

Client Alert

Latham & Watkins Tax Department

IRS Issues Final Regulations on Continuity of Interest for Tax-Free Reorganizations

On September 16, the IRS issued final regulations providing guidance with respect to measuring “continuity of interest” in tax-free reorganizations. The regulations generally follow the proposed regulations that the IRS issued last year, although the final rules expand upon the proposed regulations in several respects.

In general, for an acquisition to qualify as a tax-free “reorganization,” regardless of the form of the transaction, a substantial part of the value of the target corporation’s equity must be preserved through the issuance of equity in the acquiring corporation. Although opinions differed on the subject, most tax advisors generally believed that to qualify as a reorganization, the fair market value of the acquirer’s stock to be received by the target shareholders had to be at least equal to 40 percent of the total value of all consideration (depending on the form of the transaction a higher percentage of stock could be required).

Moreover, prior to the issuance of the new regulations, it was generally believed that the fair market value of the acquirer stock was measured at the closing of the transaction. Thus, in a merger of T into P, where T shareholders were to receive a combination of P stock and cash, it was possible for a transaction to meet the continuity of interest requirement at the time the merger

agreement was signed but — due to a decline in the value of P stock — fail to so qualify on the closing date.

The new regulations provide that, under certain circumstances, continuity of interest is to be measured based on the fair market value of the acquirer’s stock on the day before the contract is signed. Thus, if the regulations apply, the parties achieve greater certainty on the day the contract is signed as to whether continuity of interest is satisfied.

Moreover, the new regulations (albeit by example) confirm that the continuity of interest requirement is satisfied where at least 40 percent of the target stock is exchanged for stock of the acquirer.

The new regulations apply to binding contracts that provide for fixed consideration. The regulations also treat certain types of contracts that call for contingent consideration as providing for fixed consideration. Specifically, a contract is treated as providing for fixed consideration if it gives each target shareholder an election to receive stock and/or money or other property, so long as it specifies the minimum number or percentage of shares and the maximum amount of money and other property to be received by the target shareholders.

In the case of such contracts, the determination whether continuity of interest is satisfied is made by assuming

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the issuance of the minimum amount of stock and the maximum amount of cash and other property.

Placing stock into escrow to secure customary representations and covenants will not prevent a contract from qualifying as a fixed consideration contract under the new regulations. Similarly, customary anti-dilution clauses, and the possibility that some

shareholders may exercise dissenters' rights, will not prevent a contract from being treated as providing for fixed consideration.

Contingent consideration other than that which is specifically permitted under the regulations will generally make the "signing date" rule unavailable.

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