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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

REG-129706-04

RIN 1545-BD53

Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that provide guidance regarding the satisfaction of the continuity of interest requirement for corporate reorganizations. These proposed regulations affect corporations and their shareholders. This document also provides a notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments and requests for a public hearing must be received by November 8, 2004.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-129706-04), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-129706-04), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the IRS Internet site at [www.irs.gov/regs](http://www.irs.gov/regs) or via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-129706-04).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Christopher M. Bass, (202) 622-7770; concerning submissions and comments, concerning the hearing, Guy Traynor, (202) 622-7180 (not-toll free numbers).

SUPPLEMENTARY INFORMATION:

**Background**

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

Section 1.368-1(e) provides that the purpose of the COI requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. COI requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in the issuing corporation, it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation.

In a transaction in which the shareholders of the target corporation receive both money and acquiring corporation stock, commentators have expressed concern that the transaction could fail to satisfy the COI 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. Commentators have noted that attempts to mitigate this concern have led to complexity in structuring transactions intended to qualify as reorganizations. These proposed regulations provide guidance to help address those concerns.

### **Explanation of Provisions**

The IRS and Treasury Department believe that there are certain cases in which the determination of whether the COI requirement is satisfied should be made by reference to the signing date value of the issuing corporation stock to be issued in the transaction. 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. Therefore, these proposed regulations provide that in determining whether the COI requirement is satisfied, the consideration to be exchanged for the proprietary interests in the target corporation is valued as of the end of the last business day before the first date there is a binding contract to effect the potential reorganization, provided the consideration to be provided to the target corporation shareholders is fixed in such contract and includes only stock of the issuing corporation and money.

For this purpose, a binding contract is an instrument enforceable under applicable law against the parties to the instrument. The IRS and Treasury Department understand that tender offers are a frequent acquisition vehicle. Because the terms of a tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934 and the regulations promulgated thereunder are fixed in a manner similar to those of a binding contract, these proposed regulations provide that such a tender offer, even if not pursuant to a binding contract, will be treated as a binding contract for purposes of

these regulations.

The proposed regulations provide that the presence of a condition outside the control of the parties shall not prevent an instrument from being a binding contract. For example, the fact that the completion of a tender offer is subject to a shareholder vote or the target shareholders tendering a sufficient amount of target stock will be considered a condition outside the control of the parties.

Finally, these proposed regulations provide that consideration is fixed if the contract states the exact number of shares of the issuing corporation and the exact amount of money, if any, to be exchanged for the proprietary interests in the target corporation. However, where the consideration is comprised of only issuing corporation stock and money, variable consideration will be treated as fixed consideration if a target corporation shareholder has an election to receive stock and/or money in respect of target corporation stock and the minimum amount of issuing corporation stock and the maximum amount of money that the target shareholders might receive can be determined. For purposes of determining whether a transaction that involves such variable consideration satisfies the continuity of interest requirement, these proposed regulations assume the issuance of the minimum number of shares and the maximum amount of money allowable under the contract, without regard to the number of shares and amount of money actually exchanged for proprietary interests in the target corporation.

In the course of developing these regulations, the IRS and Treasury Department considered whether the rule provided in these proposed regulations should be applied in other cases and what presumptions or conventions would be necessary to assess

whether the COI requirement has been satisfied in such other cases. The IRS and Treasury Department request comments in this regard.

This regulation is proposed to apply to transactions occurring pursuant to binding contracts entered into after the date these regulations are published as final regulations in the **Federal Register**.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It 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. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on their impact on small businesses.

### **Comments and Requests for Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written (a signed original and 8 copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department request comments regarding the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date,

time, and place for the public hearing will be published in the **Federal Register**.

### **Drafting Information**

The principal author of these proposed regulations is Christopher M. Bass, 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.

### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be 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 by:

1. Redesignating paragraphs (e)(2) through (e)(7) as (e)(3) through (e)(8), respectively.
2. Adding new paragraph (e)(2).
3. Newly designated paragraph (e)(7) is further redesignated as (e)(7)(i) and

Examples 10, 11, and 12 are added.

4. Adding paragraph (e)(7)(ii).

The additions 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 shall 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, provided the consideration is fixed in such contract and includes only stock of the issuing corporation and money.

(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. 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.

(B) 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 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. 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. Placing part of the stock issued or money paid in escrow to secure customary target representations and warranties will not prevent the consideration from being fixed.

(B) Special rule for shareholder elections. Notwithstanding the provisions of paragraph (e)(2)(iii)(A) of this section, consideration is also treated as fixed if a target corporation shareholder has an election to receive stock and/or money in respect of target corporation stock and the contract states the minimum number of shares of the issuing corporation and the maximum amount of money to be exchanged for the proprietary interests in the target corporation. In this case, the determination of whether a proprietary interest in the target corporation is preserved shall be made by assuming the issuance of the minimum number of shares and the maximum amount of money allowable under the contract and without regard to the number of shares and amount of money actually exchanged thereafter for proprietary interests in the target corporation.

(iv) Effective date. Paragraph (e)(2) applies to transactions occurring pursuant to binding contracts entered into after the date these regulations are published as final regulations in the **Federal Register**.

\* \* \* \* \*

(7)(i) Examples. \* \* \*



\* \* \* \* \*

Example 10. Fixed consideration on signing date. 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. Pursuant to the contract, the T shareholders will receive 40 P shares and \$60 in exchange for all of the outstanding stock of T. Ten of the P shares, however, will be placed in escrow to secure customary target representations and warranties. At the end of the day on January 2 of Year 1, the P stock trades for \$1 per share. On June 1 of Year 1, the P stock trades for \$.25 per share. Under paragraph (e)(2) of this section, there is a binding contract with 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 as of the end of the day on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$40 of P stock and \$60, 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 11. Modification of binding contract. The facts are the same as in Example 10, 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 and \$60 in exchange for all of the outstanding T stock. At the end of the day on March 31 of Year 1, the P stock trades for \$.80 per share. Under paragraph (e)(2) of this section, although there was a binding contract with 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. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock as of the end of the day on March 31 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$40 of P stock and \$60, 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 12. The facts are the same as in Example 11 except that, at the end of the day on March 31 of Year 1, the P stock trades for \$.51 per share. As in Example 11, whether the transaction satisfies COI is determined by reference to the value of the P stock as of the end of the day on March 31 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$25.50 of P stock and \$60, a substantial part of the value of the proprietary interest in T is not preserved. Therefore, the transaction does not satisfy the continuity of interest requirement.

(ii) Effective date. Paragraph (e)(7)(i) Examples 10, 11, and 12 apply to transactions occurring pursuant to binding contracts entered into after the date these

regulations are published as final regulations in the **Federal Register**.

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Acting Deputy Commissioner for Services and Enforcement.