[4830-01-p] Published September 16, 2005

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9225

RIN 1545-BD53

Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulation.

SUMMARY: This document contains final regulations that provide guidance regarding the satisfaction of the continuity of interest requirement for corporate reorganizations. The final regulations affect corporations and their shareholders.

DATES: Effective Date: These regulations are effective September 16, 2005.

FOR FURTHER INFORMATION CONTACT: Jeffrey B. Fienberg, at (202) 622-7770 (not a toll free number).

SUPPLEMENTARY INFORMATION:

Background

The Internal Revenue Code of 1986 (Code) provides for general nonrecognition treatment for reorganizations described in section 368 of the Code. In addition to complying with the statutory and certain other requirements, to qualify as a reorganization, a transaction generally must satisfy the continuity of interest (COI) requirement. COI requires that, in substance, a substantial part

of the value of the proprietary interests in the target corporation be preserved in the reorganization.

On August 10, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG-129706-04) in the **Federal Register** (69 FR 48429) (hereinafter the proposed regulations) identifying certain circumstances in which the determination of whether a proprietary interest in the target corporation is preserved would be made by reference to the value of the issuing corporation's stock on the day before there is an agreement to effect the potential reorganization. In particular, in cases in which the consideration to be tendered to the target corporation's shareholders is fixed in a binding contract and includes only stock of the issuing corporation and money, the issuing corporation stock to be exchanged for the proprietary interests in the target corporation would be valued as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization (the signing date rule). Under the proposed regulations, 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. The signing date rule is based on the principle that, in cases in which a binding contract provides for fixed consideration, the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date.

No public hearing regarding the proposed regulations was requested or held. However, several written and electronic comments regarding the notice of

proposed rulemaking were received. After consideration of the comments, the proposed regulations are adopted as revised by this Treasury decision.

Explanation of Provisions

These final regulations retain the general framework of the proposed regulations but make several modifications in response to the comments received. The following sections describe the most significant comments and the extent to which they have been incorporated into these final regulations.

A. Fixed Consideration

As stated above, the proposed regulations require that the consideration in a contract be fixed in order for the signing date rule to apply. One commentator identified a number of contractual arrangements that do not provide for fixed consideration within the meaning of the proposed regulations, but, nevertheless, are arrangements in which the consideration should be treated as fixed and, therefore, eligible for the signing date rule. In particular, the commentator identified a number of circumstances in which, rather than stating the number of shares and money to be exchanged for target corporation shares, a contract may provide that a certain percentage of target corporation shares will be exchanged for stock of the issuing corporation. One such circumstance is where a merger agreement permits the target corporation some flexibility in issuing its shares between the signing date and effective date of the potential reorganization. Such an issuance may occur, for example, upon the exercise of employee stock options. As a result, the total number of outstanding target corporation shares at the effective time of the merger and, therefore, the total

number of shares of the acquiring corporation to be issued in the merger, may not be known when the merger agreement is signed.

In addition, a contract may permit the target corporation shareholders to elect to receive stock (the number of shares of which may be determined pursuant to a collar) and/or money or other property in respect of target corporation stock, but provide that a particular percentage of target corporation shares will be exchanged for stock of the issuing corporation and a particular percentage of target corporation stock will be exchanged for money. In these cases, if either the stock or the cash consideration is oversubscribed, adjustments are made to the consideration to be tendered in respect of the target corporation shares such that the specified percentage of target corporation shares is, in fact, exchanged for stock of the issuing corporation.

The IRS and Treasury Department agree that a contract that provides for either the percentage of the number of shares of each class of target corporation stock, or the percentage by value of the target corporation shares, to be exchanged for issuing corporation stock should be treated as providing for fixed consideration, as long as the target corporation shares to be exchanged for issuing corporation stock and the target corporation shares to be exchanged for consideration other than issuing corporation stock each represents an economically reasonable exchange. Just as in cases in which 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, in these cases, the target corporation shareholders generally can be viewed as being

subject to the economic fortunes of the issuing corporation as of the signing date. Accordingly, these final regulations include an expanded set of circumstances in which a contract will be treated as providing for fixed consideration.

B. Contingent Consideration

The fact that a contract provides for contingent consideration will generally prevent a contract from being treated as providing for fixed consideration. One commentator suggested that a contract should not be treated as failing to provide for fixed consideration solely because it provides for contingent consideration that can only increase the proportion of issuing corporation stock to cash to be exchanged for target corporation shares. Where stock of the issuing corporation is the only type of consideration that is subject to a contingency, the delivery of any of the contingent consideration to the target corporation shareholders will enhance the preservation of the target corporation's shareholders' proprietary interests. Therefore, these final regulations provide for a limited exception to the general rule that an arrangement that provides for contingent consideration will not be one to which the signing date rule applies. The exception applies to cases in which the contingent consideration consists solely of stock of the issuing corporation and the execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if none of the contingent consideration were delivered to the target corporation shareholders.

The IRS and Treasury Department continue to study whether other arrangements involving contingent consideration should be within the scope of

the signing date rule. Among these arrangements are cases in which the contingent consideration consists not only of issuing corporation stock but also of money or other property and cases in which the issuing corporation stock to be issued in respect of target corporation stock is determined pursuant to a collar.

C. Nature of Consideration

As described above, under the proposed regulations, the signing date rule applies only when the consideration to be provided in respect of target corporation shares includes only stock of the issuing corporation and money. One commentator suggested that the signing date rule should be expanded to apply to transactions in which the non-stock consideration includes property other than money. Under these final regulations, the signing date rule may apply in such cases. Therefore, under these final regulations, the signing date rule may apply, for example, in cases in which proprietary interests in the target corporation are exchanged for stock and securities of the issuing corporation.

D. Valuation

1. The "as of the end of the last business day" rule

The proposed regulations require that, if the signing date rule applies, the consideration to be tendered in respect of the target corporation shares surrendered be valued as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization. One comment requested clarification of the meaning of as of the end of the last business day. That comment suggested that an average of the high and low trade price on that day should be an acceptable value for this purpose. Alternatively, the comment

suggested that if a single trade were to determine the value of the issuing corporation stock, the closing price of the issuing corporation stock on the relevant market should be used. The comment further described an approach for identifying the relevant stock market.

In response to these comments, these final regulations remove the requirement that the consideration be valued as of the end of the last business day before the first date that there is a binding contract. Instead, they provide general guidance that the consideration to be exchanged for target corporation shares pursuant to a contract must be valued the day before such contract is a binding contract.

2. New issuances

The IRS and Treasury Department recognize that the application of the requirement that the consideration to be exchanged for proprietary interests in the target corporation be valued on the last business day before the first date there is a binding contract to effect the potential reorganization may be unclear in cases in which the consideration does not exist prior to the effective date of the reorganization. For example, suppose that, in the potential reorganization, the issuing corporation will issue a new class of its stock in exchange for the shares of the target corporation. The question has arisen as to how to value those to be issued shares under the signing date rule, given that they do not exist on the last business day before the first date that there is a binding contract to effect the potential reorganization. Thus, these final regulations clarify that this new class of stock will be deemed to have been issued on the last business day before the

first date there is a binding contract to effect the potential reorganization for purposes of applying the signing date rule.

E. Escrowed Stock

1. Pre-closing covenants

The proposed regulations provide that placing part of the stock issued or money paid into escrow to secure customary target representations and warranties will not prevent the consideration in a contract from being fixed. One comment suggested that this rule should be expanded to include consideration placed in escrow to secure target's performance of customary pre-closing covenants (rather than representations and warranties). That commentator stated that there is no reason to distinguish between customary pre-closing covenants, on the one hand, and customary representations and warranties, on the other hand. The IRS and Treasury Department agree. Accordingly, these final regulations extend the rule related to escrows to include consideration placed in escrow to secure target's performance of customary pre-closing covenants.

2. Effect of escrowed consideration on satisfaction of COI

Some commentators have indicated that certain examples in the proposed regulations suggest that escrowed stock, even if it is forfeited to the issuing corporation, is treated as preserving the target shareholders' proprietary interests in the target corporation. 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. Accordingly, the examples in these final regulations reflect that forfeited stock is not treated as preserving the target corporation shareholders' proprietary interests in the target corporation and forfeited non-stock consideration is not treated as counting against the preservation of the target corporation's shareholders' proprietary interest in the target corporation. The IRS and Treasury Department continue to consider the effect on COI of escrowed consideration and contingent consideration.

3. Revenue Procedure 84-42

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.

F. Anti-Dilution Provisions

One comment suggested that consideration in a contract should not be treated as fixed unless the contract includes a customary anti-dilution provision. The commentator posited an example in which the absence of an anti-dilution

clause and the occurrence of a stock split with respect to the stock of the issuing corporation prior to the effective date of a potential reorganization results in the value of the consideration received in respect of the target corporation shares being substantially different from its value on the day before the first date there is a binding contract.

The IRS and Treasury Department do not believe that the absence of a customary anti-dilution provision should necessarily preclude the application of the signing date rule as dilution may not, in fact, occur. However, the IRS and Treasury Department are concerned that application of the signing date rule is not appropriate if the contract does not contain an anti-dilution clause relating to the stock of the issuing corporation and the issuing corporation alters its capital structure between the first date there is an otherwise binding contract to effect the potential reorganization and the effective date of the potential reorganization in a manner that materially alters the economic arrangement of the parties to the binding contract. Accordingly, these final regulations provide that, in such cases, the consideration will not be treated as fixed.

G. Contract modifications

The proposed regulations require that if a term of a binding contract that relates to the amount or type of consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, then the date of the modification shall be treated as the first date there is a binding contract. Thus, such a modification requires that the stock of the issuing corporation be

valued as of the end of the last business day before the date of the modification in order to determine whether the transaction satisfies the COI requirement.

One commentator suggested that a contract should not be treated as being modified for this purpose if the modification has the sole effect of increasing the number of shares of the issuing corporation to be received by the target shareholders. The IRS and Treasury Department agree that, because such a modification only enhances the preservation of the target corporation's shareholders' proprietary interests, it is not appropriate to value the consideration to be provided to the target corporation shareholders as of the day before the date of the modification rather than as of the day before the date of the original contract, at least in cases in which the transaction would have satisfied the COI requirement under the signing date rule if there had been no modification. Therefore, these final regulations provide that a modification that has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders will not be treated as a modification if the execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interest in the target corporation if there had been no modification. In such cases, the determination of whether a proprietary interest in the target corporation has been preserved is made by reference to the value of the consideration as of the last business day before the first date the contract was binding, not the last business day before the modification. The IRS and Treasury Department continue to consider whether this exception should be

extended to certain cases in which the modification results in not only additional shares of the issuing corporation to be issued to target corporation shareholders, but also additional money or other property to be transferred to target corporation shareholders.

H. Application of Principle Illustrated by Examples

One commentator asked whether the principle that the COI requirement is satisfied where 40 percent of the target corporation stock is exchanged for stock in the issuing corporation that is illustrated in the examples of the proposed regulations (which relate to the application of the signing date rule) also applies in cases in which the signing date rule does not apply. The IRS and Treasury Department believe that this principle is equally applicable to cases in which the signing date rule does not apply as it is to cases in which the signing date rule does apply.

I. Restricted Stock

The IRS and Treasury Department are continuing to consider the appropriate treatment of restricted stock in the determination of whether the COI requirement is satisfied.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose a collection of

information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Christopher M. Bass of the Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.368-1 is amended as follows:

1. Paragraph (e)(1)(i) is amended as follows:

A. Removing the language “(e)(3)” and adding in its place “(e)(4)” wherever it appears.

B. Removing the language “(e)(3)(i)(A)” and adding “(e)(4)(i)(A)” in its place.

2. Redesignating paragraphs (e)(2) through (e)(7) as (e)(3) through (e)(8), respectively.

3. Adding a new paragraph (e)(2).

4. In newly designated paragraphs (e)(3) through (e)(8), removing the language “(e)(6)” wherever it appears, and adding the language “(e)(7)” in its place.

5. In newly designated paragraphs (e)(3) through (e)(8), removing the language “(e)(4)” wherever it appears, and adding the language “(e)(5)”in its place.

6. In newly designated paragraphs (e)(3) through (e)(8), removing the language “(e)(3)” wherever it appears, and adding the language “(e)(4)” in its place.

7. In newly designated paragraphs (e)(3) through (e)(8), removing the language “(e)(2)” wherever it appears, and adding the language “(e)(3)” in its place.

8. In newly designated paragraph (e)(4)(ii)(B), removing the language “(e)(3)(i)(A)” wherever it appears, and adding the language “(e)(4)(i)(A)” in its place.

9. In newly designated paragraph (e)(7), Example 1, removing the language “(e)(1) and (2)” wherever it appears, and adding the language “(e)(1) and (3)” in its place.

10. In newly designated paragraph (e)(7), Example 2, make the following revisions:

A. Remove the language “(e)(3)(i)(B)” wherever it appears, and add the language “(e)(4)(i)(B)” in its place.

B. Remove the language “(e)(3)(i)(A) and (ii)(B)” wherever it appears, and add the language “(e)(4)(i)(A) and (ii)(B)” in its place.

11. In newly designated paragraph (e)(7), Example 3, removing the language “(e)(1) and (2)” wherever it appears, and adding the language “(e)(1) and (3)” in its place.

12. In newly designated paragraph (e)(7), Example 4, paragraph (iii), removing the language “(e)(3)(i)(A) and (B)” wherever it appears, and adding the language “(e)(4)(i)(A) and (B)” in its place.

13. In newly designated paragraph (e)(7), Example 6, removing the language “(e)(3)(i)(A) and (B)” wherever it appears, and adding the language “(e)(4)(i)(A) and (B)” in its place.

14. In newly designated paragraph (e)(7), Example 8, removing the language “(e)(3)(i)(A)” wherever it appears, and adding the language “(e)(4)(i)(A)” in its place.

15. Revising newly designated paragraph (e)(8).

The addition and revision read as follows:

§1.368-1 Purpose and scope of exception of reorganization exchanges.

* * * * *

(e) * * *

(2) Measuring continuity of interest--(i) In general. In determining whether a proprietary interest in the target corporation is preserved, the consideration to

be exchanged for the proprietary interests in the target corporation pursuant to a contract to effect the potential reorganization shall be valued on the last business day before the first date such contract is a binding contract, if such contract provides for fixed consideration.

(ii) Binding contract--(A) In general. A binding contract is an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) shall not prevent an instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, shall not prevent an instrument from being a binding contract.

(B) Modifications--(1) In general. If a term of a binding contract that relates to the amount or type of the consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, the date of the modification shall be treated as the first date there is a binding contract.

(2) Exception. Notwithstanding paragraph (e)(2)(ii)(B)(1) of this section, a modification of a term that relates to the amount or type of consideration the target shareholders will receive in a potential reorganization will not be treated as a modification for purposes of that provision if--

(i) That modification has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders; and

(ii) The execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interest in the target corporation if there had been no modification.

(C) Tender offers. For purposes of this paragraph (e)(2), a tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934 [15 U.S.C. 78n(d)(1)] and Regulation 14D (17 CFR 240.14d-1 through 240.14d-101) and is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees. If a modification (not pursuant to a binding contract) of such a tender offer is subject to the provisions of Regulation 14d-6(c) (17 CFR 240.14d-6(c)) and relates to the amount or type of the consideration received in the tender offer, then the date of the modification shall be treated as the first date there is a binding contract.

(iii) Fixed consideration--(A) In general. A contract provides for fixed consideration if it provides--

(1) The number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for all of the proprietary interests in the target corporation;

(2) The number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or by specific description), if any, to be exchanged for each proprietary interest in the target corporation;

(3) The percentage of the number of shares of each class of proprietary interests in the target corporation, or the percentage (by value) of the proprietary interests in the target corporation, to be exchanged for stock of the issuing corporation, provided that the proprietary interests in the target corporation to be exchanged for stock of the issuing corporation and the proprietary interests in the target corporation to be exchanged for consideration other than stock of the issuing corporation each represents an economically reasonable exchange as of the last business day before the first date there is a binding contract to effect the potential reorganization; or

(4) The percentage of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation, provided that the portion of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation and the portion of each proprietary interest in the target corporation to be exchanged for consideration other than stock of the issuing corporation each represents an economically reasonable exchange as of the last business day before the first date there is a binding contract to effect the potential reorganization.

(B) Shareholder elections--(1) In general. A contract that is not described in paragraph (e)(2)(iii)(A) of this section and pursuant to which a target

corporation shareholder has an election to receive stock and/or money and other property in respect of target corporation stock is treated as providing for fixed consideration if the contract provides--

(i) The minimum number of shares of each class of stock of the issuing corporation and the maximum amount of money and other property (identified either by value or by specific description) to be exchanged for all of the proprietary interests in the target corporation; or

(ii) The minimum percentage of the number of shares of each class of proprietary interests in the target corporation, or the minimum percentage (by value) of the proprietary interests in the target corporation, to be exchanged for stock of the issuing corporation, provided that the proprietary interests in the target corporation to be exchanged for stock of the issuing corporation and the proprietary interests in the target corporation to be exchanged for consideration other than stock of the issuing corporation each represents an economically reasonable exchange as of the last business day before the first date there is a binding contract to effect the potential reorganization.

(2) Special rules. (i) In the case of a shareholder election described in paragraph (e)(2)(iii)(B)(1)(i) of this section, the determination of whether a proprietary interest in the target corporation is preserved shall be made by assuming the issuance by the issuing corporation of the minimum number of shares of each class of stock of the issuing corporation and the maximum amount of money and other property allowable under the contract and without regard to the number of shares of each class of stock of the issuing corporation

and the amount of money and other property actually exchanged thereafter for proprietary interests in the target corporation.

(ii) In the case of a shareholder election described in paragraph (e)(2)(iii)(B)(1)(ii) of this section, the determination of whether a proprietary interest in the target corporation is preserved shall be made by assuming the issuance of issuing corporation stock in exchange for the minimum percentage of the number of shares of each class of proprietary interests in the target corporation, or the minimum percentage (by value) of proprietary interests in the target corporation, as the case may be, to be exchanged for stock of the issuing corporation allowable under the contract and without regard to the percentage of the number of shares of each class of proprietary interests in the target corporation, or the percentage (by value) of proprietary interests in the target corporation, actually exchanged for stock of the issuing corporation.

(C) Contingent consideration--(1) In general. In general, the fact that a contract provides for contingent consideration will prevent a contract from being treated as providing for fixed consideration. However, a contract will not fail to be treated as providing for fixed consideration solely as a result of a provision that provides for contingent consideration, if--

(i) The contingent consideration consists solely of stock of the issuing corporation; and

(ii) The execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation

shareholders' proprietary interests in the target corporation if none of the contingent consideration were delivered to the target corporation shareholders.

(2) Exception for escrows. For purposes of paragraph (e)(2)(iii)(C)(1) of this section, contingent consideration does not include consideration paid in escrow to secure target's performance of customary pre-closing covenants or customary target representations and warranties.

(D) Escrows. Placing part of the consideration to be exchanged for proprietary interests in the target corporation in escrow to secure target's performance of customary pre-closing covenants or customary target representations and warranties will not prevent a contract from being treated as providing for fixed consideration.

(E) Anti-dilution clauses. The presence of a customary anti-dilution clause will not prevent a contract from being treated as providing for fixed consideration. However, the absence of such a clause will prevent a contract from being treated as providing for fixed consideration if the issuing corporation alters its capital structure between the first date there is an otherwise binding contract to effect the potential reorganization and the effective date of the potential reorganization in a manner that materially alters the economic arrangement of the parties to the binding contract.

(F) Dissenters' rights. The possibility that some shareholders may exercise dissenters' rights and receive consideration other than that provided for in the binding contract will not prevent the contract from being treated as providing for fixed consideration.

(G) Fractional shares. The fact that money may be paid in lieu of issuing fractional shares will not prevent a contract from being treated as providing for fixed consideration.

(iv) Valuation of new issuances. For purposes of applying paragraph (e)(2)(i) of this section, any class of stock, securities, or indebtedness that the issuing corporation issues to the target corporation shareholders pursuant to the potential reorganization and that does not exist before the first date there is a binding contract to effect the potential reorganization is deemed to have been issued on the last business day before the first date there is a binding contract to effect the potential reorganization.

(v) Examples. For purposes of the examples in this paragraph (e)(2)(v), P is the issuing corporation, T is the target corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A is an individual, no transactions other than those described occur, and the transactions are not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e)(2):

Example 1. Application of signing date rule. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. Twenty of the P shares, however, will be placed in escrow to secure customary target representations and warranties. The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is $1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is $.25 per share. None of the stock placed in escrow is returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement

is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $40 of P stock and $60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 2. Treatment of forfeited escrowed stock. (i) The facts are the same as in Example 1 except that T's breach of a representation results in the escrowed consideration being returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $20 of P stock and $60 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

(ii) The facts are the same as in Example 2 (i) except that the consideration placed in escrow consists solely of eight of the P shares and $12 of the cash. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $32 of P stock and $48 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 3. Redemption of stock received pursuant to binding contract. The facts are the same as in Example 1 except that A owns 50 percent of the outstanding stock of T immediately prior to the merger and receives 10 P shares and $30 in the merger and an additional 10 P shares upon the release of the stock placed in escrow. In connection with the merger, A and S agree that, immediately after the merger, S will purchase any P shares that A acquires in the merger for $1 per share. Shortly after the merger, S purchases A’s P shares for $20. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. In addition, S is a person related to P under paragraph (e)(4)(i)(A) of this section. Accordingly, A is treated as exchanging his T shares for $50. Because, for continuity of interest purposes,

the T stock is exchanged for $20 of P stock and $80 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 4. Modification of binding contract--continuity not preserved. The facts are the same as in Example 1 except that on April 1 of Year 1, the parties modify their contract. Pursuant to the modified contract, which is a binding contract, the T shareholders will receive 50 P shares (an additional 10 shares) and $75 of cash (an additional $15 of cash) in exchange for all of the outstanding T stock. On March 31 of Year 1, the value of the P stock is $.50 per share. Under paragraph (e)(2) of this section, although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. Because the modified contract provides for the number of P shares and the amount of money to be exchanged for all of the proprietary interests in T, under paragraph (e)(2) of this section, the modified contract is a binding contract providing for fixed consideration as of April 1 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on March 31 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $25 of P stock and $75 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 5. Modification of binding contract disregarded--continuity preserved. The facts are the same as in Example 4 except that, pursuant to the modified contract, which is a binding contract, the T shareholders will receive 60 P shares (an additional 20 shares as compared to the original contract) and $60 of cash in exchange for all of the outstanding T stock. In addition, on March 31 of Year 1, the value of the P stock is $.40 per share. Under paragraph (e)(2) of this section, although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. Nonetheless, the modification has the sole effect of providing for the issuance of additional P shares to the T shareholders. In addition, the execution of the terms of the contract without regard to the modification would have resulted in the preservation of a substantial part of the value of the T shareholders' proprietary interest in T because, for continuity of interest purposes, the T stock would have been exchanged for $40 of P stock and $60 of cash. Therefore, the modification is not treated as a modification under paragraph (e)(2) of this section. Accordingly, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Despite the modification, the transaction continues to satisfy the continuity of interest requirement.

Example 6. New issuance. The facts are the same as in Example 1, except that, in lieu of the $60 of cash, the T shareholders will receive a new class of P securities that will be publicly traded. In the aggregate, the securities will have a stated principal amount of $60 and bear interest at the average LIBOR (London Interbank Offered Rates) during the 10 days prior to the potential reorganization. If the T shareholders had been issued the P securities on January 2 of Year 1, the P securities would have had a value of $60 (determined by reference to the value of comparable publicly traded securities). Whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock and the P securities to be issued to the T shareholders on January 2 of Year 1. Under paragraph (e)(2)(iv) of this section, for purposes of valuing the new P securities, they will be treated as having been issued on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $40 of P stock and $60 of other property, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 7. Economically unreasonable exchange. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 2 of Year 1. At that time, A is T's sole shareholder. Pursuant to the contract, 60 percent of the T stock will be exchanged for $80 of cash and 40 percent of the T stock will be exchanged for 20 shares of P stock. As of January 2, 20 shares of P stock have a value of $20, representing only 20 percent of the value of the total consideration to be received by the T shareholders. Because the percentage of proprietary interests in the target corporation to be exchanged for stock of the issuing corporation and the proprietary interests in the target corporation to be exchanged for money do not each represent an economically reasonable exchange as of the last business day before the first date there is a binding contract to effect the potential reorganization, under paragraph (e)(2)(iii)(A)(3) of this section, the contract is not treated as a binding contract that provides for fixed consideration.

Example 8. Absence of anti-dilution clause. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and $60 of cash in exchange for all of the outstanding stock of T. The contract does not contain a customary anti-dilution provision. The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is $1 per share. On April 10 of Year 1, P issues its stock to effect a stock split; each shareholder of P receives an additional share of P for each P share that it holds. On April 11 of Year 1, the value of the P stock is $.50 per share. Because P altered its capital structure between January 3 and June 1 of Year 1 in a manner that materially alters the economic arrangement of the parties, under paragraph (e)(2)(iii)(E) of this section, the contract is not treated as a binding contract that provides for fixed consideration.

Example 9. Shareholder election with a proration mechanism. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, at the shareholders' election, each share of T will be exchanged for cash of $1 or, alternatively, P stock that has a value of $1, if the value of each share of P stock is at least $.80 and no more than $1.20 on the effective date of the potential reorganization; 1.25 shares of P stock, if the value of each share of P stock is less than $.80 on the effective date of the potential reorganization; or .83 shares of P stock, if the value of each share of P stock is more than $1.20 on the effective date of the potential reorganization. In addition, the contract provides for a proration mechanism to ensure that 50 percent of the T shares will be exchanged for cash and 50 percent of the T shares will be exchanged for P stock. On January 2 of Year 1, T has 100 shares outstanding. The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is $1 per share. Because the contract provides for the percentage of the number of shares of each class of proprietary interests in T, and the percentage (by value) of the proprietary interests in T, to be exchanged for stock of P and the other requirements of paragraph (e)(2)(iii)(A)(3) of this section are satisfied, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for $50 of P stock and $50 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

* * * * *

(8) Effective date. Paragraphs (e)(1) and (e)(3) through (e)(7) of this section apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. Paragraph (e)(1)(ii) of this section, however, applies to transactions occurring after August 30, 2000, unless the transaction occurs pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter. Taxpayers who entered into a binding agreement on or after January 28, 1998, and before August 30, 2000, may request a private letter ruling permitting them to apply the

final regulation to their transaction. A private letter ruling will not be issued unless the taxpayer establishes to the satisfaction of the IRS that there is not a significant risk of different parties to the transaction taking inconsistent positions, for Federal tax purposes, with respect to the applicability of the final regulations to the transaction. Paragraph (e)(2) of this section applies to

transactions occurring pursuant to binding contracts entered into after September 16, 2005.

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: September 6, 2005

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).