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February 4, 2004

The Honorable Pamela F. Olson
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Dear Secretary Olson and Commissioner Everson:

I am pleased to submit the New York State Bar Association Tax Section's Report No. 1051 on Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations. It is quite common in corporate reorganizations for a portion of the stock consideration provided by the acquiring corporation to target shareholders to be subject to arrangements that render its receipt contingent upon events that will occur after the transaction has been consummated. Typical variable stock consideration arrangements include, for example, stock escrows to secure representations and warranties and contingent stock rights. This report addresses how the requirements of a tax-free reorganization under section 368 of the Internal Revenue Code, particularly the continuity of proprietary interest requirement, should apply in these circumstances.

Current law is unclear and there is also considerable inconsistency in treatment depending on the particular arrangement by which the variable stock consideration is provided. It is our experience

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that transactions involving variable stock consideration generally can be structured to satisfy the continuity of interest requirement, but at the cost of interfering with the parties' desired business terms. Those forms of variable stock consideration arrangement treated as preserving continuity under current law often do not convey an inherently more proprietary interest than those arrangements that are adversely treated. The uncertainty and inconsistency of current law therefore does little to further the underlying purposes of the continuity of proprietary interest requirement.

The recommendation of this report is that continuity of proprietary interest be measured when the parties enter into the reorganization transaction, even if receipt of a portion of the acquirer stock consideration by target shareholders is contingent on subsequent events. The Report generally recommends that such variable stock consideration be treated as a proprietary interest to the extent of its fair market value on that date, provided that the target shareholders also receive a substantial interest representing current ownership of acquirer stock.

The Report also generally recommends treating variable stock consideration consistently, regardless of the legal form of arrangement by which it is provided. However, we advocate somewhat different treatment of typical stock escrow arrangements that secure customary representations and warranties. In that situation, if the target shareholders are appropriately treated as owning the underlying stock under general income tax principles, we believe the escrowed stock should count favorably towards satisfaction of the continuity of interest requirement to the same extent as if it were issued directly to the target shareholder.

Our recommendations address only satisfaction of the continuity of proprietary interest requirement and certain collateral matters discussed in the report. We do not propose applying our recommended approach more generally.

If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully submitted,



Lewis R. Steinberg
Chair

cc: Eric Solomon, Deputy Assistant Secretary, Regulatory Affairs,
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