June 26, 2012

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments Concerning Measurement of Continuity of Interest In Reorganizations

Dear Commissioner Shulman:

Enclosed are comments concerning the measurement of continuity of interest in reorganizations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

William M. Paul  
Chair, Section of Taxation

Enclosure

cc: Emily S. McMahon, Assistant Secretary (Tax Policy), Department of the Treasury  
William J. Wilkins, Chief Counsel, Internal Revenue Service
These comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these comments was exercised by John Sweet of the Corporate Tax Committee of the Section of Taxation (the “Committee”). Substantive contributions were made by Julie A. Divola, David B. Strong and David Wheat. The comments were reviewed by Joseph M. Pari, the Committee Chair, Robert H. Wellen of the Section’s Committee on Government Submissions and Eric Solomon, the Section’s Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these comments have clients who might be affected by the federal tax principles addressed by these comments, no such member, or the firm or organization to which such member belongs, has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject of these comments.

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Date: June 26, 2012
EXECUTIVE SUMMARY

Final regulations adopted in 2011 provide a special rule to value stock and other property for purposes of the continuity of interest requirement applicable to tax-free reorganizations. Under these regulations, if there is a “binding contract” that provides for “fixed consideration” to be received by the target corporation shareholders, the consideration is valued on the last business day before the contract is signed rather than on the day the transaction closes.

Proposed regulations issued at the same time as the final regulations would add valuation rules for certain types of contracts that do not provide for “fixed consideration.” The proposed regulations would allow stock to be valued in certain cases using an average of prices between signing and closing and specified “floor” and “ceiling” prices.

We commend the Internal Revenue Service (the “Service”) and the U.S. Department of Treasury (the “Treasury”) for their ongoing efforts to improve the rules for measuring continuity of interest, and we recommend prompt adoption of the proposed regulations. We have a few specific recommendations, however, to help clarify the final regulations and to clarify and improve the proposed regulations:

Final Regulations
• Clarify Example 2, dealing with the treatment of forfeited escrowed stock.
• Clarify the phrases, “property identified by value,” “specific description” and “specified value,” dealing with non-stock consideration.
• Provide a special rule to value dissenters’ appraisal rights.
• Provide a mechanism to value acquiror stock based on an average price during a time period before signing.

Proposed Regulations
• Clarify that the average price rule and the definition of “closing date” operate independently of the floor price rule and the ceiling price rule.
• Apply the floor price rule, the ceiling price rule and the average price rule to other property as well as to acquiror stock.
• Make the average price rule available, even if the average price does not determine all elements of consideration exchanged for the target stock.

In addition, we reply to the request for comments, in the preamble to the proposed regulations, as to whether a more generic concept of valuation should be used in certain cases, and whether different items of consideration should be valued at different times. Our general view is that the existing framework in the final and proposed regulations should be retained, and that any incremental rules should be kept as simple and predictable as possible. In particular, we believe the signing date, average price, and floor and ceiling price rules in the final and proposed regulations should be retained, and that such rules can be adapted, as necessary or appropriate, to determine the valuation of non-stock consideration.

Finally, we note that additional guidance is needed regarding the effect of potential post-closing adjustments to items of consideration on the continuity of interest requirement. We intend to submit a separate report on this subject.
Continuity of interest ("COI") is a nonstatutory requirement for tax-free reorganizations. The Treasury Regulations state that the purpose of the COI requirement is “to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss,” and that COI requires that “in substance a substantial part of the value of the proprietary interests in the target corporation be preserved.” Examples in the regulations generally indicate that COI is achieved if at least 40 percent of the aggregate value of the consideration received by the target corporation shareholders for their stock consists of stock of the acquiror. Accordingly, an important aspect of the COI requirement is the valuation of the acquiror stock and other consideration received by the target shareholders. In accordance with general tax principles, the acquiror stock and other consideration are valued on the date of the exchange for COI purposes.

Final regulations adopted in 2011 (the “Final COI Regulations”), however, provide a special rule for measuring COI if there is a “binding contract” that provides for “fixed consideration.” Under this rule, the consideration is valued on the last business day before the first date of the binding contract (the “Signing Date”). Thus, changes in the value of acquiror stock and other property received by the target shareholders between the Signing Date and the “Closing Date” (defined as the date on which the exchange of consideration occurs) do not affect the determination of COI. This Signing Date rule is deemed appropriate in cases where a binding contract provides for fixed consideration, because in those cases the target shareholders are subject to the economic fortunes of the acquiror as of the Signing Date.

Proposed regulations issued on the same day as the Final COI Regulations (the “Proposed COI Regulations”) provide special valuation rules for two types of contracts that do not provide for fixed consideration.

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1 See, e.g., Paulsen v. Commissioner, 469 U.S. 131 (1985), and cases cited therein.
2 Reg. §1.368-1(e)(1)(i).
3 Reg. § 1.368-1(e)(2)(v), Exs. (1), (2), (6), (9), (12). The term “acquiror” refers to the corporation that issues its stock in the transaction, either the acquiring corporation or a corporation in control of the acquiring corporation, as the case may be.
4 In relation to general tax principles, see, e.g., Philadelphia Park Amusement Co. v. United States, 130 Ct. Cl. 166 (1954) (cost basis of franchise extension received in exchange for a bridge equal to fair market value determined as of date on which exchange was effected). In relation to the COI requirement in particular, see, e.g., Southwest Natural Gas Co. v. Commissioner, 14 T.C. 81 (1950), aff’d, 189 F.2d 332 (5th Cir. 1951) (COI requirement not satisfied based on relative fair market values of items of consideration delivered by acquiror in respect of target assets determined as of date on which statutory merger was effected).
First, the Proposed COI Regulations provide that the value of acquiror stock would be determined using an average of prices of acquiror stock after the Signing Date and before the Closing Date, if the consideration exchanged for the target stock is based on such average price.\footnote{Prop. Reg. § 1.368-1(e)(2)(vi)(C).}

Second, the Proposed COI Regulations apply to contracts providing that the consideration will vary as the value of acquiror stock changes between the stock’s Signing Date value and either a lower value (the “Floor Price”) or a higher value (the “Ceiling Price”).\footnote{Prop. Reg. §§ 1.368-1(e)(2)(vi)(A) and (B).} If the value of acquiror stock on the Closing Date is below the Floor Price, COI is measured by reference to the Floor Price. Similarly, if the Closing Date value is higher than the Ceiling Price, COI is measured by reference to the Ceiling Price. In these two cases, Target shareholders are considered subject to the economic fortunes of the acquiror, because the contract does not protect them from declines in value below the Floor Price or deprive them of the benefit of increases in value above the Ceiling Price.

We commend the Service and the Treasury Department for the ongoing improvements to the rules for measuring COI. We believe that the Signing Date rule in the Final COI Regulations establishes a framework for measuring COI that will operate effectively in most transactions, and that the Proposed COI Regulations represent an appropriate extension of the same principles. Accordingly, we recommend prompt adoption of the Proposed COI Regulations.

We have some specific recommendations, however, to clarify the Final COI Regulations and to clarify and improve the Proposed COI Regulations.

In addition, we have thoughts in response to the request in the preamble to the Proposed COI Regulations as to whether a more generic concept of valuation should be used, and whether different items of consideration should be valued at different times.

Finally, we note the need for guidance relating to COI where the amount of stock or other consideration is subject to post-closing adjustments. These matters are beyond the scope of the Final COI Regulations and the Proposed COI Regulations, but they continue to be important. We intend to submit a separate report on this subject.

RECOMMENDATIONS

A. Final COI Regulations

The following are our recommendations to clarify the Final COI Regulations. We acknowledge that the Service and Treasury have devoted considerable resources to the development of the Signing Date rule in the Final COI Regulations, and that the threshold for modifications is high. In our view, all of our recommendations could be implemented by revenue ruling or other guidance without modification to the Final COI Regulations themselves.
1. Clarify Regulation section 1.368-1(e)(2)(v) Example 2 on Forfeited Escrowed Stock

Regulation section 1.368-1(e)(2)(v) Example 2 reflects a conclusion that escrowed acquiror stock that is forfeited and returned to the acquiror after the Closing Date does not count toward satisfaction of the COI requirement.9 The Service and Treasury stated this conclusion in the 2005 predecessor to the Final COI Regulations, and the conclusion has not changed.10

If this conclusion prevails in all cases, the determination whether a transaction qualifies as a reorganization may not be possible until termination of the escrow, which may not occur for a year or more after the Closing Date. As Example 2 illustrates, the parties may address this concern by funding the escrow with acquiror stock and cash or other property in the same proportions as the consideration received for the target stock (and distributing stock and cash or other property from the escrow in the same proportions). Nevertheless, we believe that in some circumstances it is appropriate to include the value of escrowed stock in measuring COI even if that stock is subsequently returned to the acquiror.

A trio of 1970s revenue rulings supports treating a forfeiture of escrowed stock in one of two possible ways, depending on how the forfeited stock is valued:

- If the number of shares of stock forfeited is based on their initial negotiated value, the forfeiture would be treated as a reduction of the consideration received by the target shareholders.11

- If the number of shares of acquiror stock forfeited is based on their value at the time of forfeiture, the forfeiture would be treated as a separate taxable redemption of the stock.12

The justification for redemption treatment in the latter case is that the shareholders receive the benefit or detriment of changes in the value of the escrowed stock from the time the escrow is established until the forfeiture. In other words, the shareholders have the burdens and benefits of ownership of the escrowed stock during that time.13

9 We assume that the same treatment is intended for all forfeited stock regardless of whether the stock is escrowed.
10 The preamble to those final regulations (T.D. 9225 (Sept. 15, 2005)) states:

The IRS and Treasury Department believe that escrowed consideration that is forfeited should not be taken into account in determining whether the COI requirement is satisfied. This conclusion reflects the view that the forfeiture of escrowed consideration is in substance a purchase price adjustment….The IRS and Treasury Department continue to consider the effect on COI of escrowed consideration and contingent consideration.

The preamble does not acknowledge that a forfeiture may be treated as a separate transaction, as discussed below.
13 Significantly, in Rev. Rul. 78-376, the Service cited United States v. Davis, 370 U.S. 65 (1962) for the proposition that the use of appreciated property to satisfy a liability is a taxable disposition of the property.
In our view, consistent with these rulings and with the principles of the Signing Date rule, if a forfeiture of stock (escrowed or not) is treated, not as an adjustment to the consideration received, but as a separate redemption (as in Rev. Rul. 78-376), the forfeited stock should count favorably toward COI using the same value originally used for purposes of the purported reorganization. Similarly, if a forfeiture of non-stock consideration (escrowed or not) is treated as a separate disposition (and, again, not as an adjustment to the consideration), the property should still count against COI, again using the value used for purposes of the purported reorganization. Using this approach, the reorganization and related COI analysis would be unaffected by a subsequent forfeiture or disposition of stock or other property (including a redemption of stock) to acquiror or a related person. The forfeiture or other disposition would be treated as a transaction separate from the potential reorganization.

Other relevant provisions of the COI regulations also support the same conclusion, i.e., that, if a forfeiture of stock is treated as a separate redemption, the forfeiture should not adversely affect COI. Pursuant to Regulation section 1.368-1(e)(1)(i), a redemption of stock issued in a purported reorganization counts favorably toward COI unless the redemption is “in connection with the potential reorganization.” Regulation section 1.368-1(e)(8) Example (4) illustrates the rule. In Rev. Rul. 99-58, 1999-2 C.B. 701, the Service ruled that ongoing market stock repurchases by acquiror were not “in connection with” a potential reorganization and did not affect COI. One of the facts noted is: “There was not an understanding between the [target] shareholders and [acquiror] that the [target] shareholders' ownership of the [acquiror] shares would be transitory.” Although not specifically noted by the Service, it is also significant that the stock was repurchased in the market at the market price.

In the typical case, the parties enter into an escrow arrangement for bona fide business purposes and do not know whether or to what extent escrowed stock will be forfeited. As in Rev. Rul. 99-58, there is no understanding that the former target shareholders’ ownership of the escrowed shares will be “transitory”. If, in determining the amount of stock forfeited, the stock is valued at its current value, the former target shareholders will have the benefits and burdens of ownership of the acquiror stock until forfeiture, as in both Rev. Rul. 78-376 and Rev. Rul. 99-58.

Thus, in our view, such a forfeiture or redemption does not occur “in connection with a potential reorganization.” If the target shareholders are properly treated as owning the escrowed stock as of the Closing Date, COI should not be affected if that stock is subsequently forfeited.14

Example 2 of the Final COI Regulations does not address the difference between forfeitures treated as adjustments to consideration and those treated as separate redemptions of the escrowed stock. In our view, Example 2 should be read as applying only to the former situation, such that separate deemed redemptions of escrowed stock do not affect COI. In this

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14 This approach would be consistent with cases such as Seagate Technology, Inc. v. Commissioner, T.C. Memo 2000-361 (mere fact that restricted stock was originally received as consideration in an asset sale did not cause a subsequent sale of such stock to relate back to asset sale; instead, subsequent sale of restricted stock held to be a separate transaction because proceeds of such sale were determined based on independent market forces and did not effectively involve any adjustment or revision of the original selling price of the assets; relation-back doctrine of Arrowsmith v. Commissioner, 344 U.S. 6 (1952), not applied).
way, common escrow arrangements could be structured without lingering uncertainty as to whether the transaction qualifies as a reorganization.

We recommend that Example 2 be clarified by a revenue ruling in which two types of transactions are discussed:

- If the amount of stock to be forfeited is determined by reference to the value of the stock used for COI purposes (e.g., the Signing Date value if the Signing Date rule applies or otherwise the Closing Date value), the forfeiture is a reduction in the amount of stock received by the target shareholders and, as Example 2 states, the forfeited stock is excluded from the COI determination.

- If the amount of stock to be forfeited is determined by reference to the value of the stock at a later time (e.g., at the time of the post-Closing Date determination that gives rise to the forfeiture or at the time of forfeiture itself), the forfeiture is treated as a separate stock redemption, and the forfeited stock is included in the COI determination.

2. Clarify Regulation section 1.368-1(e)(2)(i) on Property “Identified by Value” and Related Concepts

Regulation sections 1.368-1(e)(2)(i) and 1.368-1(e)(2)(iii) introduce the concepts of property (other than acquiror stock) “identified by value,” property identified “by specific description” and the “specified value” of property:

If a portion of the consideration provided for in [a binding] contract consists of other property identified by value, then this specified value of such other property is used for purposes of determining the extent to which a proprietary interest in the target corporation is preserved.

A contract provides for fixed consideration if it provides the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified by value or by specific description), if any, to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation.

Regulation section 1.368-1(e)(v) Example 6 addresses the valuation of a new class of publicly-traded acquiror securities and concludes that the Signing Date rule applies to the securities (as well as to the acquiror stock), and that the Signing Date value is based on the traded price of comparable securities. The primary focus of Example 6, however, is Regulation section 1.368-1(e)(2)(iv) dealing with the valuation of newly-issued instruments.

Otherwise, the regulations do not explain when other property is “identified by value” or how to determine the Signing Date value of other property that is identified “by specific description.”
In our view, other property should be considered “identified by value” if the parties specify an agreed value thereof in a binding contract. The parties should be bound by such specified value under the Danielson rule, and, if it is reasonable, the Service should respect such value. That is, the same regime should apply regardless of whether the property is actually “identified by value” in the usual sense, or the property is identified “by specific description” but the value is agreed.

In the case of property that is identified by specific description with no agreed value, if the property is publicly-traded, its Signing Date value should be determined by reference to the publicly-traded price, as in Example 6. We do not expect many transactions to include non-cash, non-traded other property that is not “identified by value” (including property with agreed value), but in such cases there seems to be no alternative to valuing the property under general valuation principles.

We believe these clarifications can be implemented by revenue ruling, notice or other guidance without modification to the Final COI Regulations.

3. Clarify Treatment of Dissenters’ Appraisal Rights

Under Regulation section 1.368-1(e)(2)(iii)(F), the possibility that some target shareholders may exercise dissenters’ appraisal rights and receive consideration other than that provided in the binding contract will not prevent the contract from being treated as providing for fixed consideration. However, that provision does not specify whether cash actually paid to dissenters could adversely impact COI. To address this omission, parties may adjust the mix of consideration payable to non-dissenting shareholders to increase the stock consideration and reduce the cash otherwise payable to non-dissenting shareholders. This adjustment, however, may not be adequate if it is determined after the Closing Date that dissenters are entitled to more cash than was expected.

**Example.** T has outstanding 100 shares of stock, each worth $10. P wants to acquire T in a merger in which the consideration will consist of 60% cash and 40% P stock. The Signing Date value of P stock is $1 per share. The merger agreement provides that each share of T stock is to be exchanged for 4 shares of P stock and $6 cash. However, if there are dissenting shareholders, the mix of cash and stock to be paid to non-dissenting shareholders will be adjusted under a formula to reach the 60-40 split. Under the formula, it is assumed that each dissenting share will receive $10 cash, the agreed value of T stock. The adjustment will ensure satisfaction of COI if the dissenting shareholders receive no more than $10 cash per T share. If, however, they receive more than $10 cash

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16 For an example of property identified by value and not by specific description, see Hendrix v. Commissioner, T.C. Memo. 2011-133 (taxpayers donated stock to family trusts and to a foundation; amount of stock determined by value, not number of shares).
per share, which may not be determined until long after closing, the value of the P stock consideration would fall below 40%.

We recommend guidance to clarify Regulation section 1.368-1(e)(2)(iii)(F) and address this issue. Specifically, we recommend that the rights of dissenting shareholders (to receive cash equal to the appraised value of their target shares) be valued, for COI purposes, using the value of their target stock as specified in (or determined by reference to) the binding contract ($10 in the example). This rule would reflect the economics of the dissenting shareholders’ position at the Signing Date or the Closing Date (as applicable) and would also be similar to and consistent with Regulation section 1.368-1(e)(2)(i), discussed above. That is, it would essentially treat a dissenting shareholder’s right to receive the appraised value of target shares as “other property” that is “identified by value.”

In our view, this approach would not present any potential for abuse given that the appraisal rights, if exercised, would be the subject of an independent proceeding that would not be subject to manipulation by the parties to the transaction.

4. Allow Pre-Signing Date Average Price Valuation

As discussed in parts B.1.- B.3., below, Proposed Regulation section § 1.368-1(e)(2)(vi)(C) allows the Closing Date value of acquiror stock to be determined using an average of prices of acquiror stock after the Signing Date and before the Closing Date, if the consideration to be exchanged for target stock is based on the same average.

We believe a similar rule should apply for purposes of determining the Signing Date value of acquiror stock in transactions subject to the Signing Date rule. Contracting parties often use an average of prices covering a short period prior to the Signing Date to value acquiror stock and to determine the amount of acquiror stock issued to target shareholders. The purpose of such a convention is to minimize the impact of price fluctuations leading up to the Signing Date that might result from leaks about the negotiations or unrelated events that may affect the market on a particular date.

We recommend guidance to provide that, in determining the value of acquiror stock for COI purposes, an average price will be used in lieu of the actual price on the Signing Date if (a) the average price is based on prices of acquiror stock over a consecutive number of trading days (not exceeding, e.g., ten trading days) ending on, or within a specified number of days (again, not exceeding, e.g., ten days) prior to, the Signing Date, and (b) the contract uses such average to determine the consideration to be exchanged for the target stock, in the same manner as the average price rule in the Proposed COI Regulations. See part B.3., below. In our view, such a rule would not pose abuse potential, especially in light of the limited time period over which averaging would be permitted.

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Cf. Reg. § 1.409A-1(b)(5)(iv)(A) (permitting taxpayers to value publicly traded stock using an average selling price during a specified period within 30 days of the applicable valuation date).
Such an averaging convention could be implemented by revenue procedure without modification to the Final COI Regulations.

B. Proposed COI Regulations

1. Clarify That the Average Price Rule and the Closing Date Definition Operate Independently of the Floor Rule and the Ceiling Rule

Proposed Regulation section 1.368-1(e)(2)(vi)(C) provides that, in determining the Closing Date value of acquiror stock for COI purposes, an average price may be used in lieu of the Closing Date price if (a) the average price is based on prices of acquiror stock after the Signing Date and before the Closing Date, and (b) the contract uses the average price, so computed, in determining the number of acquiror shares, the amount of money and the other property to be exchanged for the target stock. Proposed Regulation section 1.368-1(e)(2)(vi)(D) contains the definition of Closing Date.

We believe the Closing Date definition is intended to apply, and should apply, for COI purposes in any potential reorganization in which the Closing Date value of acquiror stock is relevant (e.g., if the contract does not provide for “fixed consideration” under the Signing Date rule). In addition, we believe the average price rule is intended to apply and should apply whenever the conditions are met, regardless of whether or not the transaction involves a floor price or a ceiling price.

However, language in Proposed Regulation section 1.368(e)(2)(vii) Example 3 creates uncertainty regarding the scope of these provisions. The example concludes: “…the rules of paragraph (e)(2)(vi) of this section do not apply because the contract does not provide for either a Floor Price or a Ceiling Price.” In turn, Paragraph (e)(2)(vi) includes the floor and ceiling rules (clauses (A) and (B)), as well as the average price rule (clause (C)) and the Closing Date definition (clause (D)). Thus, this statement in the example literally means the average price rule and the Closing Date definition apply only where there is a Floor Price or a Ceiling Price. However, the example later refers to the defined term “Closing Date,” which suggests that the Closing Date definition does apply to the facts of the example.

We recommend that final regulations clarify that clauses (C) and (D) apply regardless of whether or not there is a floor price or a ceiling price, such that the average price rule and Closing Date definition operate independently of clauses (A) and (B).

2. Apply Floor Rule, Ceiling Rule and Average Price Rule to Other Property in Addition to Acquiror Stock

The floor rule, the ceiling rule and the average price rule in Proposed Regulation section 1.368-1(e)(2)(vi), if applicable, would determine the value of the acquiror stock issued in the potential reorganization. There are no corresponding rules for other property.

In certain circumstances (for example, where “other property” is publicly traded), the parties might employ price protection mechanisms (utilizing a floor and/or ceiling price) or average pricing mechanisms with respect to other property. In these cases, we believe the average price rule and the floor and ceiling price rules could reasonably be applied to other
property in the same manner as they apply to acquiror stock. As a conceptual matter, we see no reason to limit these rules to acquiror stock.

Accordingly, we recommend that the Proposed COI Regulations be modified so that the floor rule, the ceiling rule and the average price rule apply to other property as well as to acquiror stock.

3. Apply Average Price Rule Even if Average Price Does Not Determine All Elements of Consideration

Under the average price rule, a post-Signing Date, pre-Closing Date average price of acquiror stock may be used for COI purposes, but only if the same average price is used to determine the amounts of all the consideration to be exchanged for the target stock—acquiror stock, money and other property.

In our view, the average price rule (applied to the average price of acquiror stock) should be available if the average price determines the amount of acquiror stock to be exchanged for the target stock. It should not be necessary for the average stock price to also determine the amount of cash or other property. However, the average price rule should not apply if a price of acquiror stock, other than the average price used to determine stock consideration, is used to determine the amount of cash or other property.

Example. Under a binding contract, T is to merge into A. The T shareholders are to receive (a) $400 worth of A stock, based on the average traded price of A stock during a specified period after the Signing Date and before the Closing Date, and (b) $600 cash regardless of the traded value of the A stock. The value of the A stock declines after the average price is determined, and the T shareholders receive only $300 worth of A stock based on its Closing Date value, plus the agreed $600 cash. In our view, the average price rule should apply, and the COI requirement should be satisfied.

If instead the amount of cash was to be adjusted to offset, in whole or in part, the change in value of A stock between the Signing Date and the Closing Date, the arrangement should not qualify under the average price rule. If the adjustment did not qualify as a “floor” or “ceiling” arrangement, the value of the A stock should be determined as of the Closing Date. On these facts, that stock value would be $300. If the amount of cash were adjusted to offset the full decline in the value of the A stock, to $700 (or to offset part of the decline in value, to $650), the COI percentage would be reduced accordingly.

In addition, if the recommendation set forth in part B.2., above, is adopted, i.e., if the average price rule is applied to other property as well as to acquiror stock, we believe the same rule should apply with respect to the average price of the other property.
C. Response to Request for Comment in Preamble to Proposed COI Regulations

1. Request for Comment

In the preamble to the Proposed COI Regulations, the Service and Treasury request comments on whether it would be appropriate for different items of consideration to be valued for COI purposes on different dates, i.e., for each item, “the date that the target shareholders first became subject to the economic fortunes of owning the item.” One possible approach is described as follows:

For example, future guidance could provide that an item of consideration is valued for COI purposes at the earliest date on which the target shareholders (in the aggregate) become fully subject to the appreciation and depreciation in the value of that item pursuant to a binding contract to effect the potential reorganization, but not later than the date of the reorganization exchange.

For the following reasons, we believe this approach should not be adopted.

2. General

a. Resources to Develop New Rules

The Signing Date rule and its related elements have been refined over a number of years. As implemented in the Final COI Regulations, they collectively constitute a practical system. The enhancements in the Proposed COI Regulations would make the system even more practical in light of common transactional patterns that incorporate basic price protection and price averaging mechanisms.

The approach described in the preamble would apparently abandon this system under certain circumstances in favor of a more general rule and would require substantial resources to develop an entirely new system (or sub-system) that would apply to the valuation of acquiror stock and other property in cases where the Signing Date rule did not apply in its entirety.

In our view, such resources could be applied to more important projects. More important, for the reasons discussed below, we do not believe the approach described in the preamble would improve the Final COI Regulations and Proposed COI Regulations.

b. Administrative Rules

In our view, the rules to determine value for COI purposes at any time other than closing are primarily rules of administrative convenience. As such, they should be as simple and predictable as possible, while remaining consistent with the purpose of the COI requirement. As we understand the preamble, the approach described therein would substitute a general principles-based rule under certain circumstances for the more mechanical rules in the Final COI Regulations and the Proposed COI Regulations. However, because of their inherent uncertainty in application to particular situations, we believe such general principles-based rules are not appropriate in this context.
As examples of uncertainty, it may be difficult to determine what is the “item of consideration” to be valued and “the date that the target shareholders first became subject to the economic fortunes of owning the item.” Suppose the consideration received by the target shareholders for their stock consists of acquiror stock and an option, exercisable at the Closing Date, to purchase other property from acquiror. Regarding the non-stock consideration, is the “item of consideration” to be valued the option or the other property itself? If the item of consideration is the other property, do “the target shareholders first become subject to the economic fortunes of owning” the property at the Signing Date or at the Closing Date? We expect these types of issues to arise relatively often where rights to “other property” are involved.

3. **Potential Application to Acquiror Stock Consideration**

Under the approach described in the preamble, the contractual terms relating to each item of consideration—both stock and non-stock—would have to be analyzed to determine the date on which that the target shareholders “become fully subject to the appreciation and depreciation in the value of that item.” Such a burdens-and-benefits approach might seem reasonable in valuing acquiror stock, because the COI requirement focuses on the target shareholders’ continuing stock interest in the target through ownership of acquiror stock. If the target shareholders are not fully subject to the economic fortunes of owning acquiror stock until the Closing Date, it could be argued that there is no COI through such stock ownership until the Closing Date.

However, even as applied to acquiror stock consideration, the approach described in the preamble would represent a major shift. For example, this approach would be inconsistent with the floor rule and the ceiling rule in the Proposed COI Regulations. If stock is subject to a floor or ceiling price or both (a collar), the target shareholders are not “fully subject” to the appreciation and depreciation in the acquiror stock at any time before the Closing Date. Thus, the approach described in the preamble could eliminate desirable flexibility provided in the Proposed COI Regulations.

4. **Potential Application to Non-Stock Consideration**

As stated above, the COI requirement focuses on the target shareholders’ continuing stock interest in the target through ownership of acquiror stock. This focus does not apply to non-stock consideration, and, in our view, a burdens-and-benefits analysis of the type described in the preamble to the Proposed COI Regulations is not appropriate for dealing with such consideration.

All types of non-stock consideration (including options, other rights to acquire property and derivatives, even if they relate to acquiror stock) constitute “other property” and count against COI in the same manner. Thus, if, under the contract, the acquiror stock qualifies for valuation under the Signing Date rule, that stock value can be compared with the value at the Signing Date of rights to receive other property, taking into account any contingencies in the contract.
There is no reason to delay the valuation of other property, even if the contract provides for contingent consideration consisting of such other property. Under the Final COI Regulations, so long as the contingency does not depend on the value of the acquiror stock, acquiror assets or a surrogate therefor, the Signing Date rule applies to both acquiror stock and other property. If the value of such other property is specified in the binding contract, the parties should be bound to use such specified value, and the Service should respect such value if reasonable (as discussed in part A.2., above). Presumably, the specified value of the other property at the Signing Date would reflect the value of the property itself with a discount to take into account any contingencies on the right to receive the property, including escrows (but no discount to reflect the delay between the Signing Date and the Closing Date). In other words, a “closed transaction” concept, based on valuation of the other property at the Signing Date, should apply.

D. Guidance Needed on COI and Post-Closing Contingent and Escrowed Consideration

COI issues can arise if target shareholders are entitled to contingent consideration after closing, or if a portion of the consideration is escrowed. In the early cases dealing with contingent stock, the issue was whether contingent stock could be received tax-free as stock under section 354. Ultimately, the Service agreed that such stock could be treated as stock for reorganization purposes and promulgated a series of revenue rulings and revenue procedures setting forth requirements for favorable letter rulings in this area. The Service has not published guidance on this subject since the mid-1980s—a time when letter rulings on acquisitive reorganizations were far more common than they are today and long before the adoption of the regulations that completely transformed the substantive COI requirements.

Perhaps more important, neither the case law nor the administrative guidance dealt specifically with the impact of contingent or escrowed consideration on COI. Practitioners

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18 Reg. § 1.368-1(e)(2)(iii)(C).
20 The preamble to the 2005 final regulations (T.D. 9225 (Sept. 15, 2005)) recognized that these issues were open with respect to escrowed stock:

One commentator requested clarification regarding the impact of the proposed regulations on Revenue Procedure 84-42 (1984-1 C.B. 521). Rev. Proc. 84-42 includes certain operating rules of the IRS regarding the issuance of letter rulings, including the circumstances in which the placing of stock in escrow will not prevent the IRS from issuing a private letter ruling. The IRS and Treasury Department continue to review the existing revenue procedures relating to reorganizations in light of the numerous regulatory changes since the publication of these procedures and the policy against issuing rulings in the reorganization area unless there is a significant issue, which is reflected in Rev. Proc. 2005-3. Rev. Proc. 84-42 is not amended at this time.
commonly treat the letter ruling guidelines as dispositive regarding the effect of contingent and escrowed stock on COI, but there is no direct guidance on these matters. 21

Contingent and escrowed consideration have been common features of acquisitions for decades. Valuation issues involving contingent and escrowed consideration seem especially ripe now that the Final COI Regulations have adopted a Signing Date rule, and the Proposed COI Regulations have been published to supplement that rule.

We acknowledge that this subject is beyond the scope of the Final COI Regulations and the Proposed COI Regulations themselves. It continues to be important, however, and we intend to submit a separate report on this subject.

21 As discussed in part A.1., above, the Final COI Regulations could be read as inconsistent with published rulings regarding the treatment of forfeited escrowed stock.