COMMENTS ON THE EFFECT OF PRE-CLOSING CHANGES IN ACQUIROR STOCK VALUE ON CONTINUITY OF INTEREST

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

The comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation. Principal responsibility was exercised by Robert Woodward and John Sweet. Substantive contributions were made by Julie Divola, Stuart Offer, Mark Silverman and David Wheat. The comments were reviewed by Bob Wellen of the Section of Taxation's Committee on Government Submissions and by Joe Pari, Supervisory Council Director.

Although the members of the Section of Taxation who participated in preparing this report have clients who would be affected by the federal tax principles addressed by the report, or have advised clients on the application of these principles, no such member (or firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of the report.

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Executive Summary

The 2003-2004 Priority Guidance Plan published by the Treasury and Internal Revenue Service includes, under the caption "Corporations and Their Shareholders", the following item:

> Guidance regarding the effect of pre-closing changes of acquiror stock value on continuity of interest.

This report provides comments of individual members of the Corporate Tax Committee of the Section of Taxation on this proposed guidance, and recommends an approach for application of the continuity of interest ("COI") requirement in corporate reorganizations that may be affected by pre-closing changes in the value of the acquiring corporation stock.

We believe that the value of the acquiring corporation stock for purposes of applying the COI requirement of Treasury Regulation § 1.368-1(e)(1) (the "COI value") should be determinable as of the day prior to the date the acquisition agreement between the acquiring corporation and the target corporation is signed. Accordingly, we recommend that in cases where the stock of the acquiring corporation to be issued in the transaction is traded on an established market, the COI value of that stock would be determined by reference to the closing market price on the last trading date prior to the date the acquisition agreement is executed. Alternatively, if the parties specifically adopt in the acquisition agreement another commercially reasonable method for valuing the acquiror stock (such as the average closing price over the last 20 trading days prior to the signing date), that valuation method would be employed to determine the COI value of the acquiror stock. In cases where the acquiror stock is not traded on an established market, the COI value of the acquiring corporation stock would be determined based upon the fair market value of that stock, determined under general principles as of the date prior to the signing date. The COI value of the target corporation stock would be determined by reference to the COI value of the acquiring corporation stock and the fair market value (as of the date prior to the execution date of the acquisition agreement) of any other consideration to be exchanged for target corporation stock in the transaction.[1]

Under our recommended approach, the parties would be able to determine whether "a substantial part of the value of the proprietary interests in the target corporation [is] preserved," within the meaning of Treasury Regulation § 1.368-1(e)(1)(i), by reference to the ratio of (a) the aggregate COI value of the acquiring corporation stock issued in exchange for the target corporation stock to (b) the aggregate COI value of the target corporation stock (the "COI percentage"). This approach would

[1] Cash consideration payable on or before the closing date would be valued without regard to any time value factors. Valuation issues could arise in cases where target shareholders will receive consideration other than cash or acquiring corporation stock (or where acquiring corporation stock is not publicly traded), but these issues exist generally and do not result from the recommended approach.

disregard any decline in the value of the acquiring corporation stock that occurs after the execution of the acquisition agreement but before the closing of the transaction.

We recommend that the Treasury and Internal Revenue Service (the "IRS") publish appropriate guidance approving the use of this general approach in determining the COI percentage. Although the Treasury and IRS may want to propose Treasury regulations to deal with COI valuation issues more comprehensively, we advocate the publication of guidance in a revenue ruling, revenue procedure or notice as soon as is feasible to deal with the simple case in which the amount of acquiror stock and other consideration to be received by the target corporation shareholders at closing is fixed as of the signing date.[2]

Discussion

To qualify as a "reorganization" under Section 368[3], a transaction must satisfy the COI requirement as well as numerous other requirements. Treasury Regulation § 1.368-1(e)(1)(i), as amended in 1998 and 2000, describes the COI requirement as follows:

> Continuity of interest 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 [i.e., the acquiring corporation, or the corporation controlling the acquiring corporation in a triangular reorganization], 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. However, a proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed.

This regulation was amended significantly in 1998 and 2000 to focus on the nature of the consideration provided for the target corporation stock, rather than the continued holding of that consideration by the target corporation's "historic" shareholders. The 1998 and 2000 amendments greatly simplified the COI requirement and were strongly supported by members of the ABA Section of Taxation.

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[2] For a summary of certain additional issues that the Treasury and IRS may want to consider in connection with this recommendation, see "Other Considerations" below. We do not believe that the existence of these additional issues should delay the issuance of guidance with respect to the simple case.

[3] Unless otherwise indicated, all "Section" references are to the Internal Revenue Code of 1986, as amended.

The revised COI regulation did not specifically address, however, the methodology for determining whether a "substantial part of the value of the proprietary interest in the target corporation [is] preserved in the reorganization." The language of Treasury Regulation § 1.368-1(e)(1)(i) appears to treat the "proprietary interest" represented by stock of the target corporation as "preserved" if it is exchanged for stock of the acquiring corporation, regardless of the value of the acquiring corporation stock at the closing date. Nevertheless, the IRS has not clearly addressed the COI issue where the trading value of the acquiring corporation stock provided as consideration for the target corporation stock, as of the closing date, is less than the value immediately before the execution date of the acquisition agreement.

Under present law, the critical factor in determining whether the COI requirement is satisfied is the percentage of the value of the total consideration provided to the target shareholders in the form of acquiring corporation stock. The current practice of tax advisors in making this determination derives from Revenue Procedure 77-37,[4] which provides operating rules for advance ruling letters under Section 368. Section 3.02 of Revenue Procedure 77-37 stated that the IRS ordinarily would rule that the COI requirement of the regulations prior to the 1998 and 2000 amendments was satisfied

> if there is continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof within the meaning of section 368(c) of the Code) on the part of the former shareholders of the acquired or transferor corporation which is equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation as of the same date. It is not necessary that each shareholder of the acquired or transferor corporation receive in the exchange stock of the acquiring or transferee corporation, or a corporation in "control" thereof, which is equal in value to at least 50 percent of the value of his former stock interest in the acquired or transferor corporation, so long as one or more of the shareholders of the acquired or transferor corporation have a continuing interest through stock ownership in the acquiring or transferee corporation (or a corporation in "control" thereof) which is, in the aggregate, equal in value to at least 50 percent of the value of all of the formerly outstanding stock of the acquired or transferor corporation.

The revenue procedure goes on to state that sales of stock occurring prior or subsequent to the exchange in the reorganization are taken into account in determining whether the 50 percent guideline is met. That position concerning pre- or post-reorganization sales now has been disavowed in the 1998 and 2000 amendments to the COI regulation, except in cases involving sales to corporations that are related to the acquiror and certain redemptions.

By focusing on stock values "as of the effective date of the reorganization," the approach of Section 3.02 of Revenue Procedure 77-37 makes it difficult to determine

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4 1977-2 C.B. 568, 569.

prior to the closing whether the COI requirement will be met in transactions where (a) the ratio of acquiring corporation stock to be issued in exchange for the target corporation stock is based on pre-closing values and (b) a significant amount of cash or other property ("boot") is exchanged for the target corporation stock. This may force the parties to restructure or abandon transactions where the acquiror stock value declines between the signing date and the closing date. In our view, this rule creates an unnecessary burden on standard commercial transactions. As explained below, no significant COI policy is advanced by using closing date values, rather than signing date values.

It is not unusual for the measurement of the COI percentage to be a critical issue in forward mergers intended to qualify under Section 368(a)(1)(A), either as a "straight A" reorganization or as a forward subsidiary merger described in Section 368(a)(2)(D), where there is a substantial amount of boot.[5] In those cases, even though the parties agree to have the acquiring corporation stock issued in exchange for a number of shares of the target corporation stock that would satisfy the COI requirement based on the value of the acquiror stock when the acquisition agreement is signed, subsequent declines in the trading value of the acquiror stock may cause the total value of the acquiror stock to be issued, determined at the closing date, to be less than the requisite COI percentage. In our experience, this problem most frequently occurs in cash election mergers, where the target shareholders have the right to elect to receive either a specified amount of cash or a specified number of shares of acquiror stock, or a combination of each, in exchange for their shares of target stock, and the exchange ratio for converting shares of target stock into shares of acquiror stock is fixed or subject to a floor that does not fully adjust for pre-closing declines in the trading value of the acquiror stock. Our recommended approach would confirm that the COI percentage can be measured in these cases based upon the value of the acquiror stock on the date prior to the agreement date, without requiring the parties to change the economic terms of their transaction.

We believe that our recommendation would significantly simplify the operation of the COI rules and would not raise any tax policy concerns. The purpose of the COI rules is to distinguish reorganizations from transactions that resemble taxable sales. Transactions that satisfy the COI rules based on signing date values do not resemble taxable sales. Further, we see little or no abuse potential. Any abuse concern could be addressed by limiting the new rule to customary acquisition agreements.

We believe the advantages of having a straightforward rule that reduces taxpayer uncertainty, combined with the lack of abuse potential, justify the use of our recommended approach in lieu of the closing date approach of Rev. Proc. 77-37 and other possible approaches that could unnecessarily complicate the COI analysis without advancing any significant policy concerns. For example, we reject approaches that would

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[5] These transactions present significant potential tax risk to the acquiring corporation as well as to the target shareholders, since failure to meet the COI requirement would cause recognition of any gain realized by the target and its shareholders, with the target's resulting tax liability being assumed by the acquiror in the merger.

measure COI (i) by reference to stock values as of the date of any required shareholder or regulatory approval, (ii) by reference to the date of any amendment to the acquisition agreement regardless of whether the amendment relates to the amount or relative composition of the consideration to be provided to the target corporation shareholders or (iii) by attempting to take into account stock value declines that can be attributed to the announcement of the transaction.

The following examples illustrate the operation of our recommended approach.

Example 1 (Cash Election Merger). The acquiring corporation, P, and the target corporation, T, enter into a merger agreement on January 5, 2004, relating to a proposed merger of T with and into P. Each of P and T has a single class of common stock that is publicly traded. Under the merger agreement, the T shareholders have the right to elect to receive, in exchange for each share of T stock, either $50 cash or two shares of P stock, or a combination of $25 cash and one share of P stock, provided that 50 percent of the outstanding T shares must be exchanged for cash and 50 percent of the outstanding T shares must be exchanged for P stock. The merger agreement specifies the procedure to be followed for distributing cash or P stock to the T shareholders, and includes a mandatory proration procedure to meet the 50 percent cash and P stock amounts by allocating cash or P stock among the T shareholders. The closing price of P stock on the New York Stock Exchange on January 2, 2004, the last trading day prior to the signing of the merger agreement by P and S, is $25 per share. The closing of the merger is set to occur as soon as possible after the approval of the merger agreement by the T shareholders at a special meeting. The merger agreement is not subject to approval by the P shareholders. On the date of the special meeting of the T shareholders and on the closing date, the trading value of P stock has declined to $10 per share. Under the recommended approach, P and T would be entitled to compute the COI percentage by reference to the value of the P stock on the last trading day prior to the execution of the agreement ($25 per share) rather than the trading value of the P stock on the date of the special meeting of the T shareholders and the closing date ($10 per share). Accordingly, since the COI percentage calculated on this basis is 50 percent, the COI requirement would be satisfied.

Example 2 (Cash Tender Followed by Merger). The facts are the same as in Example 1, except that the merger agreement requires or permits P, as soon as possible after the signing of the merger agreement, to commence a tender offer to acquire up to 50 percent of the T stock for $50 per share in cash. Upon the closing of the tender offer, 50 percent of the T stock is purchased for cash. One month later, the merger agreement is approved by the T shareholders. Six months thereafter, when the merger receives regulatory approval, T merges with and into P, with each share of T stock held by shareholders other than P being converted into two shares of P stock. If the COI requirement is satisfied, the tender offer and merger will be treated as an "A" reorganization under Rev. Rul. 2001-26[6] and the authorities cited therein. Since P and T would be entitled to compute the COI percentage by reference to the value of the P stock on the last trading day prior to the execution of the agreement ($25 per share) rather than

[6] 2001-1 C.B. 1297.

the trading value of the P stock on the date of the special meeting of the T shareholders or the closing date ($10 per share), the COI requirement would be satisfied.

We believe our recommended approach would be consistent with operating rules in several analogous areas, where Congress and the IRS generally have been flexible in dealing with issues relating to stock value fluctuations. Analogous areas include the following:

Section 305. Rev. Rul. 75-468[7] involved a merger in which shareholders of the target corporation were to receive preferred stock of the acquiring corporation with a value, as of the date of the merger agreement, of $20 per share. The preferred stock was callable by the acquiring corporation after 5 years from the date of its issuance at $21 per share (representing a redemption premium of 5 percent). On the effective date of the merger, the fair market value of the preferred stock was only $18 (resulting in a redemption premium as of that date of 16 percent).

The issue in the ruling was whether the difference between the redemption price and the issue price should be treated as a reasonable redemption premium (rather than a distribution of property to which section 301 applied by virtue of sections 305(b)(4) and (c)). Under then applicable Treasury Regulations, a redemption premium not in excess of 10 percent on stock that was not redeemable for 5 years from the date of issuance was considered reasonable.[8] Accordingly, the redemption premium on the acquiring corporation's preferred stock was reasonable (within the meaning of the regulations) if measured on the date of the agreement but not if measured on the effective date of the merger.

The IRS concluded that the redemption premium was reasonable. In support of its conclusion, the IRS explained that the increase in redemption premium (from 5 percent to 16 percent) arose "solely as a result of market conditions" and that a redemption premium in excess of 10 percent was not bargained for or intended.

In a subsequent ruling involving similar facts (where a redemption premium on preferred stock to be issued pursuant to a tender offer was 10 percent as of the date of the agreement but increased to about 21 percent as of the date of issuance), the IRS similarly concluded that the redemption premium was reasonable.[9] The IRS explained:

> It is not improper for the terms of the stock issued in the exchange to be intended to afford the [target] shareholders the benefit of the full 10 percent reasonable redemption premium. Nor is it the intent of the [IRS] to restrain the use of tender offers or other forms of acquisition merely because they may be subject to unforeseen events arising between the time the terms of the transaction are agreed to and the time of consummation.

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[7] 1975-2 C.B. 115.

[8] Treas. Reg. 1.305-5(b)(2) (prior to amendment by T.D. 8643, 12/20/95).

[9] Rev. Rul. 81-190, 1981-2 C.B. 84; see also PLR 8752008 (following Rev. Rul. 81-190 and Rev. Rul. 75-468).

The IRS recently declared both of these rulings obsolete.[10] Although no specific reason was given for this action, a likely reason is that the 10-percent reasonable redemption premium standard that applied when the rulings were issued has been superseded.[11]

Section 367. In the case of a transfer of stock of a U.S. target corporation by U.S. persons to a foreign acquiring corporation, the "substantiality" prong of the active trade or business test under Treasury Regulation § 1.367(a)-3(c)(3) is deemed satisfied if, at the time of the transfer, the fair market value of the transferee foreign corporation is at least equal to the fair market value of the U.S. target corporation.[12] In several private letter rulings, the IRS has treated this substantiality requirement as being satisfied based on the relative values at the time the parties entered into the agreement for the transfer, notwithstanding that market price fluctuations could have caused the value of the U.S. target corporation to exceed the value of the foreign corporation as of the closing date.[13]

Section 382. For purposes of determining whether a corporation has undergone an "ownership change" (within the meaning of Section 382(g)), any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock is not taken into account.[14] In addition, each share of the same class of stock is treated as having the same value, without regard to any control premium or blockage discount.[15] These rules simplify the determination of percentage changes in stock ownership and prevent ownership changes that otherwise might result from changes in market values of stock.

Section 424 (formerly Section 425). Under Section 424(a), an incentive stock option (as defined in Section 422(b)) or an option granted under an employee stock purchase plan (as defined in Section 423(b)) generally will not lose its tax-advantaged status as a result of being assumed or substituted in a merger, consolidation, reorganization (whether or not described in Section 368) or other specified corporate transaction, if

> (i) (A) the excess of the aggregate fair market value of the shares subject to the option immediately after the substitution or assumption over the aggregate option price of such shares is not more than (B) the excess of the aggregate fair market value of all shares subject to the option immediately before such substitution or assumption over the aggregate option price of such shares, and

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[10] Rev. Rul. 2003-99, 2003-34 I.R.B. 388.

[11] See Section 305(c)(1) (as added in 1990 by P.L. 101-508) and Treas. Reg. § 1.305-5(b) (as amended by T. D. 8643 in 1995).

[12] Treas. Reg. § 1.367(a)-3(c)(3)(iii).

[13] PLR 200020018 (Feb. 15, 2000), PLR 199929039 (Apr. 12, 1999), and PLR 199903048 (Oct. 21, 1998). See Treas. Reg. § 1.367(a)-3(c)(9) (authorizing the issuance of private letter rulings where a taxpayer is substantially in compliance with the active trade or business test of Treas. Reg. § 1.367(a)-3(c)(3), of which the substantiality requirement is a part).

[14] Section 382(l)(3)(C).

[15] Treas. Reg. § 1.382-2(a)(3)(i).

> (ii) the new option or the assumption of the old option does not give the employee additional benefits which he did not have under the old option.[16]

Regulations issued under former Section 425 (the predecessor to Section 424) state as follows:

> Any reasonable methods may be used to determine the fair market value of the stock subject to the option immediately before the assumption or substitution and the fair market value of the stock subject to the option immediately after the assumption or substitution. Such methods include the valuation methods described in §20.2031-2 of this chapter (the Estate Tax Regulations). In the case of stock listed on a stock exchange, the fair market value may be based on the last sale before and the first sale after the assumption or substitution if such sales clearly reflect the fair market value of the stock, or may be based upon an average selling price during a longer period, such as the day or week before, and the day or week after, the assumption or substitution. If the stocks are not listed, or if they are newly issued, it will be reasonable to base the determination on experience over even longer periods. *In the case of a merger, consolidation, or other reorganization which is arrived at by arm's-length negotiations, the fair market value of the stock subject to the option before and after the assumption or substitution may be based upon the values assigned to the stock for purposes of the reorganization. For example, if in the case of a merger the parties treat each share of the merged company as being equal in value to a share of the surviving company, it will be reasonable to assume that the stocks are of equal value so that the substituted option may permit the employee to purchase at the same price one share of the surviving company for each share he could have purchased of the merged company.*[17]

This regulation provides direct support for our recommended approach in determining the COI percentage.

Sections 851 and 856. Under Section 851(b)(3)(B), a corporation generally cannot qualify as a regulated investment company (a "RIC") if more than 25 percent of the value of its total assets is invested in the securities (other than Government securities or the securities of other RICs) of any one issuer. However, a corporation that has qualified and elected to be taxed as a RIC will not lose its status as a RIC if it fails this 25-percent test solely as a result of the fluctuation in market values of its investments in securities.[18] A similar rule applies in determining the qualification of a REIT under the investment diversification tests of Section 856(c)(4).[19] These rules prevent unanticipated declines in market values from disqualifying RICs and REITs.

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16 See Sections 422, 423 and 424; Treas. Reg. § 1.425-1(a)(1)(ii).

17 Treas. Reg. § 1.425-1(a)(7) (emphasis added).

18 Section 851(d); Treas. Reg. § 1.851-5, Example 6.

19 Treas. Reg. § 1.856-2(c)(3).

Section 1274. In determining the "test rate" of interest for a debt instrument issued in consideration for the sale or exchange of property, taxpayers generally are entitled to use the lower of (i) the lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the first month in which there is a binding written contract that substantially sets forth the terms under which the sale or exchange is ultimately consummated, or (ii) the lowest applicable Federal rate (based on the appropriate compounding period) in effect during the 3-month period ending with the month in which the sale or exchange occurs.[20] Under this rule, a debt instrument that has "adequate stated interest" determined as of the contract date will not cease to have adequate stated interest due to subsequent increases in interest rates occurring prior to the closing date.

Other Considerations

Specific issues that the Treasury and IRS may want to consider in connection with the general approach recommended in this report (and for which additional guidance may be deemed necessary or appropriate) include the following:

Minimum COI Percentage. In Section 3.02 of Rev. Proc. 77-37, the IRS approved a COI percentage of 50 percent as satisfying the COI requirement for advance ruling purposes. Most tax advisors, however, believe that a favorable opinion on meeting the COI requirement can be rendered if the COI percentage, determined by reference to the value of the acquiror stock on the closing date, is at least 40 percent.[21]

Variable Number of Shares to Be Issued at Closing (Collar Arrangements). We believe it would be appropriate to modify the general approach recommended in this report in the case of certain acquisition agreements under which the number of shares of acquiring corporation stock to be issued to target shareholders at closing is subject to adjustment based on the closing date value of the acquiror shares (e.g., a typical "collar" arrangement).

Example. Acquiring corporation stock is trading at $1 per share on the date prior to the signing date. For each share of target corporation stock, target shareholders will receive $1 in cash plus (i) a number of shares of acquiror stock worth $1 if the closing date price of acquiror stock is within a specified range, (ii) a lesser number of acquiror shares worth at least $1 if the closing date price of acquiror stock is above that range or (iii) a greater number of acquiror shares worth no more than $1 if the closing date price of acquiring corporation stock is below that range. Under these facts, if the closing date price of acquiring corporation stock is above the specified range, the

[20] Treas. Reg. § 1.1274-4(a)(1)(ii).

[21] This belief is based largely on the Supreme Court's decision in John A. Nelson Co. v. Helvering, 296 U.S. 374, 36-1 U.S.T.C. ¶ 9019 (1935), where consideration consisting of 38 percent acquiror preferred stock and 62 percent cash in exchange for target stock was held sufficient to meet the COI requirement. The Supreme Court confirmed this interpretation of Nelson in Paulsen v. Commissioner, 469 U.S. 131, 141, 85-1 U.S.T.C. ¶ 9116 (1985), describing Nelson as a case where the taxpayer received consideration of 38 percent preferred stock and 62 percent cash.

COI percentage (determined under our recommended approach by valuing the acquiring corporation stock issued to target shareholders by reference to the value of such stock on the date prior to the signing date) would be less than 50 percent and thus the COI requirement may not be satisfied, even though the COI requirement would be satisfied if the stock issued to target shareholders was valued by reference to the closing date price of acquiror stock. One way to apply a signing date approach in this context would be to assume, for purposes of determining the COI percentage, that target shareholders will receive a number of acquiring corporation shares based on the value of acquiring corporation shares on the day prior to the signing date. Alternative approaches, which deviate from a strict signing date approach, include (i) valuation of acquiror shares by reference to the date the consideration to be received by target shareholders becomes fixed under the agreement and (ii) valuation of acquiror shares by reference to the higher of signing date and closing date values.

Additional Payments to Protect Against Price Declines (Cash "Top-Up" Arrangements). Similarly, the COI requirement may not be satisfied under the general approach recommended in this report in cases where the agreement provides for the payment of additional cash at closing to compensate target corporation shareholders for limited declines in value of acquiring corporation stock between signing and closing. In this regard, it may be appropriate to adopt a *de minimis* rule under which additional cash payments that are less than a specified percentage (e.g., 5%) of the aggregate COI value of the target corporation stock, determined on the date prior to the signing date, are disregarded.

Effect of Amendments to Acquisition Agreements. Acquisition agreements are often amended, sometimes repeatedly. The aim of our recommended approach of reducing taxpayer uncertainty could be frustrated if COI were required to be retested by reference to acquiring corporation stock values as of the date of any amendment to the original agreement. Accordingly, we believe that modifications to an acquisition agreement generally should not require retesting of COI. However, we acknowledge that retesting may be considered appropriate in cases where the modification significantly alters the amount or relative composition of the consideration to be received by target corporation shareholders.

Application of Recommended Approach in Other Contexts. Pre-closing changes in stock value may also have an impact on the qualification under Section 355 of certain divisive transactions (which are subject to a similar COI requirement),[22] and the qualification of certain reverse triangular mergers involving boot under Section 368(a)(2)(E), which requires that at least 80 percent of the voting power and at least 80 percent of all other classes of stock of the target corporation be acquired by the acquiring corporation in exchange for acquiring corporation voting stock. We believe these issues generally should be resolved using the same approach to valuation of the acquiror stock as we have recommended for measuring COI in this report, although we acknowledge

[22] Treas. Reg. § 1.355-2(c).

that applying such an approach to reverse triangular mergers may be considered problematic given the specific language of Section 368(a)(2)(E).

"Backing Into" Continuity. In cases where the value of acquiring corporation stock increases between signing and closing, a transaction may satisfy the COI requirement if COI values were determined by reference to closing date values, even though the transaction would not satisfy the COI requirement based on the value of acquiring corporation stock on the date prior to the signing date. In these cases, it may be appropriate to test COI based on closing date values. However, because these cases would involve transactions that were not structured to qualify as reorganizations as of the signing date (and that may fail to qualify as reorganizations even if the COI requirement is met), this issue may be of little practical significance.

Contingent Stock Arrangements. We are not making a recommendation at this time regarding the application of our recommended approach to contingent stock arrangements in which the number of shares of acquiring corporation stock to be received by target corporation shareholders is contingent on post-closing events.