the reorganization, represents at least 50 percent of the aggregate consideration provided to the target shareholders in the reorganization. The Revenue Procedure should

specify that taxpayers may rely on these guidelines and the Service will not challenge transactions that satisfy this safe harbor.

We also recommend that the safe-harbor eliminate certain restrictions contained in Revenue Procedure 84-42, discussed below, that we believe are not appropriate, even under current law, and that would be irrelevant if our substantive proposals are adopted. We strongly support continuing the current requirement in Revenue Procedure 84-42 that there be a specific, bona fide, non-tax business purpose for an Escrowed Stock or Contingent Stock Rights arrangement and think it is appropriate to require taxpayers to demonstrate that the terms of the arrangement are rationally related to that purpose. We also support a requirement that the calculation mechanism for issuance or forfeiture of shares be objectively determinable. These requirements are necessary to prevent abuse. We also understand the need for the requirement that the contingency that determines whether shares are issued to the target shareholders not be within the control of the issuer or the target shareholders.

However, we believe many of the other requirements currently set forth in Revenue Procedure 84-42 are neither necessary nor appropriate. As discussed above, we do not think the issuance of Escrowed Stock or Contingent Stock Rights should disqualify a reorganization merely because the rights can be assigned or negotiated, and strongly recommend eliminating the condition that the rights not be assignable. We recommend reconsideration of the restriction that limits the term of an arrangement to a maximum of five years. We can discern no general policy or technical justification for these restrictions under current law and they often impede unnecessarily the business

terms to which parties would otherwise have agreed. Of course, the taxpayer would have to explain to the satisfaction of the Service or its tax counsel why terms that are unusual relative to other similar commercial arrangements are necessary and consistent with the taxpayer's asserted business purpose for the contingent stock arrangement. But if it can do so, we do not see why tax-free treatment should be precluded.

The condition that Escrowed Stock not be subject to return based on termination of employment or similar circumstances should also be reconsidered. We assume this restriction was intended to distinguish stock escrow arrangements from restricted stock granted in an employment context. We have previously provided to you a report on the treatment of restricted stock in the context of reorganizations.[53] That distinction would be irrelevant if our recommendations regarding the treatment of restricted stock were adopted.

Finally, we recommend eliminating, in the case of Escrowed Stock, the requirement that dividends and voting rights pass through to the target shareholders as a condition to satisfying the safe harbor. Of course, the absence of a pass-through of dividends and voting rights may be highly relevant to the tax treatment of the reorganization, as discussed above. Such an Escrowed Stock arrangement should be subject to no better or worse treatment than a Contingent Stock Rights arrangement that similarly conveys no current right to participate in dividends. But if the reorganization qualifies as a tax-free reorganization when this fact is appropriately taken into account, we do not see why tax-free treatment should be precluded.

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[53] *See* n. 47, *supra*.