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December 27, 2011

# IRS ISSUES REGULATIONS REGARDING THE VALUATION OF STOCK-BASED CONSIDERATION PACKAGES IN M&A TRANSACTIONS

## *Some Tax-free Deals Now Easier to Accomplish Despite Volatile Capital Markets*

By David B. Strong

### EXECUTIVE SUMMARY

On December 19, 2011, the IRS finalized prior temporary regulations and issued additional proposed regulations regarding the valuation of stock-based consideration packages for purposes of the “continuity of interest” requirement applicable to most tax-free reorganizations under Section 368 of the Internal Revenue Code. In general, the continuity of interest requirement dictates that a minimum percentage of a consideration package *by value* must be in the form of the acquiring corporation’s stock (generally assumed to be about 40%). In addition, if the value of the acquiring corporation’s stock is measured as of the closing date, the possibility of price fluctuations between signing and closing can make the tax treatment of a transaction uncertain. In order to address this issue, the final regulations define the circumstances under which the acquiring corporation’s stock will be valued as of the last business day before the day on which a deal is signed (referred to as the “signing-date rule”). As a result, pursuant to the signing-date rule, a transaction may still qualify as tax-free even if the relative value of the acquiring corporation’s stock declines between signing and closing.

The following basic example illustrates the signing-date rule contained in the final regulations:

- On January 3 of Year 1, an acquiring corporation (“X”) and a target corporation (“T”) sign a binding contract pursuant to which T will be merged with and into X on June 1 of Year 1.
- Pursuant to the contract, the T shareholders will receive 40 X shares and \$60 cash in exchange for all the outstanding stock of T.
- On January 2 of Year 1, X stock is worth \$1 per share. On June 1 of Year 1, T merges with and into X pursuant to the terms of the contract and as of that date X stock has declined in value and is worth only \$.75 per share.

Under the final regulations, and despite the decline in the value of X stock between signing and closing, the transaction will satisfy the continuity of interest requirement and will have the ability to qualify as a tax-free reorganization. Specifically, pursuant to the signing-date rule, the value of the X stock to be delivered to the T shareholders will be deemed to represent 40% of the total consideration package (40 X shares \* \$1 per share = \$40). By comparison, if the closing-date value for X stock was used, the transaction may not qualify as a tax-free reorganization because the value

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of the X stock to be delivered to the T shareholders would represent only approximately 33% of the total consideration package (40 X shares \* \$.75 per share = \$30).

## SHAREHOLDER ELECTION MECHANISMS

The final regulations adopt prior temporary regulations that were originally issued in 2007, and that later expired in 2010, with only a few minor changes. One of the changes in the final regulations clarifies that certain “shareholder election” mechanisms, whereby a target corporation’s shareholders can make individual elections regarding the desired mix of stock and cash to be received in connection with a transaction, will not prevent the application of the signing-date rule. This change effectively provides acquiring corporations with enhanced flexibility in situations where the shareholders of a target corporation may have different ongoing investment objectives or tax profiles.

## PRICE PROTECTION MECHANISMS

In addition to the final regulations, related proposed regulations create entirely new rules that are designed to address certain types of price protection mechanisms (such as “variable-ratio stock collars” and cash “top-up” or “top-down” arrangements). Previously, such price protection mechanisms would have prevented the use of the signing-date rule. However, if the same general concepts set forth in the proposed regulations are eventually reflected in final regulations, the parties to a transaction may be able to utilize price protection arrangements and apply a special variation of the signing-date rule that utilizes the underlying “floor” or “ceiling” price for the acquiring corporation’s stock.

As an illustration of a price protection mechanism that may qualify for the proposed special variation of the signing-date rule, consider the following example, which is based on an example contained in the proposed regulations:

- On January 3 of Year 1, an acquiring corporation (“X”) and a target corporation (“T”) sign a binding contract pursuant to which T will be merged with and into X on June 1 of Year 1.
- Pursuant to the contract, the T shareholders will receive 50 X shares and \$50 cash in exchange for all the outstanding stock of T, subject to a price adjustment mechanism whereby the amount of cash will be adjusted depending upon the closing-date value of X stock.
- Under the terms of the price adjustment mechanism, if the average price of X stock over the five-day period preceding the closing date exceeds \$1, the amount of cash will be reduced by 50 times the excess of that price over \$1 (subject to an aggregate minimum of \$40).
- At the same time, and again under the terms of the price adjustment mechanism, if the average price of X stock over the five-day period preceding the closing date is less than \$1, the amount of cash will be increased by 50 times the excess of \$1 over that price (subject to an aggregate maximum of \$60).
- On January 2 of Year 1, X stock is worth \$1 per share. On June 1 of Year 1, T merges with and into X pursuant to the terms of the contract and as of that date X stock has declined in value and is worth only \$.75 per share (with the preceding five-day average price of X stock also equaling \$.75 per share).
- Upon the closing of the transaction, and due to the decline in the price of X stock, the T shareholders receive aggregate consideration of \$97.50, in the form of \$60 cash and 50 shares of X stock with an aggregate closing-date value of \$37.50.

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Based on the terms of the price adjustment mechanism, the T shareholders are certain to receive aggregate consideration with a value of \$100 on the closing date as long as the value of X stock is between \$.80 and \$1.20 per share (with a “floor” mix of \$60 cash and \$40 X stock and a “ceiling” mix of \$40 cash and \$60 X stock). Furthermore, utilizing the approach of the proposed regulations, the transaction can satisfy the continuity of interest requirement and qualify as tax-free reorganization based on the relative value of X stock and cash as determined using the lower “floor” value for X stock of \$.80 per share. As a result, 40% of the consideration package (or \$40) will be deemed to be received by the T shareholders in the form of X stock and the continuity of interest requirement will be satisfied (despite the aggregate closing date value of \$37.50 for the 50 shares of X stock).

### EFFECTIVE DATE; ADDITIONAL CONSIDERATIONS

The final regulations apply to all transactions that occur pursuant to binding contracts entered into after December 19, 2011. In addition, parties to transactions should take care to note that the final regulations are not elective and the signing-date rule will apply in all cases that fit within the defined parameters of the regulations. This could potentially prevent a transaction from qualifying as a tax-free reorganization if, for example, the continuity of interest requirement was not satisfied as of the signing date and the share price of the acquiring corporation’s stock subsequently increased between signing and closing.

Finally, parties to transactions should also be aware that the final regulations contain rules that address a variety of special situations, including cases where:

- a contract is subsequently modified by the parties after the original signing date;
- an acquisition is conducted in the form of a tender offer;
- a portion of the consideration package may be placed in escrow;
- a contingent adjustment may occur to the consideration package; or
- the acquiring corporation alters its capital structure between signing and closing.

### MORRISON & FOERSTER CONTACTS

Throughout the course of the development of the final and proposed regulations, members of Morrison & Foerster’s Transactional Tax Group participated in submitting extensive comments to the IRS and the Treasury Department. In the end, many of these comments were incorporated into the final and proposed regulations. As a result, Morrison & Foerster is well ahead of the curve in this area. Please feel free to contact one of our tax partners listed below for further information on the final regulations or the proposed regulations.

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