NEW YORK STATE BAR ASSOCIATION

TAX SECTION

PROPOSED REGULATIONS REGARDING CONTINUITY OF INTEREST AND PRE-CLOSING STOCK VALUE FLUCTUATION

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TABLE OF CONTENTS

Page

I. Introduction 1

II. Scope of Report and Summary of Recommendations 3

III. Recommendations 4

A. Clarification of "fixed consideration" 4

1. "Fixed consideration" should refer to aggregate consideration (as distinguished from per share consideration) 6

2. Increases and decreases to the amount of stock and cash consideration occurring between the signing and closing dates should not prevent merger consideration from being considered "fixed," provided that such increases and decreases are de minimis or do not change the proportion (using Signing Date Value) of stock and cash consideration, or, alternatively, result in a *greater* proportion of stock consideration (using Signing Date Value) than the proportion measured at signing 12

3. The proposed regulations should be expanded to apply to merger agreements that utilize "collars" to determine merger consideration 17

B. The proposed regulations' 40 percent stock consideration threshold should apply to both fixed and non-fixed merger consideration 21

C. The regulations should clarify the meaning of 'the end of the last business day'. 22

D. The regulations should clarify that if a modification of a tender offer is subject to a binding contract, continuity should be tested using the Acquiror stock value as of the close of the last business day before the signing of

such contract, even if the original (unmodified) tender offer was not subject to a binding contract....23

E. The scope of the proposed regulations should be expanded to apply to merger consideration that includes boot other than cash....24

F. The scope of the proposed regulations' escrow rule should be clarified....27

IV. Conclusion....29

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

By The New York State Bar Association Tax Section*

I. Introduction

This Report of the New York State Bar Association Tax Section offers recommendations with respect to proposed regulations regarding the determination of the continuity of interest requirement applicable to tax-free reorganizations under Section 368 of the Internal Revenue Code of 1986, as amended (the "Code"), that the U.S. Department of the Treasury (the "Treasury") and the Internal Revenue Service (the "Service") published in the Federal Register on August 10, 2004.[1]

The proposed regulations respond to taxpayer concerns that an acquisition that is intended to qualify as a reorganization may fail to satisfy the continuity of proprietary interest requirement under Section 368 of the Code as a result of a decline in the value of the stock of the acquiring corporation (the "Acquiror") between the date that the parties agree to the terms of the transaction (the signing date) and the date that the transaction closes (the closing date). [2] Earlier this year, the New York State Bar Association Tax Section submitted to the Treasury and the Service a Report that discussed this topic in considerable detail.[3] In that Report, we commented

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1 Notice of Proposed Rulemaking (REG-129706-04), published in the Federal Register on August 10, 2004; Proposed Treasury Regulation Section 1.368-1(e)(2) and (7)(i), Examples 10, 11 and 12.

2 *See* Notice of Proposed Rulemaking (REG-129706-04), Preamble ("[C]ommentators have expressed concern that the transaction could fail to satisfy the [continuity] requirement as a result of a decline in the value of the acquiring corporation's stock between the date the parties agree to the terms of the transaction (the signing date) and the date the transaction closes. . . . These proposed regulations provide guidance to help address those concerns.").

3 *See* New York State Bar Association Tax Section Report No. 1050, *Report on Continuity of Interest and Pre-Closing Stock Value Fluctuation* (January 23, 2004), reproduced at 2004 TNT 17-21.

that the current practice of relying solely on the value of the Acquiror stock on the closing date (the "Closing Date Value") to determine whether the continuity of interest requirement has been satisfied leads to significant taxpayer uncertainty and transactional inefficiency. As a result of that current practice, parties to merger agreements often craft complicated provisions that increase the amount of stock consideration and decrease the amount of cash consideration in order to ensure (with as much certainty as possible) that the merger will satisfy the continuity requirement even if the value of the Acquiror's stock declines between the signing date and the closing date. Furthermore, unsophisticated parties that enter into merger agreements lacking such complicated mechanisms may be disadvantaged by the current practice of measuring continuity. In our prior Report, we encouraged the Service to promulgate regulations along the lines of the proposed regulations, because we believe that the purposes of the reorganization rules can best be served by measuring Acquiror stock value at signing rather than closing in many cases.

The proposed regulations provide that continuity will be determined based on the value of Acquiror stock as of the end of the last business day before the signing date (the "Signing Date Value"), provided that the acquisition agreement is a binding contract that provides for fixed consideration consisting only of stock and cash.[4] By using the Signing Date Value of Acquiror stock in such situations, the proposed regulations acknowledge that shareholders of the target corporation (the "Target") are subject to the "economic fortunes" of the Acquiror as of the signing date. [5]

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[4] Proposed Treasury Regulation Section 1.368-1(e)(2)(i).

[5] Notice of Proposed Rulemaking (REG-129706-04), Preamble.

While the proposed regulations, if finalized, would be a significant step towards quelling taxpayer uncertainty and transactional inefficiency and would be consistent with the underlying premises of the reorganization provisions of the Code,[6] we believe that certain aspects of the proposed regulations should be clarified, principally the meaning of "fixed consideration."

II. Scope of Report and Summary of Recommendations

This Report offers the recommendations set forth below. Regarding the proposed regulations' definition of "fixed consideration", this Report recommends that:

- the regulations confirm that "fixed consideration" refers to the aggregate pool of consideration (not the per share consideration);
- increases and decreases to the amount of stock and cash consideration that occur between the signing and closing dates should not prevent consideration from being considered "fixed," provided that such increases and decreases are de minimis or do not change the proportion of stock and cash consideration, or, alternatively, result in a *greater* proportion of stock consideration than the proportion measured at signing; and
- acquisition agreements that utilize a traditional "collar" to determine the amount of consideration should be tested using Signing Date Value, provided that the collar adheres to requirements described in this Report.

This Report also recommends that:

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[6] See Treas. Reg. Sec. 1.368-1(b).

- the 40 percent stock consideration threshold presented by Examples 10 and 11 of the proposed regulations should apply to both fixed and non-fixed consideration transactions;
- the meaning of "the end of the last business day" be clarified;
- the rules applicable to modified tender offers be clarified;
- Signing Date Value should be used to measure continuity in the case of transactions involving boot other than cash; and
- the scope of the proposed regulations' escrow rule should be clarified.

III. Recommendations

We respectfully submit the following recommendations regarding the proposed regulations as set forth below.

A. Clarification of "fixed consideration"

The proposed regulation provides that "Consideration is fixed in a contract if the contract states the number of shares of the issuing corporation and the amount of money, if any, to be exchanged for the proprietary interests in the target corporation."[7] The Preamble states that the contract must state the "exact" number of Acquiror shares. The proposed regulation goes on to provide a special rule "if a target corporation shareholder has an election to receive stock and/or money" in exchange for Target stock. In that case, if the contract "states the minimum number of shares of the issuing corporation and the maximum amount of money to be exchanged", then the consideration is considered to be fixed and continuity is tested "by

[7] Prop. Treas. Reg. Sec. 1.368-1(e)(2)(iii).

assuming the issuance of the minimum number of shares and the maximum amount of money allowable under the contract" (the "Max Min Rule").

There are ambiguities regarding the way that this definition of fixed consideration would apply to real-world acquisition agreements. First, it appears that the definition aims to determine whether the aggregate consideration to be delivered is "fixed," rather than the per share consideration. Indeed, as discussed below, we concur that "fixed" should be determined by reference to aggregate consideration, because, among other reasons, per share consideration is often subject to elections permitting shareholders to decide whether they wish to receive stock or cash. In many transactions, these elections do not change the aggregate amount of cash or stock to be delivered and therefore should not be relevant to the question of whether the consideration is fixed or continuity is satisfied.

But, if aggregate consideration is the aim, the concept in the regulations needs refinement, because acquisition agreements often do not literally "state" the number of Acquiror shares or the amount of cash to be delivered. Instead, the aggregate pool of consideration is often defined by reference to the percentage of outstanding Target shares that will be exchanged for Acquiror stock and the percentage of outstanding Target shares that will be exchanged for cash. However, even that approach, based on percentage of outstanding Target shares, is not universal, as will be seen below.

Thus, we believe that if a merger agreement does specify the aggregate number of Acquiror shares and the aggregate amount of cash to be delivered as consideration, the consideration should be considered fixed. Further, if a merger agreement specifies, as is far more typical, a fixed percentage of outstanding Target shares to be exchanged for Acquiror stock and a fixed percentage of outstanding Target shares to be exchanged for cash and specifies the

number of Acquiror shares to be exchanged for each Target share that will receive stock and a fixed dollar amount to be exchanged for each Target share that will receive cash, that too should be considered fixed (see Example 1 below). In addition, if a fixed aggregate number of shares and fixed aggregate amount of cash is derivable from the formula set forth in the merger agreement, that should also be considered "fixed" (see Example 2 below).

The above rules should, however, include caveats and flexibility to address the possibility that the aggregate consideration could change between signing and closing based on changes in the capitalization of Target or Acquiror, as discussed in III.A.2 below. For example, Target could issue additional shares as employees exercise stock options. As a result of that increase in the number of Target shares outstanding, the aggregate pool of merger consideration would also increase in most transactions. We recommend that if these changes are de minimis or if they do not change the proportion of the total consideration that constitutes stock (or if the changes result in a greater proportion of stock), they should not cause the consideration to fail to be fixed.

1. "Fixed consideration" should refer to aggregate consideration (as distinguished from per share consideration).

The proposed regulations should be clarified to indicate that "fixed consideration" refers to the aggregate pool of consideration to be received by Target shareholders. We believe that the proposed regulations mean to refer to aggregate consideration, but, as currently drafted, the proposed regulations' definition of "fixed consideration" arguably could be interpreted to mean that the amount of Acquiror stock and cash to be exchanged for each Target share must be fixed.[8]

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[8] Proposed Treasury Regulation Section 1.368-1(e)(2)(iii).

Continuity of interest has historically been interpreted to be an aggregate concept, rather than a per share concept. For example, in Revenue Procedure 77-37, the Service stated:

> It is not necessary that each shareholder of the acquired or transferor corporation receive in the exchange stock of the acquiring or transferee corporation, or a corporation in "control" thereof, which is equal in value to at least 50 percent of the value of his former stock interest in the acquired or transferor corporation, so long as one or more of the shareholders of the acquired or transferor corporation have a continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof) which is, in the aggregate, equal in value to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation.[9]

Further, measuring whether consideration is fixed by looking to the aggregate consideration provided in the acquisition agreement is consistent with the intent of the proposed regulations, because it has the result that continuity depends on whether the Target shareholders as a group are subject to the economic fortunes of the Acquiror as of the signing date. If aggregate merger consideration is fixed in the acquisition agreement, then the aggregate value of that consideration rises and falls with the value of the Acquiror stock beginning on the signing date.

At a practical level as well, it makes sense that the determination of whether consideration is fixed should not be tested on a per share basis. Many transactions provide for Target shareholder elections that do not affect the aggregate pool of stock or cash consideration but do permit Target shareholders to elect to receive stock or cash consideration, subject to proration if either the cash pool or the stock pool is oversubscribed. Such elections should not prevent the merger consideration from being considered fixed as long as the total number of Acquiror shares and the total amount of cash are unaffected by the Target shareholders' elections. The following example illustrates the mechanics of a typical part cash/part stock

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[9] Revenue Procedure 77-37, 1977-2 C.B. 568.

merger in which shareholders are entitled to make such an election. Such mergers are often referred to as "cash election mergers."

> ***Example 1 (Cash Election Merger with Fixed Exchange Ratio).*** On January 1, 2005 Target, a publicly traded corporation with 100 outstanding shares, and Acquiror, also a publicly traded corporation, sign a binding contract pursuant to which Target will be merged into Acquiror, with Acquiror surviving the merger. The merger is intended to qualify as a reorganization under Section 368(a)(1)(A) of the Code. The merger agreement provides that each Target share will be exchanged for either (a) three shares of Acquiror stock or (b) $3 cash. A Target shareholder may elect whether to receive Acquiror shares or cash. However, the merger agreement contains a proration mechanism that adjusts the per Target share consideration in the event that Acquiror stock or cash is "oversubscribed" (i.e., in the event that Target shareholders holding more than 50 percent[10] of the outstanding Target shares elect to receive Acquiror stock or, alternatively, Target shareholders holding more than 50 percent of the outstanding Target shares elect to receive cash).
>
> Assume that Target shareholders holding 75 Target shares elect to receive cash consideration and Target shareholders holding 25 Target shares elect to receive stock consideration. The proration mechanism in the agreement will apply because more than 50 percent of Target shares have elected to receive cash. The 25 Target shareholders electing to receive stock consideration thus will receive a total of 75 shares of Acquiror stock. The 75 shareholders who elected to receive cash consideration will receive $2 cash each and one Acquiror share each for a total of $150 cash and 75 Acquiror shares. The shareholder elections affect which shareholders get which consideration, but they have no effect on the total consideration delivered, consisting of 150 Acquiror shares and $150 cash.

The merger consideration described in the example above should be considered fixed (and continuity should be measured at signing) on the basis of the aggregate merger consideration that the merger agreement provides. That the per share merger consideration is not known until after shareholders elect the type of consideration they wish to receive should be irrelevant to the determination of whether the merger consideration satisfies continuity of interest under the proposed regulations. Shareholder elections that do not affect the aggregate number of

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[10] There is no necessary correlation between this 50 percent threshold and the signing date ratio between the amounts set forth in clauses (a) and (b). For example, if Signing Date Value is $1 per share, then the value of clause (a) equals the value of clause (b), but that does not mean that the maximum percentage of Target shares to be exchanged for cash must be 50 percent.

Acquiror shares or the aggregate amount of non-stock consideration should not be relevant to the determination whether the consideration is fixed.

Although we believe that, in light of the above example and the fact that continuity has always been an aggregate concept, fixed should be determined by reference to the aggregate consideration, the concept of fixed aggregate consideration itself needs refinement. It may be tempting to define "fixed" by reference to the aggregate number of Acquiror shares and the aggregate amount of cash to be delivered. As discussed in III.A.2 below, however, defining "fixed" by reference to the aggregate number of Acquiror shares and the aggregate amount of cash consideration—without some flexibility to vary--would mean that many transactions would fail to be considered fixed, because, among other reasons, the number of Target shares outstanding in many cases will change, at least incrementally, between signing and closing.

As an alternative to defining "fixed" by reference to the aggregate number of Acquiror shares and the aggregate amount of cash, "fixed" could potentially be determined by requiring a fixed percentage of outstanding Target shares to be exchanged for stock, a fixed percentage of outstanding Target shares to be exchanged for cash, a fixed dollar amount of cash to be delivered for each Target share that will receive cash and a fixed number of Acquiror shares to be delivered for each Target share that receives stock. Indeed, many merger agreements do so specify the consideration (see Example 1). Thus, that approach would apply appropriately in many transactions.

However, there are transactions which provide for a fixed aggregate pool of stock and cash (subject to the possibility of increases and decreases described in III.A.2 below) and which should therefore be tested for continuity using Signing Date Value but do not specify a fixed percentage of outstanding Target shares to be exchanged for stock or cash. In particular,

parties sometimes seek to equalize the value of the consideration to be received for each Target share. In Example 1, a Target shareholder who chooses to receive Acquiror stock gets greater value than a Target shareholder who chooses cash if the Acquiror stock goes up in value, and vice versa if the Acquiror stock goes down in value. Example 2 below illustrates a formula in which the value of the consideration received per Target share is independent of whether that consideration is received in the form of cash or stock (or both), yet the overall pool of stock and cash consideration is fixed. Thus, in Example 2 below, shareholders as a whole (and indeed each shareholder) are exposed to increases and decreases in the value of the Acquiror stock from the time of signing.

> ***Example 2 (Equalization Formula).*** On January 1, 2005 Target, a publicly traded corporation with 100 outstanding shares, and Acquiror, also a publicly traded corporation, sign a binding contract pursuant to which Target will be merged into Acquiror, with Acquiror surviving the merger. The merger is intended to qualify as a reorganization under Section 368(a)(1)(A) of the Code. Under the merger agreement, each Target share will be exchanged for either (a) an amount of cash equal to $1 plus the value of one Acquiror share at closing (the "Per Share Cash Consideration") or (b) a number of Acquiror shares equal to the quotient (the "Exchange Ratio") obtained by dividing (i) $1 plus the value of one Acquiror share at closing by (ii) the value of one Acquiror share at closing (the "Per Share Stock Consideration"). Shareholders are entitled to choose, under the merger agreement, whether to receive the cash consideration or the stock consideration, but the merger agreement provides for a proration mechanism. Unlike the proration mechanism in Example 1, this proration mechanism does not provide for a maximum percentage of outstanding Target shares that may be exchanged for stock or cash. Instead, it provides that in the event that the number of Target shares electing cash exceeds the quotient obtained by dividing (i) $1 multiplied by the number of Target shares outstanding at closing by (ii) the Per Share Cash Consideration (the "Maximum Target Shares to Receive Cash"), then each Target share that elects stock will receive the Stock Consideration and each Target share electing cash will receive (x) an amount of cash equal to the Per Share Cash Consideration multiplied by a fraction (the "Cash Fraction"), which is the Maximum Target Shares to Receive Cash divided by the total number of Target shares electing cash and (y) a number of shares of Acquiror stock equal to the product of the Exchange Ratio and a fraction equal to one minus the Cash Fraction. A similar proration formula applies if the Acquiror stock consideration

is oversubscribed.[11] The following table shows (in the case of cash oversubscriptions) that the aggregate number of shares and the aggregate amount of cash delivered to Target shareholders is invariant regardless of shareholder elections or changes in Acquiror stock price. The same result would apply in the case of stock oversubscriptions.

Acquiror Stock Price at Closing	Exchange Ratio	Per Share Cash Considn	Per Share Stock Considn	Maximum Target Shares to Receive Cash	Number of Target Shares Electing Cash	Number of Target Shares Electing Stock	Cash Fraction	Total Cash Delivered	Total Number of Acquiror Shares Delivered
$1	2	$2	2 shares	50	50	50		$100	100
$1	2	$2	2 shares	50	100	0	0.5	$100	100
$5	1.2	$6	1.2 shares	16.7	50	50	0.334	$100	100
$5	1.2	$6	1.2 shares	16.7	100	0	0.167	$100	100
$0.50	3	$1.50	3 shares	66.7	100	0	0.667	$100	100

The type of shareholder elections described in Examples 1 and 2 above differ from the type of shareholder election presupposed by the Max Min Rule of Proposed Treasury Regulation Section 1.368-1(e)(2)(iii)(B). Under the Max Min Rule, if an agreement provides for a shareholder election—any election—then continuity is measured based on the minimum amount of stock and maximum amount of cash that could be issued. That rule appears to presuppose that shareholder elections affect the number of Acquiror shares or the amount of cash to be delivered. The example below illustrates the type of transaction that the Max Min Rule appears to contemplate.

> ***Example 3 (Shareholder Elections Affect Pools).*** On January 1, 2005 Target, a publicly traded corporation, with 100 outstanding shares and Acquiror, also a publicly traded corporation, sign a binding contract pursuant to which Target will be merged into Acquiror, with Acquiror surviving the merger. The merger is intended to qualify as a reorganization under Section 368(a)(1)(A) of the Code.

[11] Put more simply, the total consideration to be paid by Acquiror is 100 Acquiror shares plus $100 in cash, each Target share will be exchanged for a package of cash and/or stock consideration in any case worth the closing date value of one Acquiror share plus $1, Target shareholders will have a choice of receiving that amount of value in the form of either all cash or all Acquiror stock, and proration will be made if the cash or stock elections are oversubscribed.

> The merger agreement provides that Target shareholders may elect to exchange each Target share he or she owns for either (a) three shares of Acquiror stock or (b) $3 cash, provided that a maximum of 66-2/3% of the Target shares outstanding may be exchanged for Acquiror shares and a maximum of 66-2/3% of the Target shares outstanding may be exchanged for cash. In this case, shareholder elections will affect the type of consideration to be delivered. If shareholders make the elections described in Example 1 (75 Target shares elect to receive cash, 25 Target shares elect to receive Acquiror stock), then $200 cash and 100 Acquiror shares will be delivered. If instead Target shareholders owning 25 Target shares elect cash and Target shareholders owning 75 Target shares elect Acquiror stock, then $100 cash and 200 Acquiror shares will be delivered.

As proposed, the Max Min Rule appears to apply both too broadly and too narrowly. It is unnecessarily complicated for transactions, such as those described in Examples 1 and 2, that involve shareholder elections not affecting the aggregate consideration to be received by the target shareholders. The shareholder elections in those examples should not give rise to a need to calculate a maximum and a minimum. On the other hand, there may be transactions where the Max Min Rule should apply, because the aggregate amount of cash or stock is variable, even though the variability has nothing to do with shareholder elections. In any event, to the extent that the Max Min Rule is retained, it needs the same kinds of refinements discussed in Section III.A.2. of this Report applicable to the general rule.

2. Increases and decreases to the amount of stock and cash consideration occurring between the signing and closing dates should not prevent merger consideration from being considered "fixed," provided that such increases and decreases are de minimis or do not change the proportion (using Signing Date Value) of stock and cash consideration, or, alternatively, result in a *greater* proportion of stock consideration (using Signing Date Value) than the proportion measured at signing.

Merger agreements frequently provide for increases, and occasionally provide for decreases, to the amount of cash and stock consideration as a result of events occurring between the signing date and the closing date. We recommend that as long as a merger agreement otherwise complies with the fixed consideration rule of the proposed regulations, pre-closing

increases and decreases to stock and cash consideration that are de minimis or that do not change the proportion (using Signing Date Value) of stock and cash consideration to be delivered, or that result in a *greater* proportion (using Signing Date Value) of stock consideration than the proportion measured at signing, should not prevent merger consideration from qualifying as "fixed."

Merger agreements typically permit the Target some flexibility to issue shares of Target stock between signing and closing. For example, such issuances would frequently occur by reason of the exercise of employee stock options. Issuances may also occur by reason of acquisitions by the Target between signing and closing. Thus, a merger agreement often does not specify the precise number of Acquiror shares or precise amount of cash to be exchanged. Instead, as discussed above, the limitations on the amount of stock or cash to be issued are usually expressed by referring to the maximum percentage of outstanding Target shares that may be exchanged for Acquiror stock or cash. An increase in the number of outstanding Target shares should not cause the merger consideration to fail the "fixed" requirement if the increase in merger consideration does not change the ratio of stock consideration to cash consideration. For example, if in Example 1, Target issued two additional shares between signing and closing, a total of 153 of Acquiror shares and $153 of cash would be delivered to Target shareholders as consideration instead of 150 Acquiror shares and $150 cash. Assuming Signing Date Value of the Acquiror stock is $1 per share, the ratio would remain 50 percent stock and 50 percent cash.

Although less common, merger agreements sometimes permit a Target corporation to repurchase its shares between signing and closing. Target share repurchases raise an issue not raised by Target share issuances, because the cash paid by the Target could be viewed as boot. Indeed, the example of Target share repurchases raises a broader question

regarding the definition of "fixed." Specifically, if there are post-signing transactions that are part of the plan of acquisition but not part of the acquisition agreement (e.g., a planned repurchase by Acquiror of shares issued in the merger), should those transactions preclude the transaction from qualifying as fixed and therefore preclude eligibility for the Signing Date Value rule? We believe that the possibility of Target share repurchases or extraordinary distributions pre-closing and of Acquiror share repurchases post-closing should not preclude treatment of the transaction as fixed. That being said, if the payments involved do constitute boot, they should be taken into account for purposes of continuity.[12] That is, Signing Date Value should still be used to measure Acquiror stock price, but use of Signing Date Value should not preclude taking into account boot that is paid in the transaction at any time.

Consider, for example, the case of a Target that has common stock and preferred stock outstanding. Suppose that a merger agreement for the acquisition of the Target provides for "fixed" stock and cash consideration in exchange for the common stock of Target and provides for preferred stock of the Acquiror to be delivered in exchange for the preferred stock in Target but also permits the Target to redeem its outstanding preferred stock for cash after signing but before closing. Such a redemption should not preclude reliance on Signing Date Value. Status as "fixed" could be tested based on the assumption that the preferred will not be redeemed. Alternatively, if Target plans to redeem the preferred, status as "fixed" could be tested on the assumption that the preferred will in fact be redeemed. The possibility that some preferred shareholders might not tender their shares and others will, so that some of the preferred is redeemed and some is not, should not cause the transaction to fail to qualify for the Signing Date Value rule. Regardless of which approach is taken to determine whether the transaction

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[12] See Treas. Reg. Sec. 1.368-1(e)(1)(ii).

satisfies the "fixed" requirement of the regulations, if the transaction does satisfy the "fixed" requirement, then continuity should be measured based on Signing Date Value. If any preferred stock is redeemed and the cash paid to the preferred holders constitutes boot, then continuity should be measured taking such boot into account (but otherwise using Signing Date Value).

To take another example, if a merger agreement requires the Target to offer to redeem convertible preferred shares after signing but before closing, the transaction should still be eligible for the Signing Date Value rule. If the conversion right is in-the-money, the preferred shareholders will likely convert, rather than have their shares redeemed. If the conversion right is not in-the-money, the preferred shareholders will likely not convert and instead will have their shares redeemed. Often, it is fairly clear which of these outcomes is likely to occur. Thus, one approach would be to test for "fixed" by assuming that whichever of these outcomes is more likely will in fact occur. Another approach would be to test for "fixed" under each outcome. Whichever approach is used to determine whether the transaction is "fixed," the possibility that all shareholders will be redeemed, some shareholders will be redeemed or no shareholders will be redeemed should not preclude application of the Signing Date Value rule. If the transaction satisfies the "fixed" requirement, then continuity should be measured using Signing Date Value, and any boot paid to redeem the preferred shareholders should be taken into account in measuring continuity.

The possibility that some shareholders may dissent to the transaction and ultimately, after an appraisal proceeding in court, receive cash for their shares, should not prevent the transaction from being considered "fixed". Any cash that is paid should be tested to determine if it is boot and, if so, folded into the overall continuity calculation, but the possibility of dissenting shares should not preclude reliance on Signing Date Value. Similarly, the

possibility that some shareholders may receive cash in lieu of fractional shares should not prevent a transaction from being considered "fixed".

It is also possible that the number of Acquiror shares to be issued to Target shareholders may increase without a corresponding increase in the amount of cash to be issued. Merger agreements often provide that additional Acquiror stock may be added to the merger consideration between the signing and closing dates (and cash eliminated from the merger consideration) in order to obtain an opinion of tax counsel.[13] Although such adjustments are motivated by the practice of using Closing Date Value to measure continuity, it may be that cautious practitioners will continue to include such adjustments if there is any doubt about whether a transaction qualifies for using Signing Date Value. In such a case where the number of Acquiror shares increases by virtue of the adjustment, the Target shareholders receive a *more* substantial continuing interest in the Acquiror than they would absent the adjustment. A merger agreement that otherwise contains fixed cash and stock consideration should not fail the "fixed" requirement if the proportion of Acquiror stock (using Signing Date Value) to cash *increases* between the signing and closing dates. Likewise, if a merger agreement is modified in a manner that changes the consideration to be delivered by increasing the proportion of Acquiror stock to be delivered (based on the original Signing Date Value), the original Signing Date Value should continue to be used to test continuity, even if continuity would be failed by testing based on the Acquiror stock value on the last business day prior to the modification date.

Last, the potential for the Acquiror to dilute the value of its stock between signing and closing by pursuing excessive stock splits or issuances should be considered. Such actions dilute the value of each individual share of Acquiror stock. However, the proposed regulations

[13] Based on Signing Date Values, all these mechanisms increase the proportion of Acquiror stock consideration relative to total merger consideration.

merely require that a merger agreement provide for a fixed number of Acquiror shares and amount of cash to be exchanged for Target stock. Consequently, under this rule a merger agreement could provide, for example, that $50 cash and 50 shares of Acquiror stock (worth $1 using the Signing Date Value of the Acquiror stock) will be exchanged for all outstanding shares of Target stock. Under the proposed regulations, this merger consideration should satisfy continuity because the merger consideration in the binding contract is fixed and provides that 50 percent of the merger consideration consists of Acquiror stock and 50 percent consists of Acquiror shares. Shortly after the signing date, however, the Acquiror could conduct a stock split where each outstanding share of Acquiror stock was recapitalized into two shares of Acquiror stock. Thereafter, each share of Acquiror stock would be worth approximately half the value that it had on the signing date. We believe that the regulations should require that consideration will not be treated as "fixed" unless the contract provides for customary anti-dilution provisions with respect to the Acquiror stock. Most commercial agreements do provide for such provisions so the rule would be aimed at avoiding abuses.

3. The proposed regulations should be expanded to apply to merger agreements that utilize "collars" to determine merger consideration.

We recommend that the proposed regulations be expanded to apply to merger consideration that is structured through the use of a "collar." Part-stock, part-cash merger agreements that utilize a collar provide that the number of Acquiror shares or the amount of cash to be paid depends on the value of the Acquiror stock. A collar is a mechanism that guarantees the Target shareholders will receive a fixed value per share of Target stock so long as the Acquiror stock price remains within a specified band of values. Under the collar, the Acquiror pays additional Acquiror shares (up to a maximum limit) if the Acquiror stock price declines, and fewer Acquiror shares (but no less than a minimum limit) if the Acquiror stock price

increases. The collar provides price protection to the Target shareholders by ensuring that, within a range of Acquiror stock values, the value of the consideration paid to the Target shareholders is fixed. Although, as we commented in our earlier Report,[14] collars are a common method of providing price protection to Target shareholders, merger consideration structured through the use of a collar would not qualify for the Signing Date Value rule that is provided under the proposed regulations, because it would not be considered "fixed". We believe that the tax law should not force parties to a merger agreement to choose between price protections for Target shareholders by using a traditional collar or relative certainty of tax result by providing for fixed merger consideration.

We recommend that continuity be tested using the Signing Date Value of the Acquiror stock in merger agreements that utilize collars provided that (a) the collar provides for a fixed value of Acquiror stock that will be paid to Target shareholders if the value of Acquiror stock falls within a specified band of values, the center point of which bears some reasonable relationship to the Signing Date Value of the Acquiror stock (or perhaps instead falls within a specified percentage of either Signing Date Value or a trailing average of Acquiror stock prices) and the upper and lower limits of which are equidistant from the band's center point and (b) the collar provides for a maximum number of Acquiror shares to be paid if the value of Acquiror stock drops below the lower limit of the band and a minimum number of Acquiror shares to be paid if the value of Acquiror stock exceeds the upper limit of the band. Example 4 illustrates a collar that would satisfy these requirements:

> ***Example 4 (Collar).*** On January 1, 2005, Target, a publicly traded corporation with 100 shares outstanding, and Acquiror, also a publicly traded corporation, sign a binding contract under which Target will be merged into Acquiror, with

[14] *See* New York State Bar Association Tax Section Report No. 1050, Report on Continuity of Interest and Pre-Closing Stock Value Fluctuation (January 23, 2004), reproduced at 2004 TNT 17-21.

> Acquiror surviving the merger. The merger is intended to qualify as a tax-free reorganization under Section 368(a)(1)(A) of the Code. The Signing Date Value of the Acquiror's stock is $1 per share. Under the merger agreement, each share of Target stock will be exchanged for either (a) $1 in cash or (b) either (i) $1 worth in Acquiror stock provided that each share of Acquiror stock is worth at least $0.80 and no more than $1.20, (ii) 1.25 shares of Acquiror stock if each share of Acquiror stock is worth less than $0.80 at closing or (iii) 0.83 shares of Acquiror stock if each share of Acquiror stock is worth more than $1.20 at closing. Shareholders are entitled to choose, under the merger agreement, whether to receive the cash consideration or the stock consideration, and the merger agreement provides for a proration mechanism to the effect that 50 percent of the Target shares will be exchanged for cash consideration and 50 percent for stock consideration. Thus, Target shareholders will receive (in the aggregate) (a) $50 cash plus (b) either (i) Acquiror stock worth $50 provided that each share of Acquiror stock is worth at least $0.80 and no more than $1.20 at closing, (ii) 62.5 Acquiror shares if each share of Acquiror stock is worth less than $0.80 at closing or (iii) 41.5 Acquiror shares if each share of Acquiror stock is worth more than $1.20 at closing.

The proposed regulations should be revised to allow such a collar to be tested using Signing Date Value, because Target shareholders in collar transactions that satisfy the requirements specified above are subject to the "economic fortunes" of the Acquiror as of the signing date.[15] In the example above, if the value of Acquiror stock were to drop to $0.50 on the closing date, the Target shareholders would only receive $81.25 aggregate merger consideration ($50 cash plus 62.5 Acquiror shares valued at $0.50 per share). If instead the value of Acquiror stock increased to $1.50, the Target shareholders would receive $112.25 of aggregate merger consideration ($50 cash plus 41.5 Acquiror shares valued at $1.50 per share). Merger consideration structured as a collar that satisfies the requirements we describe exposes the Target shareholders to the economic benefits and burdens of the Acquiror stock beginning on the signing date.

Collars also provide a degree of price protection to Target shareholders by providing a fixed value of consideration within the band. We do not believe that the price

[15] See Notice of Proposed Rulemaking (REG-129706-04), Preamble.

protection implicit in the type of collar we describe should prevent eligibility for the Signing Date Value rule, because the collars we describe provide roughly equal upside and downside protection. They are symmetric. On the downside (i.e., if Acquiror stock price drops), collars are better than the fixed consideration transactions that the proposed regulations already are meant to address, because the collar provides additional stock consideration as the Acquiror stock price drops. The tradeoff is that Target shareholders receive fewer Acquiror shares if the Acquiror stock price increases. Where the upside and downside price neutralization is symmetric, we believe collars should be eligible for the Signing Date Value rule.

Assuming that the proposed regulations are amended to permit transactions with collars of the type described above to be eligible for the Signing Date Value rule, continuity should be tested by assuming that the merger consideration consists of the number of shares that the collar formula would produce if the Acquiror stock were worth the Signing Date Value. In Example 4, using Signing Date Value of the Acquiror stock of $1, the merger consideration would consist of $50 in cash plus Acquiror stock worth $50 (i.e., 50 shares). The transaction should satisfy continuity because the $50 worth of Acquiror stock represents 50 percent of the total.

Note that although most transactions in which the stock consideration is subject to a collar provide for a shareholder election, the Max Min Rule does not make sense when applied to collar transactions. The Max Min Rule requires the use of Signing Date Value and measures continuity assuming that the maximum amount of cash and the minimum amount of stock will be delivered. But, because Signing Date Value is at or close to the midpoint of the band, and the minimum number of Acquiror shares is paid at the high end of the band, the collar itself would not provide for the minimum number of Acquiror shares to be issued if the Acquiror stock price

had a value equal to the Signing Date Value. The Max Min Rule involves mutually inconsistent assumptions (Signing Date Value and minimum number of Acquiror shares) when applied to collars.

B. The proposed regulations' 40 percent stock consideration threshold should apply to both fixed and non-fixed merger consideration.

The proposed regulations provide taxpayers with an important clarification of the level of stock consideration necessary in order to satisfy the requirement that a "substantial" part of the value of the proprietary interests in the target continue as a proprietary interest in the Acquiror.[16] The 40 percent clarification would quell significant taxpayer uncertainty regarding that requirement. We recommend that the proposed regulations clarify that the 40 percent stock consideration threshold applies to both fixed and non-fixed merger consideration.

As currently drafted, the proposed regulations' Examples 10 and 11 could be interpreted to apply solely to merger consideration that is fixed in the merger agreement and that otherwise satisfies the requirements set forth in the proposed regulations.[17] We see no reason to apply the 40 percent threshold to fixed merger consideration, but not to non-fixed merger consideration. The presence of fixed consideration is relevant to the issue whether Signing Date Value should be used to measure continuity, because non-fixed consideration is difficult to measure prospectively. But fixed consideration is not relevant to the issue of what the appropriate continuity threshold is. That threshold requirement derives from the principle that a reorganization must be a readjustment of corporate forms. At such time as a non-fixed

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16 Treasury Regulation Section 1.368-1(e).

17 Proposed Treasury Regulation Section 1.368-1(e)(7)(i), Example 10.

consideration transaction is measured for purposes of the continuity requirement, it should be subject to the same threshold as a fixed consideration transaction.

C. The regulations should clarify the meaning of "the end of the last business day".

The proposed regulations provide that the Acquiror stock is valued "as of the end of the last business day" before the first date there is a binding contract.[18] This could be interpreted to mean 11:59 p.m., the close of business or the time that the relevant stock market closes on such last business day (the "Last Business Day"). In any event, the clause appears to identify a specific point in time on the Last Business Day for valuing the Acquiror stock and therefore could be read to identify the price at which the Acquiror stock last traded at such time. Individual trades of a publicly-traded stock are often significantly different from the average price on a particular day. Averages are more stable and more representative. We would recommend that the Service clarify that an average of the high and the low price on the Last Business Day or the "volume weighted average price", a price published by Bloomberg that averages all the trades on a particular day, is acceptable. If the Service does prefer a single trade to determine Signing Date Value, then we believe that the closing price of the Acquiror stock on the relevant stock market should be used.

If a stock trades on multiple markets, the taxpayer should be permitted to determine value using the primary market on which the stock trades and disregard smaller less liquid markets. If there are several markets on which a stock trades and all of them are comparably liquid, then any of them will provide a good indication of value. In general, it is unlikely that such markets would diverge greatly, so, for simplicity, if the Acquiror's stock price

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[18] Proposed Treasury Regulation Section 1.368-1(e)(2)(i).

is sufficiently high in any such market to satisfy continuity, then continuity should be considered to be satisfied.

In the case of a non-U.S. Acquiror, there may be situations where a foreign market and a U.S. market are both highly liquid. In such a case, it makes sense to use the foreign market if the boot in the transaction is denominated in the foreign currency associated with the foreign market and use the U.S. market if the boot in the transaction is denominated in U.S. dollars. That way, currency exchange rates do not need to be ascertained in order to make the continuity calculation. For example, suppose that a German Acquiror is paying 100 shares of Acquiror stock and 100 euros to acquire a Target and suppose that the German Acquiror trades in substantial volumes on both the Frankfurt Stock Exchange and the New York Stock Exchange. Suppose further that the Acquiror's stock trades at one euro per share on the Frankfurt Stock Exchange. Continuity should be considered to be satisfied, regardless of the trading price of the Acquiror's stock on the New York Stock Exchange. If the consideration were instead 100 shares of Acquiror stock and 100 dollars (and, as above, both the Frankfurt Stock Exchange and the New York Stock Exchange are highly liquid markets for this issuer's stock), then continuity should be measured by reference to the trading price on the New York Stock Exchange.

D. The regulations should clarify that if a modification of a tender offer is subject to a binding contract, continuity should be tested using the Acquiror stock value as of the close of the last business day before the signing of such contract, even if the original (unmodified) tender offer was not subject to a binding contract.

The proposed regulations would treat a tender offer that is subject to section 14(d) of the Securities Exchange Act of 1934 and Regulation 14D as a binding contract on the date of its announcement even though the tender offer is *not* binding on the offerees.[19] This rule may

[19] Proposed Treasury Regulation Section 1.368-1(e)(2)(ii)(B).

have very limited practical effect because most successful tender offers (even those that are hostile initially) are ultimately subject to a binding contract. In the case of a tender offer that is initiated without a contract, but is subsequently modified pursuant to a contract, the proposed regulations are arguably unclear as to whether continuity is measured using values on the last business day before the announcement of the modification as distinguished from the last business day before the date of the contract. In the second sentence of the proposed regulation, consider adding the words "(not pursuant to a binding contract)" so that it reads "If a modification (not pursuant to a binding contract) of such tender offer".

E. The scope of the proposed regulations should be expanded to apply to merger consideration that includes boot other than cash.

We recommend that merger consideration that includes boot other than cash should be subject to the proposed regulations' rule for testing continuity using the Signing Date Value of Acquiror stock. As currently drafted, the proposed regulations apply to merger consideration that "includes only stock of the issuing corporation and money."[20] Presumably, the scope of the proposed regulations has been limited to stock and cash because boot other than cash may be difficult to value. The taxpayer uncertainty regarding whether the continuity requirement will be satisfied due to pre-closing changes in Acquiror stock value exists equally in transactions involving merger consideration consisting of Acquiror stock and cash and in transactions involving merger consideration consisting of Acquiror stock and other types of boot. The proposed regulations already cover cases that present valuation difficulties. For example, the proposed regulations apply to merger consideration consisting of cash and the stock of a privately-held Acquiror. As another example, they apply to merger consideration consisting of cash and non-publicly traded stock (e.g., nonqualified preferred stock) of an Acquiror whose

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[20] Proposed Treasury Regulation Section 1.368-1(e)(2)(i).

common stock is publicly traded. Thus, we recommend that the scope of the proposed regulations be expanded.

If the Service does not want to expand the regulations to cover all types of non-cash boot, the regulations should at a minimum confirm that money other than U.S. dollars is permissible consideration. Further, consideration should be given to covering debt instruments. Consideration could also be given to covering instruments that are "securities" for purposes of Section 354 (i.e., debt securities and warrants). Non-stock instruments that have an equity feature (e.g., convertible debt or warrants) do raise some additional issues, however. Frequently, as the Acquiror stock price increases, those instruments will also increase in value. Ironically, such exposure of the Target shareholders to the Acquiror stock does not under current law translate into additional continuity, because non-stock instruments do not count in favor of continuity. Although beyond the scope of this Report, perhaps consideration should be given to allowing non-stock instruments that have an equity feature to them count in favor of continuity. Even if such instruments do not count towards continuity, however, we believe that they should not preclude the use of Signing Date Value for purposes of testing continuity. The real "culprits" that should not be covered by the Signing Date Value rule are instruments, such as contingent value rights, that vary *inversely* with the value of the Acquiror stock, providing for cash payments that increase for every dollar that the Acquiror stock price drops below a certain level. Such instruments should not be tested using Signing Date Value, because they compensate for decreases in Acquiror stock price with additional cash consideration.[21]

To the extent that valuation issues are behind the decision to limit the scope of the proposed regulations to cash boot, there is one circumstance in which Signing Date Value may

[21] By contrast, the collars described in Section III.A.3., above, compensate for decreases in Acquiror stock price by providing additional stock consideration.

be more difficult to apply than Closing Date Value, that is, where some or all of the consideration to be delivered is not publicly traded at the time of the signing but is publicly traded at the time of closing. That circumstance can arise where, for example, a privately held Acquiror issues stock to acquire a publicly traded Target or where a publicly held Acquiror issues a new type of instrument to acquire a publicly traded Target. The fact that the Target is publicly traded means that the consideration will generally be publicly traded from the time it is issued, that is, at closing. But, as of signing, in those examples, no public market in the consideration exists. The market in the Target stock would, of course, provide a measure of the aggregate merger consideration, but pre-announcement trading values in the Target stock omit the premium that is often paid and post-announcement trading values in the Target stock are influenced by the market's expectations about whether the acquisition will in fact occur. In addition, the trading value in the Target stock provides only an aggregate measure of the merger consideration, not a measure of the various components.

The Executive Committee split on the question whether regulations should provide for an election to use Closing Date Value in cases where some or all of the consideration is difficult to measure because it is not publicly traded at signing but will be publicly traded at closing. Against providing such an election is that it is arguably inconsistent with the general thrust of the regulations to require parties to use Signing Date Value even in circumstances, such as a private acquiror acquiring a private target, where the consideration is difficult to value. In favor of providing such an election is that such an election may reduce administrative and compliance costs in the cases to which it would apply. In such cases, absent the election, taxpayers and the Service may need to obtain an appraisal in order to determine whether continuity is satisfied. Closing Date Value would make valuation easier, because a liquid market

would exist as of that date. Further, the election does not appear to present significant opportunities for abuse. Parties could always "elect into" Closing Date Value by providing for unfixed merger consideration. If an election is provided, the regulations should require that the election is made in the binding contract that sets Signing Date Value. Parties should not be able to elect to use Closing Date Value after such contract is entered into.

F. The scope of the proposed regulations' escrow rule should be clarified.

As we commented earlier this year in our Report *Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations*, the question of whether escrowed Acquiror stock should be included in continuity of interest determinations has long concerned taxpayers.[22] The proposed regulations offer helpful guidance by indicating that Acquiror stock placed in escrow to secure customary Target representations and warranties will not prevent merger consideration from being "fixed"[23] and will count toward the determination of whether the merger consideration meets the continuity of interest requirement.[24] The proposed regulations' treatment of escrows raises a number of issues in related areas.

First, the regulations should also cover stock placed in escrow to secure Target's performance of customary pre-closing covenants. In many transactions that involve an escrow, the escrowed property secures both representations and warranties, on the one hand, and covenants, on the other hand. Conceptually, there does not seem to be any reason to cover the former and not the latter, as both relate to pre-closing matters.

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22 *See* New York State Bar Association Tax Section Report No. 1051, *Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations* (February 4, 2004).

23 Proposed Treasury Regulation Section 1.368-1(e)(2)(iii).

24 Proposed Treasury Regulation Section 1.368-1(e)(7)(i), Example 10.

Second, the proposed regulations do not address the impact of this escrow rule on pre-existing guidance regarding escrowed stock in tax-free reorganizations. Revenue Procedure 84-42 sets forth the Service's private letter ruling position with respect to escrowed Acquiror stock in a purported reorganization.[25] That Revenue Procedure states that where certain conditions are satisfied, Acquiror stock that is placed into escrow will not prevent the Service from issuing a private letter ruling regarding the proposed tax-free reorganization.[26]

The proposed regulations do not appear to impose *any* restrictions on placing Acquiror stock into escrow other than that the escrowed Acquiror stock may only be used to secure customary representations and warranties. Does the proposed regulations' escrow rule obsolete the requirements of Revenue Procedure 84-42? For example, Revenue Procedure 84-42 requires that "at least 50% of the shares issued in the transaction are *not* subject to the escrow arrangement"[27] (emphasis added). Under the proposed regulations' escrow rule, conversely, presumably *100 percent* of the Acquiror stock to be issued in the transaction may be placed into escrow to secure customary representations and warranties. The regulations, therefore, should clarify the impact of the escrow rule on the requirements of Revenue Procedure 84-42.

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25 Revenue Procedure 84-42, 1984-1 C.B. 521.

26 *See id.* Revenue Procedure 84-42 imposes the following conditions for purposes of issuing private letter rulings where Acquiror stock in a reorganization is placed into escrow: (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 percent 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.

27 *Id.*

Third, the regulations should clarify whether the escrow rule also applies to transactions that do not satisfy the "fixed" consideration requirement. The proposed regulations as currently drafted could reasonably be interpreted to mean that Acquiror stock placed into escrow to secure customary representations and warranties will qualify as stock for continuity of interest purposes only in situations where the merger consideration is otherwise fixed in the merger agreement. Are transactions falling outside of the proposed regulations subject to the seemingly more stringent requirements of Revenue Procedure 84-42? There appears to be no policy justification for having very different requirements for escrows turn on whether the merger consideration is otherwise fixed.

Fourth, the proposed regulations' treatment of escrows does not appear to cover contingent stock arrangements or to cover escrows that secure forward-looking matters, such as future earnings of the Target. While we recognize that the rule in the proposed regulations regarding escrows was likely an effort to issue guidance on one fairly straightforward factual scenario (escrows securing customary representations and warranties), without delaying the guidance to resolve more complicated scenarios, we encourage the Service to provide as much guidance as possible regarding the scope of the proposed escrow rule.

IV. Conclusion

The proposed regulations represent a significant improvement in the administrability of the continuity of interest doctrine from the point of view of taxpayers and the Service. When finalized, the regulations will ease the taxpayer uncertainty and transactional inefficiency that the current practice of implementing the doctrine causes. We believe that the proposed regulations are consistent with the underlying premise of the reorganization provisions—to separate sale transactions from transactions that "effect only a readjustment of

continuing interest in property under modified corporate forms."[28] Our recommendations aim to further that purpose. We respectfully submit the recommendations set forth in this Report to offer suggestions for improving the proposed regulations so that they apply appropriately and equitably to common commercial transactions.

[28] Treas. Reg. Sec. 1.368-1(b).