WNTS Insight

A Washington National Tax Services (WNTS) Publication

December 22, 2011

New continuity of interest regulations address important issues

The IRS on December 19 issued final and proposed regulations that address the time for measuring the continuity of interest (COI) requirement. The COI requirement is an important aspect of determining whether certain transactions qualify as tax-free reorganizations under section 368.

The final regulations apply to transactions occurring pursuant to binding contracts entered into after December 19, 2011. For transactions entered into after March 19, 2010, and occurring pursuant to binding contracts entered into on or before December 19, 2011, the parties may elect to apply the temporary regulations issued in 2007.

If adopted, the proposed regulations would apply to transactions occurring on or after the date the regulations are finalized, unless completed pursuant to a binding agreement in effect before that date.

Background

Certain transactions defined in section 368 as tax-free reorganizations require COI. The COI requirement ensures that a substantial part of the value of the proprietary interests in the target corporation is preserved in the reorganization.

Generally, the COI requirement is met if at least 40 percent of the aggregate value of the consideration received by the target shareholders is stock in the acquiring corporation. A transaction intended to qualify as a reorganization may be at risk of failing the COI requirement if the target shareholders agree to receive a fixed ratio of acquiring stock and other property and the value of the acquiring stock declines between the date the parties entered into a binding contract and the date the transaction closes.

Final regulations

The final regulations, which adopt with minor changes the 2007 temporary regulations, retain the "signing date" rule under which COI is tested on the last business day before the sales contract becomes binding *if* the contract provides for fixed consideration. This rule is based on the principle that when 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 last business day before the signing date (the pre-signing date).

A contract is deemed to provide for fixed consideration if it provides for the number of shares of each class of stock of the acquiring corporation, the amount of money, and any other property (identified either by value or by specific description) to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation. Fixed consideration includes situations in which the contract permits a target corporation shareholder to elect the mix of consideration to be received the exchange (i.e., stock of the issuing corporation, money, other property, or a combination thereof), provided that the determination of the number of shares of the issuing corporation stock to be issued is made using the value of the issuing corporation stock on the pre-signing date (a shareholder election).

The final regulations clarify that a shareholder election that does not specify -- or even may preclude -- a determination, prior to the closing date, of the mix of consideration to be received by the target corporation shareholder will not prevent a contract from satisfying the general definition of fixed consideration if that requirement is otherwise met.

Proposed regulations

The IRS has concluded that the underlying principles of the signing date rule support additional methods for determining whether COI is satisfied. Accordingly, the proposed regulations would expand the scope of the signing date rule to include situations in which the terms of the binding contract manage the potential fluctuation in the value of the stock of the issuing corporation between the pre-signing date and the closing date by including "ceiling" or "floor" value limits.

Thus, if the terms of a binding contract provide that the amount of an item of consideration may vary between the pre-signing date and the closing date as the value of the issuing corporation's stock declines, but not below a prescribed floor price, and the closing date value is less than the floor price, COI would be determined as if the consideration that would have been delivered at the floor price were issued and valued based on the floor price. Similar rules would apply when the contract includes a ceiling price and the value of the issuing corporation's stock increases between the pre-signing date and the closing date.

The proposed regulations also would permit the use of average value if the average value is based on issuing corporation stock values on dates after the signing date and before the closing date, and the binding contract uses the average price, so computed, in determining the number of shares of each class of stock of the issuing corporation, the amount of money, and other property to be exchanged for all proprietary interests in the target corporation or to be exchanged for each proprietary interest in the target corporation.

Observations

As noted above, COI is a requirement for certain types of tax-free reorganizations. The clarification in the final regulations regarding the use of shareholder elections is favorable and generally aligns with actual practice.

Similarly, the proposed regulations, if adopted, would provide more flexibility regarding the amount and mix of consideration to be received by the target shareholders without violating the COI requirement.

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