NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

THE PROPOSED CONTINUITY OF INTEREST REGULATIONS

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Report No. 1266

New York State Bar Association Tax Section

Report on Proposed Continuity of Interest Regulations

I. Introduction

This report[1] of the Tax Section of the New York State Bar Association (the "Report") offers commentary and recommendations on proposed regulations addressing the continuity of interest ("COI") requirement applicable to tax-free reorganizations under Section 368 of the Internal Revenue Code of 1986, as amended (the "Code" and, such requirement, the "COI Requirement"), that the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "Service") published in the Federal Register on December 19, 2011 (the "Proposed COI Regulations").[2] This Report also makes certain recommendations regarding the final regulations under Treas. Reg. § 1.368-1(e)(2) that were promulgated simultaneously with the issuance of the Proposed COI Regulations (the "Final COI Regulations").[3]

II. Summary of Recommendations

We recommend that Treasury and the Service narrow the scope of the Proposed COI Regulations by applying the Floor Price Rule and the Ceiling Price Rule (each as defined below) only when the relevant contract provides for a typical "market" collar (and not solely a floor or ceiling) and the pre-signing date value of the stock of the acquiring corporation approximates the midpoint between the Floor Price and Ceiling Price (each as defined below).

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[1] The principal author of this report is Joshua M. Holmes. The invaluable assistance of Rachel B. Carlton is gratefully acknowledged. Helpful comments were received from Andrew W. Needham, Deborah L. Paul, Michael L. Schler, Jodi J. Schwartz, David R. Sicular, and Eric Solomon. This Report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Notice of Proposed Rulemaking (REG-124627-11), 76 Fed. Reg. 78,592 (Dec. 19, 2011) (Prop. Treas. Reg. § 1.368-1(e)(2)(vi), (vii)).

[3] T.D. 9565, 76 Fed. Reg. 78,540 (Dec. 19, 2011) (Treas. Reg. § 1.368-1(e)(2)(i) – (v)).

If Treasury and the Service determine not to narrow the scope of the Proposed COI Regulations in this manner, we recommend that Treasury and the Service:[4]

- Provide additional examples in the Proposed COI Regulations to describe the application of the Floor Price Rule and the Ceiling Price Rule where the relevant contract provides for (1) a collar (and not solely a floor or ceiling) and/or (2) adjustments to stock consideration (and not cash consideration);
- Provide an example illustrating that the Ceiling Price Rule can protect the taxable status of a transaction (if it is in fact permissible to rely on this rule for this purpose);
- Confirm that the Proposed COI Regulations apply to transactions where the relevant contract permits more than one type of consideration to vary in accordance with the price of the stock of the acquiring corporation and provide additional guidance addressing the application of the Proposed COI Regulations to situations involving more than one floor and/or more than one ceiling;
- Extend the application of the Floor Price Rule and the Ceiling Price Rule to circumstances in which, in addition to stock of the acquiring corporation, non-cash boot is paid to the target shareholders and provide guidance on when such non-cash boot should be valued;
- Consider whether the Proposed COI Regulations should take into account the implicit call option in favor of the acquiring corporation when measuring the value of the total stock consideration to the shareholders of the target corporation on the signing date in any acquisition in which the Floor Price is set at or near the pre-signing date value of its stock; and
- Consider whether the application of the Proposed COI Regulations in certain other situations is consistent with their purpose, including:
    - when the Ceiling Price is equal to the pre-signing date value of the stock of the acquiring corporation;
    - when the range of values within a collar is extremely “narrow” or “wide”; and
    - when the contract mechanisms are “asymmetric” .

Finally, we recommend that Treasury and the Service:

- Make the Average Price Rule (as defined below) mandatory, not elective;

[4] Certain of these recommendations remain relevant even if Treasury and the Service follow our primary recommendation, which we discuss more fully in Part IV, *infra.*

- Provide guidance on valuing the stock of the acquiring corporation for purposes of measuring COI; and
- Resolve inconsistencies between the tax treatment of modifications of the original contract and economically equivalent contingent adjustments pursuant to the original contract.

III. General Overview of Proposed Continuity of Interest Regulations

In order to qualify as tax-free reorganizations under Section 368, corporate transactions must satisfy the COI Requirement. Applicable Treasury regulations require "that in substance a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization."[5] Examples in the Final COI Regulations indicate that the COI Requirement is generally satisfied if at least 40 percent of the aggregate consideration paid to shareholders of the target corporation ("T") consists of stock in the acquiring corporation ("P").[6] Generally, Revenue Procedure 77-37 indicates that taxpayers must determine whether the COI Requirement is satisfied based on the value of the P stock "as of the effective date of the reorganization," *i.e.*, the date on which the transaction closes (the "Closing Date Rule").[7] However, the Final COI Regulations provide that in certain circumstances (generally, where a binding contract provides for "fixed consideration"), taxpayers must determine whether the COI Requirement is satisfied based on the value of the P stock "on the last business day before the first date such contract is a binding contract (the pre-signing date)" (the "Signing Date Rule").[8] As discussed further below, the Proposed COI Regulations provide three alternative measurement rules in certain circumstances in which the T shareholders are "subjected to the economic fortunes of owning the

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[5] Treas. Reg. § 1.368-1(e)(1)(i).
[6] Treas. Reg. § 1.368-1(e)(2)(v) examples 1, 5, 6, 8.
[7] Rev. Proc. 77-37, 1977-2 C.B. 568.
[8] Treas. Reg. § 1.368-1(e)(2)(i).

consideration received in the exchange in the same manner as if the contract had fixed the consideration based upon" a stated price.[9]

The first two of these rules, the Floor Price Rule and the Ceiling Price Rule (each as defined below), generally apply to circumstances in which "an item of consideration" varies as the value of P stock (1) "declines between the stock's pre-signing date value and some lower value provided for in the contract" (the "Floor Price") and/or (2) "increases between the stock's pre-signing date value and some higher value provided for in the contract" (the "Ceiling Price").[10] Under the Proposed COI Regulations, if the contract provides for a Floor Price and/or Ceiling Price, the price of the P stock is at or above or at or below the Floor Price or Ceiling Price, respectively, on the pre-signing date,[11] and the price of the P stock on the closing date has fallen below the Floor Price or increased above the Ceiling Price, taxpayers must measure whether the COI Requirement is satisfied based on the Floor Price or Ceiling Price, as the case may be (each rule, respectively, the "Floor Price Rule" or the "Ceiling Price Rule"). The third rule, the Average Price Rule (as defined below), applies when the contract designates an average price of the P stock for purposes of "determining the number of shares of each class of [P stock], the amount of money, and the other property to be exchanged" for T stock (the "Average Price Mechanism").[12] If a binding contract employs an Average Price Mechanism, taxpayers "may"

[9] Notice of Proposed Rulemaking, 76 Fed. Reg. at 78,592.

[10] *Id*. While the Preamble to the Proposed COI Regulations describes the Floor Price as "lower" than the pre-signing date value and the Ceiling Price as "higher" than the pre-signing date value, Prop. Treas. Reg. § 1.368-1(e)(2)(vi)(A) and (B) allows each to be set "equal to" the pre-signing date value. In light of this apparent inconsistency, we recommend that Treasury and the Service clarify whether the Floor Price and/or the Ceiling Price may be set to equal the pre-signing date value. See Part V.D.1, *infra*.

[11] As noted in the preceding footnote, the Proposed COI Regulations would allow each of the Floor Price and Ceiling Price to equal the pre-signing date value.

[12] Notice of Proposed Rulemaking, 76 Fed. Reg. at 78,592.

determine whether the COI Requirement is satisfied based upon such price (the "Average Price Rule").[13]

Prior to the promulgation of the Signing Date Rule, the Tax Section recommended a rule that would allow taxpayers to determine whether the COI Requirement is satisfied using the value of the P stock at signing, instead of the value at closing, in order to reduce taxpayer uncertainty regarding whether a transaction would qualify as a tax-free reorganization.[14] In August 2004, Treasury and the Service issued proposed regulations adopting the Signing Date Rule in cases where the T shareholders "generally can be viewed as being subject to the economic fortunes" of P as of the signing date (the "2004 Proposed Regulations").[15] In a subsequent report, the Tax Section stated that the 2004 Proposed Regulations represented "a significant step towards quelling taxpayer uncertainty and transactional inefficiency" and provided a number of recommendations for clarifying and expanding these regulations.[16] The 2004 Proposed Regulations were finalized in September 2005[17] and later replaced with temporary regulations in March 2007 (the "2007 Temporary Regulations").[18] Upon expiration of the 2007 Temporary Regulations, the Service published Notice 2010-25, which allowed taxpayers to apply the Signing Date Rule of the 2007 Temporary Regulations on an elective basis.[19] In general, the Final COI Regulations follow the 2007 Temporary Regulations. The

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[13] See Part VI.A, *infra*, regarding the elective nature of the Average Price Rule.

[14] *See* New York State Bar Association Tax Section Report No. 1050, *Report on Continuity of Interest and Pre-Closing Stock Value Fluctuation* (Jan. 23, 2004) (the "January 2004 Report").

[15] *See* Notice of Proposed Rulemaking (REG-129706-04), 69 Fed. Reg. 48,429 (Aug. 10, 2004) (Prop. Treas. Reg. § 1.368-1(e)(2)).

[16] New York State Bar Association Tax Section Report No. 1072, *Proposed Regulations Regarding Continuity of Interest and Pre-Closing Stock Value Fluctuation* (Nov. 29, 2004) (the "November 2004 Report").

[17] T.D. 9225, 70 Fed. Reg. 54,631 (Sept. 16, 2005) (Treas. Reg. § 1.368-1(e)(2)).

[18] Temp. Reg. § 1.368-1T(e)(2), 72 Fed. Reg. 12,974 (Mar. 20, 2007).

[19] Notice 2010-25, 2010-14 I.R.B. 527.

Proposed COI Regulations would further expand the scope of transactions subject to a rule other than the Closing Date Rule.

In the November 2004 Report, we recommended that the application of the Signing Date Rule be expanded to circumstances where the relevant contract provides "a mechanism that guarantees the [T] shareholders will receive a fixed value per share of [T] stock so long as the [P] stock remains within a specified band of values," *i.e.*, a collar.[20] The Proposed COI Regulations recognize that, although such mechanisms provide a measure of price protection, the theory of the Signing Date Rule should apply to such situations because, outside of the collar, the T shareholders are "subject to the economic fortunes" of the ownership of P stock.[21] Rather than adopt a rule that would require taxpayers to use the Signing Date Rule in agreements that include a collar to fix the aggregate amount of consideration within a certain band of stock values, however, the Proposed COI Regulations would apply the Floor Price Rule or the Ceiling Price Rule in situations involving not only collars, but other price-protection mechanisms as well.

The Proposed COI Regulations suggest that as extensions of the Signing Date Rule, the Floor Price Rule and the Ceiling Price Rule are supported by the same underlying principle, namely, "that where a binding contract provides for fixed consideration, [T] shareholders can generally be viewed as being subject to the economic fortunes of [P] as of the . . . Pre-Signing Date . . . ."[22] In situations where the relevant contract provides for "fixed consideration," the Signing Date Rule treats the T shareholders as having become economically invested in the P stock on the date of signing and thus requires COI to be measured based on the pre-signing date value of the P stock. In situations where the relevant contract provides fixed consideration

[20] November 2004 Report, at 17.

[21] *See* Notice of Proposed Rulemaking, 76 Fed. Reg. 78,591.

[22] *See id.* at 78,592.

subject to adjustments above a floor, below a ceiling, or within a collar, the Proposed COI Regulations treat the T shareholders as having become economically invested in the P stock at the Floor Price or the Ceiling Price if the value of the P stock at closing is below the Floor Price or above the Ceiling Price, respectively. Thus, the Proposed COI Regulations imply that contracts with a floor, ceiling, or both provide for sufficiently "fixed" consideration and subject the T shareholders to a sufficient degree of economic exposure to warrant measuring COI based on a price other than the price of the P stock at closing. In such circumstances, the Proposed COI Regulations require that taxpayers measure COI "in the same manner as if the contract had fixed the consideration based upon" the Floor Price or the Ceiling Price (*i.e.*, as if the contract had provided for "fixed consideration" and the pre-signing date value equaled the Floor Price or the Ceiling Price, as applicable).

We believe that the Proposed COI Regulations provide welcome enhancements in taxpayer certainty regarding the tax status of a transaction at the time the parties enter into a binding contract. Especially in the case of the Floor Price Rule, the terms of the negotiated transaction will determine whether the COI Requirement will be satisfied, and fluctuations in the value of the P stock prior to the closing date will not jeopardize qualification of the transaction as a tax-free reorganization.[23] The rules recognize the prevalence of certain pricing mechanisms in the marketplace, and, as we suggested in the November 2004 Report, prevent taxpayers from having to "choose between price protections for [T] shareholders . . . or relative certainty of tax result by providing for fixed merger consideration."[24] However, we believe the actual scope of the Proposed COI Regulations reaches beyond these types of common pricing mechanisms in the

[23] Likewise, in the case of the Ceiling Price Rule, a taxpayer may structure a transaction intended to be fully taxable without concern that increases in the value of the P stock prior to the closing date may cause the COI Requirement to be satisfied. *See* Part V.A, *infra*.

[24] *See* November 2004 Report, at 18.

market to certain contract terms that do not afford a significant degree of economic exposure to fluctuations in the price of the P stock (and thus do not result in sufficiently "fixed" consideration). In this Report, we recommend that Treasury and the Service limit the application of the Floor Price Rule and the Ceiling Price Rule to pricing mechanisms that comport with the theory of these rules, *i.e.*, to those that leave the T shareholders with meaningful economic exposure to the P stock. More specifically, we recommend that the rules apply only to "symmetric" collars in which the Floor Price and the Ceiling Price are approximately equidistant from the pre-signing date value of the P stock. With a symmetric collar, the T stockholders are equally exposed to upward and downward fluctuations in the price of the P stock beyond its price protected range. However, to the extent that Treasury and the Service retain the current scope of the Floor Price Rule and the Ceiling Price Rule, we recommend that Treasury and the Service clarify certain interpretive ambiguities in the Proposed COI Regulations and consider how the proposed rules might apply to non-standard pricing mechanisms.

IV. Narrowing the Scope of the Rules to Apply Only to Symmetric Collars

As described in this Part IV, we recommend that the Floor Price Rule and the Ceiling Price Rule apply only to transactions where (1) the relevant contract provides for a collar (as opposed to a floor or ceiling only) and (2) the pre-signing date value of the P stock approximates the midpoint of the range of prices within the collar. When applied to a contract with typical "market" terms, we believe that the Floor Price Rule and the Ceiling Price Rule appropriately provide taxpayers with certainty on the signing date regarding whether a transaction will satisfy the COI Requirement. In a traditional collar, the amount of cash or the number of shares of P stock to be paid to the T shareholders in exchange for their T stock is adjusted based on the price of the P stock at closing, but both the cash and stock consideration cease to adjust and remain

fixed should the price of the P stock fall below the Floor Price or exceed the Ceiling Price. Further, the value of the P stock at the pre-signing date often approximates the midpoint between the Floor Price and the Ceiling Price. Thus, the collar affords the T shareholders price protection within a negotiated range, ensuring the value of the aggregate consideration to which they are entitled. Outside of the collar, the T shareholders bear the risks and reap the benefits of owning P stock. The magnitude of the risk borne by the T shareholders is often equivalent to the benefit they enjoy.

Each of Examples 1A and 1B describes a transaction involving a typical "market" collar where either the cash consideration or stock consideration is subject to adjustment. The examples in the Proposed COI Regulations do not specifically address collars[25] or adjustments to stock consideration.[26] We believe it is clear, however, that these types of transactions would be subject to the Floor Price Rule or the Ceiling Price Rule, as the case may be.

> ***Example 1A. Collar with adjustments to cash consideration.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the amount of cash to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than $60 of cash or less than $40 of cash (*i.e.*, the Floor Price is $0.80, and the Ceiling Price is $1.20). If, at closing, the price of P stock is between $0.80 and $1.20, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $0.80 or above $1.20, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.

[25] In the Proposed COI Regulations, example 1(ii) describes the application of the Floor Price Rule in a situation in which there is a floor, but no ceiling, and example 2 describes the application of the Ceiling Price Rule in a situation in which there is a ceiling, but no floor. *See* Prop. Treas. Reg. § 1.368-1(e)(2)(vii). Although we believe the application of the Floor Price Rule and the Ceiling Price Rule to a "market" collar is clear based on the examples provided in the proposed regulations, we would suggest adding a collar example in final regulations for completeness.

[26] *See* Part V.A, *infra*.

> ***Example 1B. Collar with adjustments to stock consideration.*** Same as Example 1A, except if the price of P stock at the closing date is below or above $1 per share, the number of shares of P stock (rather than the amount of cash) to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 62.5 or less than 41.67 shares of P stock (*i.e.*, the Floor Price is $0.80, and the Ceiling Price is $1.20). If, at closing, the price of P stock is between $0.80 and $1.20, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $0.80 or above $1.20, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.

In both of these examples, we believe the Proposed COI Regulations provide welcome certainty to taxpayers with respect to the satisfaction of the COI Requirement and should increase transactional efficiencies in negotiating and executing corporate reorganizations.

However, the Proposed COI Regulations do not require that the range of prices between the Floor Price and the Ceiling Price be symmetric, as they are in Examples 1A and 1B (for example, by requiring the range of prices between the Floor Price and the pre-signing date price to be equal to the range of prices between the pre-signing date price and the Ceiling Price).[27] In fact, they impose no standard at all. The pre-signing date price may therefore be skewed toward the low or high end of a collar. We believe that asymmetric collars of this kind present opportunities for taxpayer manipulation.

> ***Example 2A. Collar; asymmetric; cash varies.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is above $1 per share, the amount of cash to be paid to T shareholders will decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than $50 of cash or less than $0.50 of cash (*i.e.*, the Floor Price is $1, and the Ceiling Price is $1.99). If, at closing, the price

[27] In the November 2004 Report, we recommended that the Signing Date Rule apply to collars only if, among other things, "the center point of [the collar] bears some reasonable relationship to the Signing Date Value of the [P] stock (or perhaps instead falls within a specified percentage of either Signing Date Value or a trailing average of [P] stock prices) and the upper and lower limits of which are equidistant from the band's center point . . . ." November 2004 Report, at 18.

of P stock is between $1 and $1.99, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $1 or above $1.99, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.

Example 2B. Collar; asymmetric; stock varies. Same as Example 2A, except that if the price of P stock at the closing date is above $1 per share, the number of shares of P stock to be paid to T shareholders will decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 50 or less than 25.13 shares (*i.e.*, the Floor Price is $1, and the Ceiling Price is $1.99). If, at closing, the price of P stock is between $1 and $1.99, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $1 or above $1.99, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.

The Proposed COI Regulations frame the Floor Price Rule and the Ceiling Price Rule as extensions of the principles underlying the Signing Date Rule,[28] and the Signing Date Rule is intended to address situations in which the T shareholders are subject to the economic fortunes of owning the P stock because the consideration is fixed. Where a contract provides for a "market" collar, the analogy to "fixed consideration" and the Signing Date Rule is clear: the consideration is fixed, but only above and below a reasonable range of stock prices. Despite a limited degree of price protection, it is fair to say that the T shareholders still remain subject to fluctuations in the price of the P stock on the signing date. However, it is difficult to classify the consideration to the T shareholders in Examples 2A and 2B as"fixed". To the contrary, the consideration is fully variable over a wide range of P stock values, leaving the T shareholders with virtually no upside even though they bear all of the downside risk. As described more fully in Part V.D.1., the P stock is burdened by an embedded call option with a strike price equal to the Floor Price, reducing the actual value of the stock consideration to less than 50 percent even on the signing date. Nevertheless, in Examples 2A and 2B, the Proposed COI Regulations would treat the T

[28] *See* Part III, *supra*.

shareholders as if they had received 50 percent of the merger consideration in the form of stock. We believe this is inconsistent with the basic principle underlying the Signing Date Rule, which is that T shareholders entitled to fixed consideration are subject to the economic fortunes of P between signing and closing.

The application of the Floor Price Rule and the Signing Date Rule to a transaction in which the binding contract severely limits the T shareholders' economic exposure to P, seems at odds with the principles Treasury and the Service have set forth for the Signing Date Rule and the Proposed COI Regulations. By allowing (in fact, requiring) taxpayers to measure COI by reference to the Floor Price or the Ceiling Price in situations where the T shareholders have little (or no[29]) exposure to upward fluctuations in the value of the P stock[30] or little (or no) exposure to downward fluctuations in the value of the P stock, respectively, we believe the Proposed COI Regulations may apply to transactions that, at best, do not comport with the theoretical foundation of the regulations and, at worst, may inappropriately take advantage of the rules by allowing transactions to qualify as tax-free reorganizations even though the actual value of the total equity consideration on the signing date is below 40 percent. If the theory supporting application of the Floor Price Rule and the Ceiling Price Rule is that, below the floor and above the ceiling, the T shareholders are subject to the economic fortunes of the ownership of P stock, perhaps the fact that the T shareholders have little upside (when considering application of the Floor Price Rule) or downside (when considering application of the Ceiling Price Rule) is irrelevant in determining eligibility for the relevant rule. However, if the purpose of the Proposed COI Regulations is to extend the Signing Date Rule to a broader range of otherwise

[29] *See* Examples 9A and 9B, *infra*.

[30] Example 3A, *infra*, suffers from the same infirmity—T shareholders have no economic stake in the appreciation of the P stock.

similar transactions (as the Preamble suggests), the relevant inquiry should be whether, on the signing date, the T shareholders are sufficiently exposed to the economic fortunes of P such that it is reasonable to treat the contract as providing for "fixed consideration" (subject to reasonable price protection).

Although the T shareholders are not fully subject to fluctuations in the price of the P stock in collared transactions, we believe that a symmetric collar strikes a reasonable balance between price protection and fixed consideration, supporting the application of the Floor Price Rule and the Ceiling Price Rule to such "market" pricing mechanisms. As we noted in the November 2004 Report, we believe the principles supporting the Signing Date Rule should apply where the collar provides for a fixed value of P stock to be paid to the T shareholders "if the value of [P] stock falls within a specified band of values, the center point of which bears some reasonable relationship to the Signing Date Value of the [P] stock . . . ."[31] This is because a near symmetric collar "exposes the [T] shareholder to the economic benefits and burdens of the [P] stock beginning on the signing date" and provides "roughly equal upside and downside protection."[32] Thus, we recommend that Treasury and the Service narrow the scope of the Floor Price Rule and the Ceiling Price Rule to apply only to situations such as Examples 1A and 1B, where the contract provides for a reasonable, approximately symmetric collar.

V. Interpretative Ambiguities Raised by the Floor Price Rule and the Ceiling Price Rule

To the extent Treasury and the Service determine that the Proposed COI Regulations should apply to a broader set of pricing mechanisms than those described in Part IV above, we recommend that Treasury and the Service consider a number of situations and clarify the proper

[31] November 2004 Report, at 18.

[32] *Id.* at 18–19.

application of the rules. This Part V describes a series of fact patterns involving the use of floors, ceilings, and collars and makes certain recommendations regarding the application of the Floor Price Rule and the Ceiling Price Rule in these situations.

A. Basic Floors, Ceilings, and Collars

As described in Part IV above, when applied to a contract with a symmetric collar, we believe that the Proposed COI Regulations strike an appropriate balance between certainty of tax treatment and allowing some degree of price protection.[33] As illustrated in examples 1(ii) and 2 in the Proposed COI Regulations, however, they would also apply the Floor Price Rule and the Ceiling Price Rule to transactions involving either a floor or a ceiling, but not both.

> ***Example 3A. No ceiling price; cash consideration varies above floor price.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the amount of cash to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than $60 of cash (*i.e.*, the Floor Price is $0.80), and, should the price of P stock appreciate above $2 per share, T shareholders will receive no cash. If, at closing, the price of P stock is at or above $0.80, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $0.80, COI will be measured under the Floor Price Rule, and the COI Requirement will be satisfied.

> ***Example 3B. No floor price; cash consideration varies below ceiling price.*** Same as Example 3A, except in no event will T shareholders receive less than $40 of cash (*i.e.*, the Ceiling Price is $1.20), and T shareholders are fully protected against declines in the value of P stock. If, at closing, the price of P stock is at or below $1.20, COI will be measured under the Closing Date Rule, and the COI Requirement may or may not be satisfied. If, at closing, the price of P stock is above $1.20, COI will be measured under the Ceiling Price Rule, and the COI Requirement will be satisfied.

Subject to our primary recommendation in Part IV above, in the case of Example 3A, we believe the Proposed COI Regulations support the goal of increasing transactional efficiencies by

[33] *See* Examples 1A and 1B, *supra*.

providing taxpayers certainty with respect to the satisfaction of the COI Requirement. However, we note that the use of a ceiling only, with no floor, in situations where the parties intend for a transaction to qualify as a tax-free reorganization, as described in example 2 in the Proposed COI Regulations, would be quite uncommon in practice. In the context of a transaction that is intended to meet the COI Requirement, the application of the Ceiling Price Rule does not provide taxpayers with any greater certainty of satisfying this requirement than the Closing Date Rule, nor does it provide any significant benefit to the parties to the transaction. If a transaction would satisfy the COI Requirement at the Ceiling Price, it would continue to satisfy the COI Requirement if the price of the P stock increased above the Ceiling Price, so a rule which measures COI based on the Ceiling Price (instead of the higher price on the closing date) is neither helpful nor necessary.

However, consider the following:

> ***Example 3C. No ceiling price; cash consideration varies below ceiling price; taxable deal.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $80 of cash plus 20 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the amount of cash to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive less than $70 of cash (*i.e.*, the Ceiling Price is $1.50). If, at closing, the price of P stock is at or below $1.50, COI will be measured under the Closing Date Rule, and the COI Requirement will not be satisfied. If, at closing, the price of P stock is above $1.50, COI will be measured under the Ceiling Price Rule, and the COI Requirement will not be satisfied.

While the Ceiling Price Rule provides little, if any, certainty in a case where a taxpayer intends for a transaction to satisfy the COI Requirement, it may provide certainty to a taxpayer who wishes to structure a transaction that includes stock as partial consideration as a taxable sale or exchange. In Example 3C, despite the increased value of the P stock as of the closing date, the Ceiling Price Rule operates to prevent the transaction from "growing into" COI by limiting the

value used to determine COI to the Ceiling Price. However, because the COI Requirement is only one of many requirements to qualify as a tax-free reorganization, we think it is unlikely that taxpayers would rely on a transaction's failure to satisfy such requirement to ensure that the transaction is taxable.[34] Putting aside the potential benefit to parties to a taxable transaction, it seems the purpose of the Ceiling Price Rule is a definitional one—it simply provides the upper bound of a collar.[35] We recommend that Treasury and the Service clarify whether the Ceiling Price Rule is intended to protect the taxable status of transactions that are not intended to qualify as reorganizations and, if so, provide an example to this effect in final regulations.

We further recommend that Treasury and the Service include an example, similar to current examples 1(ii) and 2, describing the application of the Floor Price Rule and the Ceiling Price Rule to situations in which the stock consideration is subject to adjustment according to the value of the P stock, but the cash consideration remains fixed. In addition to Example 1B, *supra*, consider the following examples:

> ***Example 4A. No ceiling price; stock consideration varies above floor price.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the number of shares of P stock to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 62.5 shares of P stock (*i.e.*, the Floor Price is $0.80), and as the price of P stock appreciates, T shareholders receive fewer shares (although the value of the shares received will always equal $50). If, at closing, the price of P stock is at or above $0.80, COI will be measured under the Closing Date Rule, and the COI

[34] Further, we note that while taxpayers intending to consummate tax-free reorganizations are generally comfortable that a ratio of stock-to-cash consideration (the "Stock-Cash Ratio") of 40-60 will satisfy the COI Requirement, *see* note 36, *infra*, the inverse is unclear. That is, because the highest Stock-Cash Ratio at which the COI Requirement would fail to be satisfied is uncertain, we do not believe it would be reasonable for taxpayers to rely on the Ceiling Price Rule to ensure the taxable nature of a transaction.

[35] If the purpose of the Ceiling Price Rule is definitional, an alternative simpler approach would be to define a ceiling for the limited purpose of applying the Floor Price Rule to situations in which the relevant contract provides for a collar without providing a substantive requirement that requires taxpayers to measure COI based on the Ceiling Price where the closing date price exceeds the ceiling.

Requirement will be satisfied. If, at closing, the price of P stock is below $0.80, COI will be measured under the Floor Price Rule, and the COI Requirement will be satisfied.

Example 4B. No floor price; stock consideration varies below ceiling price. Same as Example 4A, except in no event will T shareholders receive less than 41.67 shares of P stock (*i.e.*, the Ceiling Price is $1.20). If, at closing, the price of P stock is at or below $1.20, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is above $1.20, COI will be measured under the Ceiling Price Rule, and the COI Requirement will be satisfied.

We believe the Floor Price Rule and the Ceiling Price Rule should apply whether the stock consideration, such as in Examples 1B, 4A, and 4B, or the cash consideration, such as in Examples 1A, 3A, and 3B, is subject to adjustment above a floor, below a ceiling, or both. Indeed, the Proposed COI Regulations do not distinguish between various types of consideration, providing that the rules apply if "an item of consideration" to be paid to the T shareholders changes as the price of the P stock varies. Nothing in the rules suggests that "an item of consideration" was intended to include only cash consideration.

Moreover, we believe that transactions in which the relevant contract provides for adjustments to the stock, as opposed to cash, consideration represent an even clearer case for the application of the Floor Price Rule instead of the Closing Date Rule. Adjustments in the number of shares of P stock to be paid as consideration in accordance with fluctuations in the value of such stock will preserve the Stock-Cash Ratio at all points above the floor and/or below the ceiling. Thus, the Stock-Cash Ratio to which the parties agree at signing is certain to be the Stock-Cash Ratio at both the Floor Price and the Ceiling Price. In addition, in such a transaction, unless the Stock-Cash Ratio at the signing date is set at the lowest ratio possible without

violating the COI Requirement (for example, 40-60),[36] the Floor Price will not represent the "precipice" of continuity (*i.e.*, the lowest price at which the COI Requirement would be satisfied).[37] In Example 3A above (and in example 1(ii) in the Proposed COI Regulations), the Stock-Cash Ratio at signing is 50-50, allowing the taxpayer to measure COI based on the Floor Price if the price of the P stock at closing drops below the Floor Price even though the COI Requirement would not be satisfied under the Closing Date Rule. However, in Example 4A, where the Stock-Cash Ratio is also 50-50 at signing, if the price of the P stock at closing drops up to $0.27 below the Floor Price (at which point the T shareholders would receive $50 of cash and 62.5 shares of P stock worth $0.53 each), the COI Requirement would still be satisfied under the Closing Date Rule. Thus, the application of the Floor Price Rule where stock consideration varies should be less controversial than the application of the Floor Price Rule where cash consideration varies because the former T shareholders will always receive a larger proprietary interest in P.

We believe the addition of an example addressing situations in which the number of shares paid to the T shareholders is adjusted in accordance with the price of the P stock, as suggested above, would help to clarify any ambiguity regarding the application of the rules to varying stock consideration.

Further, if Treasury and the Service intend for the Ceiling Price Rule to protect the expectations of taxpayers for both taxable and tax-free transactions,[38] a corollary to Example 3C

[36] For purposes of this Report, we use 40-60 as a Stock-Cash Ratio that, under common understanding, may represent the lowest such ratio that would satisfy the COI Requirement. However, we note that the parameters of the COI Requirement are not clear, and a lower Stock-Cash Ratio may, indeed, satisfy that requirement.

[37] *See* Examples 9A and 9B, *infra*.

[38] *See* notes 34 and 35, *supra*, and accompanying text.

above should be provided in final regulations to address such transactions in which the stock consideration varies.

> ***Example 4C. No floor price; stock consideration varies below ceiling price; taxable deal.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $80 of cash plus 20 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the number of shares of P stock to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive less than 13.33 shares of P stock (*i.e.*, the Ceiling Price is $1.50). If, at closing, the price of P stock is at or below $1.50, COI will be measured under the Closing Date Rule, and the COI Requirement will not be satisfied. If, at closing, the price of P stock is above $1.50, COI will be measured under the Ceiling Price Rule, and the COI Requirement will not be satisfied.

B. More Than One Item of Consideration Varies

We recommend that Treasury and the Service clarify how the Proposed COI Regulations apply to transactions where the relevant contract allows for more than one type of consideration to vary in accordance with the price of the P stock above a floor, below a ceiling, or both.[39] Under Prop. Treas. Reg. § 1.368-1(e)(vi)(A) and (B), the Floor Price Rule and the Ceiling Price Rule apply when the amount of "an" item of consideration varies. It is unclear whether these rules apply in cases where "items" of consideration vary, such as the following:

> ***Example 5A. Two items of consideration vary within a collar; subject to same floor and ceiling.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the amount of cash and/or the number of shares of P stock paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, if the price of P stock drops below $0.80 or increases above $1.20 per share, T shareholders will receive the amount of cash and the number of shares of P stock to which they would have been entitled had the price of P stock at the closing date equaled $0.80 or $1.20 per share, respectively.

[39] Note that this recommendation applies whether or not Treasury and the Service adopt our recommendation outlined in Part IV, *supra*.

Example 5B. Two items of consideration vary within one collar; cash subject to floor and stock subject to ceiling. Same as Example 5A, except if the price of P stock at the closing date is below $1 per share, the amount of cash to be paid to T shareholders will increase, such that aggregate consideration equals $100, and if the price of P stock at the closing date is above $1 per share, the number of shares of P stock to be paid to T shareholders will decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than $60 of cash or less than 41.67 shares of P stock.

Example 5C. Two items of consideration vary within one collar; stock subject to floor and cash subject to ceiling. Same as Example 5A, except if the price of P stock at the closing date is below $1 per share, the number of shares of P stock to be paid to T shareholders will increase, such that aggregate consideration equals $100, and if the price of P stock at the closing date is above $1 per share, the amount cash to be paid to T shareholders will decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 62.5 shares of P stock or less than $40 of cash.

If the Proposed COI Regulations apply where more than one item of consideration varies in accordance with the price of the P stock, we believe that, in Examples 5A, 5B, and 5C, COI would be measured under the Closing Date Rule if, at closing, the price of the P stock were between $0.80 and $1.20 (inclusive), and the COI Requirement would be satisfied. On the other hand, if, at closing, the price of the P stock were below $0.80 or above $1.20, COI would be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement would be satisfied. We believe that the principles supporting the application of the Floor Price Rule and the Ceiling Price Rule to situations in which either the stock or cash consideration varies above a floor, below a ceiling, or both also support the application of these rules to situations in which, within the same range of prices, more than one item of consideration varies. We recommend one or more examples to this effect in final regulations.[40]

[40] While Example 5A discusses a collar, the same principle should apply to a contract that provides that more than one item of consideration will vary in accordance with the price of P stock above a floor (only) or below a ceiling (only).

We also recommend that Treasury and the Service clarify the application of the Floor Price Rule and the Ceiling Price Rule where more than one item of consideration varies in accordance with the price of the P stock, and each is subject to a different floor, ceiling, or collar.[41]

> ***Example 6A. Two items of consideration vary, but are subject to different collars; stock subject to narrower collar.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the number of shares paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 62.5 or less than 41.67 shares of P stock (*i.e.*, with respect to stock consideration, the Floor Price is $0.80, and the Ceiling Price is $1.20). If the price of P stock drops below $0.80 or increases above $1.20, the amount of cash paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than $60 or less than $40 of cash (*i.e.*, with respect to cash consideration, the Floor Price is $0.64, and the Ceiling Price is $1.44).

> ***Example 6B. Two items of consideration vary, but are subject to different collars; cash subject to narrower collar.*** Same as Example 6A, except if the price of P stock at the closing date is below or above $1 per share, the amount of cash paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than $60 of cash or less than $40 of cash (*i.e.*, with respect to cash consideration, the Floor Price is $0.80, and the Ceiling Price is $1.20). If the price of P stock drops below $0.80, the number of shares of P stock paid to T shareholders will increase, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 62.5 or less than 41.67 shares of P stock (*i.e.*, with respect to stock consideration, the Floor Price is $0.64, and the Ceiling Price is $1.44).

The application of the Floor Price Rule and the Ceiling Price Rule in Examples 6A and 6B is uncertain, because the Proposed COI Regulations seem to assume one Floor Price and/or one Ceiling Price. Further, Prop. Treas. Reg. § 1.368-1(e)(2)(vi)(A) and (B) provides that, under either rule, COI is measured as if "the" consideration was issued and valued based upon the

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[41] Note that this recommendation applies whether or not Treasury and the Service adopt our recommendation outlined in Part IV, *supra*.

Floor Price or the Ceiling Price, as the case may be. It is unclear whether "the" consideration refers to the consideration subject to the particular Floor Price or Ceiling Price (such that, in Example 6A, if the value of the P stock at the closing date were $0.30, COI would be determined as if the P stock were valued and issued at its Floor Price ($0.80) and as if the cash were valued and issued at its Floor Price ($0.64) or whether COI is determined as if *all* consideration were valued and issued at the same Floor Price. We believe that the more appropriate interpretation is the latter. Because the T shareholders receive the benefit of full price protection between the "narrow" collar and the "wide" collar (or, in transactions with a floor only or ceiling only, between the higher floor and the lower floor or between the lower ceiling and the higher ceiling, respectively), in a situation where various items of consideration are subject to different collars (or floors or ceilings), the Floor Price should equal the lowest Floor Price and the Ceiling Price should equal the highest Ceiling Price (the "Low-High Rule"). We recommend that Treasury and the Service include an example in the final regulations that addresses a situation in which there is more than one floor and/or ceiling and explain the application of the rules in such a case.[42]

Finally, we recommend that Treasury and the Service clarify and, where appropriate, limit the application of the Floor Price Rule and the Ceiling Price Rule in situations where more than one item of consideration varies in accordance with the price of the P stock, but not all

[42] While Examples 6A and 6B discuss collars, the same principle applies to any contract that provides that more than one item of consideration will vary in accordance with the price of P stock and each item is subject to a different floor (with a ceiling applicable to less than all items or no items of consideration) or each item is subject to a different ceiling (with a floor applicable to less than all items or no items of consideration).

items of consideration are subject to a floor, ceiling, or both (*i.e.*, a portion of the consideration is fully variable).[43]

> ***Example 7A. Two items of consideration vary, but only stock is subject to a collar.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the amount of cash or the number of shares of P stock paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 62.5 or less than 41.67 shares of P stock (*i.e.*, with respect to stock consideration, the Floor Price is $0.80, and the Ceiling Price is $1.20).

> ***Example 7B. Two items of consideration vary, but only cash is subject to a collar.*** Same as Example 7A, except in no event will T shareholders receive more than $60 of cash or less than $40 of cash (*i.e.*, with respect to cash consideration, the Floor Price is $0.80, and the Ceiling Price is $1.20).

> ***Example 7C. Two items of consideration vary, only stock is subject to a collar, and cash consideration varies, but not in accordance with the price of P stock.*** Same as Example 7A, except if the price of P stock at the closing date is below or above $1 per share, the number of shares of P stock paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 62.5 or less than 41.67 shares of P stock (*i.e.*, with respect to stock consideration, the Floor Price is $0.80, and the Ceiling Price is $1.20). Further, the cash paid to T shareholders will increase or decrease depending on the outcome of the 2012 Presidential election and may result in aggregate consideration to T shareholders decreasing below or increasing above $100.

It is clear that, in both Examples 7A and 7B, the T shareholders have full price protection, and the consideration is thus not "fixed," even outside of the so-called collar. Further, in Example 7C, the T shareholders have some price protection within the collar, but are never fully protected, as the adjustments in cash consideration are wholly unrelated to the price of the P stock. Thus, the consideration is not "fixed" within or outside of the collar. However, because Prop. Treas. Reg. § 1.368-1(e)(2)(A) and (B) applies the Floor Price Rule and the Ceiling Price Rule to

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[43] Note that this recommendation applies whether or not Treasury and the Service adopt our recommendation outlined in Part IV, *supra*.

situations in which “an” item of consideration varies in accordance with the price of the P stock above or below a specified price, Examples 7A, 7B, and 7C each appear to fall within the literal language of the Proposed COI Regulations. We recommend that Treasury and the Service clarify that, in order for the Floor Price Rule and the Ceiling Price Rule to apply, all items of consideration must remain fixed below the floor and/or above the ceiling, as applicable. Under this approach, the transactions in Examples 7A, 7B, and 7C would be subject to the Closing Date Rule because the Floor Price Rule and Ceiling Price Rule would not apply.[44]

C. Non-Cash Boot

We recommend that Treasury and the Service clarify whether the Floor Price Rule and the Ceiling Price Rule apply in circumstances in which, in addition to P stock, the consideration paid to the T shareholders also includes non-cash boot (*i.e.*, “other property”).[45]

> ***Example 8A. Contingent consideration is non-cash boot.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive 50 widgets plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share and the fair market value of 1 widget is $1. If the price of P stock at the closing date is below or above $1 per share, the number of widgets paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 60 or less than 40 widgets (*i.e.*, the Floor Price is $0.80, and the Ceiling Price is $1.20).

> ***Example 8B. Fixed consideration is non-cash boot; other consideration varies based on price of P stock.*** Same as Example 8A, except if the price of P stock at the closing date is below or above $1 per share, the number of shares of P stock paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 62.5 or less than 41.67 shares of P stock (*i.e.*, the Floor Price is $0.80, and the Ceiling Price is $1.20).

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[44] While Examples 7A and 7B discuss collars, the same principle applies to any contract that provides that more than one item of consideration will vary in accordance with the price of P stock and not all items are subject to a floor or ceiling.

[45] Note that this recommendation applies whether or not Treasury and the Service adopt our recommendation outlined in Part IV, *supra*.

We believe there is no reason to distinguish between cash and non-cash boot for purposes of the Floor Price Rule and the Ceiling Price Rule, as each is treated in an equivalent manner with respect to the measurement of COI.[46] Also, as noted in the November 2004 Report, "taxpayer uncertainty regarding whether the [COI Requirement] will be satisfied due to pre-closing changes in [P] stock value exists equally in transactions involving merger consideration consisting of [P] stock and cash and in transactions involving merger consideration consisting of [P] stock and other types of boot."[47] Thus, we believe it would be helpful to clarify that the Floor Price Rule and the Ceiling Price Rule apply if one or more items of consideration consist of non-cash boot and to provide one or more examples discussing the application of these rules in such situations.

Further, we believe that Treasury and the Service should clarify when such non-cash boot is valued for purposes of measuring COI.[48] Because the Proposed COI Regulations do not address this question, the result in transactions involving non-cash boot is uncertain. As the Proposed COI Regulations are meant to provide certainty to taxpayers of the tax status of transactions at the time they enter into binding agreements, we recommend that non-cash boot be valued at the pre-signing date, and not the closing date, for purposes of measuring COI. This rule should apply when the non-cash boot varies according to the price of the P stock, subject to a floor and/or ceiling (see Example 8A), and when the non-cash boot is fixed and the stock (and, possibly, cash) consideration varies (see Example 8B). We also believe such a rule is necessary simply to preserve the equal treatment of cash and non-cash boot for purposes of measuring COI.

[46] *See* Treas. Reg. § 1.368-1(e)(1)(i) ("a propriety interest in the target corporation is not preserved if . . . it is acquired by the issuing corporation for consideration ***other than*** stock of the issuing corporation") (emphasis added).

[47] November 2004 Report, at 24.

[48] Note that this recommendation applies whether or not Treasury and the Service adopt our recommendation outlined in Part IV, *supra*.

Taxpayers know, with certainty, the value of cash consideration on the signing date for purposes of setting a Floor Price or Ceiling Price beyond which the cash consideration will remain fixed and should similarly be able to value non-cash boot at the pre-signing date for purposes of setting such limitations on such boot. Therefore, in both Examples 8A and 8B, we believe that the widgets should be valued at their pre-signing date value of $1 per widget, regardless of their fair market value on the closing date.[49]

D. Addressing the Potential for Taxpayer Manipulation

As discussed above and subject to our primary recommendation in Part IV, we generally agree with the principles and application of the Floor Price Rule and the Ceiling Price Rule. However, because the Proposed COI Regulations allow taxpayers to (1) set the Floor Price and/or Ceiling Price equal to the pre-signing date price of the P stock and (2) create as "narrow" or as "wide" a collar as possible, the rules may apply to transactions that employ atypical, and perhaps tax-motivated, pricing mechanisms in which the actual value of the package of equity consideration payable to the T shareholders as of the signing date is less than the amount necessary to satisfy the COI Requirement.[50] As discussed further below, the broad application of these rules may allow transactions to satisfy the COI requirement even though they do not accord with the theoretical underpinnings of the Floor Price Rule and the Ceiling Price Rule. We recommend that Treasury and the Service reconsider the Proposed COI Regulations in light of the situations addressed in this Part V.D.

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[49] While Examples 8A and 8B discuss collars, the same principle applies to any contract that provides for non-cash boot consideration and at least one item of consideration varies in accordance with the price of P stock and is subject to a floor (only) or a ceiling (only).

[50] See also Part IV, *supra*, discussing asymmetric collars.

1. Setting the Floor at the Pre-Signing Date Value

Because the Proposed COI Regulations define the Floor Price to include the pre-signing date price,[51] it is possible for a taxpayer to structure a transaction that satisfies the COI Requirement even though the actual value of the P stock payable to the T shareholders at signing is less than 40 percent of total consideration.

> ***Example 9A. Floor Price equals pre-signing date price; no ceiling; stock adjusts.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $60 of cash plus 40 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is above $1 per share, the number of shares of P stock to be paid to T shareholders will decrease, such that the total nominal value of the P stock will be $40. If the price of P stock at the closing date is below $1, T shareholders will not receive more than 40 shares of P stock (*i.e.*, the Floor Price is $1) so the nominal value of the P stock will be less than $40. If, at closing, the price of P stock is at or above $1, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $1, COI will be measured under the Floor Price Rule, and the COI Requirement will be satisfied.

In this example, when the parties enter into the binding contract, the actual value of the equity consideration payable to the T shareholders on the signing date is less than 40 percent of the total consideration because the T shareholders will receive P stock on the Closing Date with a value that is either less than or equal to 40 percent of the total consideration, but never greater than 40 percent. Consequently, the T shareholders bear all of the risk of loss of owning the P stock but enjoy none of the potential benefits of owning the P stock. As an economic matter, the P stock is subject to an embedded call option with a strike price equal to the Floor Price. On the signing date, therefore, a third party would pay no more than $40 *minus* the value of the embedded call option in favor of P for the equity rights being issued to the T shareholders. Although the equity rights being issued to the T shareholders are worth, on the signing date, less than 40 percent of the total consideration (equity rights plus $60 of cash) payable to the T shareholders, the parties

[51] Prop. Treas. Reg. § 1.368-1(e)(2)(vi)(A), (B).

in this example are nevertheless able to satisfy the COI Requirement under the Floor Price Rule. For reasons similar to those discussed in the case of Examples 2A and 2B, we believe allowing the T shareholders to utilize the Floor Price Rule where the Floor Price is set at or near the pre-signing date value of the P stock presents opportunities for taxpayers to rely on the Signing Date Rule in transactions that are fundamentally inconsistent with its principles.[52]

A similar problem arises on the same facts even if the cash is the only consideration subject to adjustment:

> ***Example 9B. Floor Price equals pre-signing date price; no ceiling; cash adjusts.*** Same as Example 9A, except that 40 shares of P stock are always issued. However, if the price of P stock at the closing date is above $1 per share, the amount of cash to be paid to T shareholders will decrease, such that aggregate consideration equals $100. In no event will T shareholders receive more than $60 of cash (*i.e.*, the Floor Price is $1). If, at closing, the price of P stock is at or above $1, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $1, COI will be measured under the Floor Price Rule, and the COI Requirement will be satisfied.

Here, although the 40 shares of P stock may appreciate from $40 to $100 between the signing date and the closing date, the benefit of the appreciation to the T shareholders is fully offset by a dollar-for-dollar reduction in the cash consideration. As in Example 9A, the T shareholders still bear all of the risk of owning the P stock but none of the potential benefits of owning the P stock. In effect, the T shareholders are receiving, as of the signing date, 40 shares of P stock, $60 of cash, and an obligation under a cash settled call option on the P stock at $1 per share. Because a third party would pay no more than $40 *minus* the value of the embedded call option for the right

[52] Indeed, whereas Examples 2A and 2B presented situations where the T shareholders had severely limited exposure to upward fluctuations in the price of P stock, in Examples 9A and 9B, the consideration is *fully* variable and the T shareholders enjoy *no* upside above the Floor Price (*i.e.*, at every point above the pre-signing date price), yet they bear all of the downside below the Floor Price.

to receive the P stock in this example, the actual value of the P stock on the signing date (net of the embedded call option) is less than 40 percent of the total consideration.[53]

2. Setting the Ceiling at the Pre-Signing Date Value

Because the Proposed COI Regulations also define the Ceiling Price to include the pre-signing date price, they allow taxpayers the ability to ensure the status of a transaction as taxable regardless of the value of the P Stock on the Closing Date.

> ***Example 10. Ceiling Price equals pre-signing date price; no floor; stock adjusts; taxable transaction.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $70 of cash plus 30 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below $1 per share, the number of shares of P stock to be paid to T shareholders will increase, such that aggregate consideration equals $100. However, in no event will T shareholders receive less than 30 shares (*i.e.*, the Ceiling Price is $1). If, at closing, the price of P stock is at or below $1, COI will be measured under the Closing Date Rule, and the COI Requirement will not be satisfied. If, at closing, the price of P stock is above $1, COI will be measured under the Ceiling Price Rule, and the COI Requirement will not be satisfied.

For reasons similar to the reasons in Examples 9A and 9B, the actual value of the P stock on the signing date is greater than 30 percent of the total consideration because the T shareholders would benefit from upward fluctuations in the price of the P stock, but would not be subject to any potential risks of owning the P stock.

Here, however, the taxpayer is seeking to establish certainty that the transaction will be taxable even if the price of the P stock on the closing date is higher than the price of the P stock on the pre-signing date and represents 40 percent or more of the total consideration at that time. As with Examples 2A, 2B, 9A, and 9B above, the application of the Ceiling Price Rule to a

[53] In fact, the cost of an implicit call or put premium is present in many of the examples described in this Report except in the case of a collar in which the benefit of the Ceiling Price is equal to the detriment of the Floor Price.

transaction in which the binding contract severely limits the T shareholders' economic exposure seems at odds with the theory supporting the Signing Date Rule and the Proposed COI Regulations.

In this case, the transaction is automatically taxable even if both (1) as of the closing date, more than 40 percent of the total consideration is P stock and (2) as of the signing date, a third party would pay, say, $50 for the right to receive the P stock to be issued in the merger (so that the value of the P stock is 50/(70+50), or over 40 percent of the total value). As discussed above, by allowing (in fact, requiring) taxpayers to measure COI by reference to the Ceiling Price in situations where the T shareholders have no (or little) exposure to downward fluctuations in the value of the P stock, we believe the Proposed COI Regulations may reach results that do not comport with the theoretical foundation of the regulations. If the theory supporting application of the Ceiling Price Rule is that, above the ceiling, the T shareholders are subject to the economic fortunes of the ownership of P stock, perhaps the fact that the T shareholders have full price protection at all prices below the pre-signing date price is irrelevant in determining eligibility for the Ceiling Price Rule. However, as discussed above, the announced principle instead appears to be related to whether the T shareholders have economic exposure on the signing date and the contract provides for "fixed consideration," subject to "market" price protection mechanisms. Thus, we recommend that Treasury and the Service reconsider the broad application of the Ceiling Price Rule in light of the relevant principles and clarify whether the rule applies to situations such as Examples 9A, 9B and 10.

3. Width of Collar

The Proposed COI Regulations do not require that the range of prices between the Floor Price and the Ceiling Price be reasonable, in line with market expectations for the price of the P

stock, or, as discussed in Part IV above, symmetric. While we generally believe that wide collars present little opportunity for abuse, for reasons similar to those discussed with respect to Examples 2A, 2B, 9A, and 9B, we believe that certain narrow collars may present opportunities for taxpayer manipulation. However, when a collar is sufficiently narrow, such that the consideration paid to the T shareholders is nearly fixed, we believe application of the Floor Price Rule and the Ceiling Price Rule comports with the theory underlying the Proposed COI Regulations.

> ***Example 11A. Wide collar; symmetric; cash varies.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the amount of cash to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than $99.5 of cash or less than $0.50 of cash (*i.e.*, the Floor Price is $0.01, and the Ceiling Price is $1.99). If, at closing, the price of P stock is between $0.01 and $1.99, COI will be measured under the Closing Date Rule, and the COI Requirement may or may not be satisfied. If, at closing, the price of P stock is below $0.01 or above $1.99, COI will be measured under the Floor Price Rule (and the COI Requirement will not be satisfied) or the Ceiling Price Rule (and the COI Requirement will be satisfied), respectively.

> ***Example 11B. Wide collar; symmetric; stock varies.*** Same as Example 11A, except if the price of P stock at the closing date is below or above $1 per share, the number of shares of P stock to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 5000 or less than 25.13 shares (*i.e.*, the Floor Price is $0.01, and the Ceiling Price is $1.99). If, at closing, the price of P stock is between $0.01 and $1.99, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $0.01 or above $1.99, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.

As illustrated in these examples, the wider the range of values within a collar, the more likely it is that the taxpayer will be required to measure COI under the Closing Date Rule. Accordingly, we believe that wide collars typically do not present opportunities for transactions to qualify as

tax-free reorganizations under the Proposed COI Regulations that are inconsistent with their purpose.[54] Further, in transactions providing for adjustments to cash consideration in accordance with the value of the P stock, as the Floor Price decreases below a price at which the COI Requirement would be satisfied, as in Example 11A, the collar is no longer useful—there is no longer certainty as to the tax status of the transaction at signing, even under the Floor Price Rule. Likewise, an artificially high Ceiling Price presents no benefit to a taxpayer seeking to preserve tax-free status (as the Ceiling Price is meaningless in this regard) and presents an increasingly smaller benefit to taxpayers seeking to preserve the taxable nature of a transaction as it moves higher. However, with a wide, asymmetric collar where the Floor Price is set to equal the pre-signing date price (as in Examples 2A and 2B discussed in Part IV above) taxpayers may benefit from the Floor Price Rule even though the actual value of the P stock on the signing date is less than 40 percent of the total consideration.[55]

Where collars are "narrowed" to a limited range of prices surrounding the pre-signing date value, taxpayers may be able to structure a transaction in a manner that is guaranteed to satisfy the COI Requirement despite an expectation that the price of the P stock will decrease after the signing date.

> ***Example 12A. Narrow collar; symmetric; cash varies.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $50 of cash plus 50 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock at the closing date is below or above $1 per share, the amount of cash to be paid to T shareholders will increase or decrease, such that aggregate consideration equals

[54] At first glance, wide collars do not seem to comport with the underlying principle of the Proposed COI Regulations and the Signing Date Rule because they result in largely variable rather than "fixed" consideration. However, where it is unlikely that the price of P stock at closing will fall outside of the collar, it is unlikely that the Floor Price Rule and the Ceiling Price Rule will apply. As a result, most wide collars will trigger the application of the Closing Price Rule, which we believe is appropriate for any transaction in which the consideration is largely variable.

[55] See Examples 2A, 2B, 9A, and 9B, *supra*, and accompanying discussion.

> $100. However, in no event will T shareholders receive more than $50.50 of cash or less than $49.50 of cash (*i.e.*, the Floor Price is $0.99, and the Ceiling Price is $1.01). If, at closing, the price of P stock is between $0.99 and $1.01, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $0.99 or above $1.01, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.
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> ***Example 12B. Narrow collar; symmetric; stock varies.*** Same as Example 12A, except if the price of P stock at the closing date is below or above $1 per share, the number of shares of P stock to be paid to T shareholders will increase or decrease, such that aggregate consideration equals $100. However, in no event will T shareholders receive more than 50.50 or less than 49.50 shares (*i.e.*, the Floor Price is $0.99, and the Ceiling Price is $1.01). If, at closing, the price of P stock is between $0.99 and $1.01, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $0.99 or above $1.01, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.
>
> ***Example 13A. Narrow collar; asymmetric; cash varies.*** Same as Example 12A, except in no event will T shareholders receive more than $50 of cash or less than $49.50 of cash (*i.e.*, the Floor Price is $1, and the Ceiling Price is $1.01). If, at closing, the price of P stock is between $1 and $1.01, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $1 or above $1.01, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.
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> ***Example 13B. Narrow collar; asymmetric; stock varies.*** Same as Example 12B, except in no event will T shareholders receive more than 50 or less than 49.50 shares (*i.e.*, the Floor Price is $1, and the Ceiling Price is $1.01). If, at closing, the price of P stock is between $1 and $1.01, COI will be measured under the Closing Date Rule, and the COI Requirement will be satisfied. If, at closing, the price of P stock is below $1 or above $1.01, COI will be measured under the Floor Price Rule or the Ceiling Price Rule, respectively, and the COI Requirement will be satisfied.

The price mechanisms described in Examples 12A, 12B, 13A, and 13B result in nearly "fixed consideration" transactions, which, if completely fixed, would have qualified under the Signing Date Rule. Instead, under the Floor Price Rule and the Ceiling Price Rule, the P stock may be valued for purposes of the COI Requirement at prices only immaterially different from the pre-signing date price. While, as discussed above, the application of the Floor Price Rule to

transactions such as these may provide a benefit to taxpayers despite an expectation that the price of the P stock will decline after signing, such benefit is significantly restricted. The proximity of the Floor Price and the Ceiling Price to the pre-signing date value constrains the opportunity for taxpayer manipulation. Indeed, where the Floor Price and Ceiling Price equal the pre-signing date value, the "collar" is a null set, resulting in a fixed consideration deal subject to the Signing Date Rule. We believe that narrow collars generally present a lesser degree of opportunity for taxpayer manipulation because they convey greater economic exposure to the P stock (*i.e.*, the price protection is very limited). Thus, the theory motivating the Proposed COI Regulations strongly supports the application of the Floor Price Rule and the Ceiling Price Rule to narrow collars and we recommend that Treasury and the Service clarify that these rules are intended to apply to situations similar to those described above.

VI. Average Price Mechanisms and Measuring the Value of P Stock

A. Average Price Rule

Prop. Treas. Reg. § 1.368-1(e)(2)(vi)(C) provides that, in cases where a binding contract utilizes the average price of the P stock at dates after signing and before closing in order to determine the consideration to be paid to the T shareholders, in determining the closing date value of the P stock for purposes of measuring COI, an average value of prices of P stock "may" be used in lieu of the closing date price. Like the Floor Price Rule and the Ceiling Price Rule, the Average Price Rule allows taxpayers to measure COI based on the price at which the T shareholders become subject to the economic fortunes of owning the P stock. We agree with the premise for the Average Price Rule, but do not believe it is necessary for this rule, unlike the similarly premised Signing Date Rule, Floor Price Rule, and Ceiling Price Rule, to apply only at

a taxpayer's election. Thus, we recommend that Treasury and the Service make the Average Price Rule mandatory, not elective.

B. Measuring the Value of P Stock

Although each of the Signing Date Rule, the Floor Price Rule, and the Ceiling Price Rule depends on a certain "value" of P stock in determining whether the relevant rule applies and/or in ultimate application of the rule to measure COI, neither the Code nor the Treasury regulations specifies how such stock is to be valued. Specifically, the Signing Date Rule requires that the P stock "be valued on the last business day before the first date such contract is a binding contract (the pre-signing date)," but does not elaborate any further.[56] The Floor Price Rule and the Ceiling Price Rule, on the other hand, allow COI to be measured based on the Floor Price or the Ceiling Price only if (1) the Floor Price is set at or below the "value" of the P stock on the pre-signing date and/or the Ceiling Price is set at or above the "value" of the P stock on the pre-signing date and (2) the "value" of the P stock on the closing date is below the Floor Price or above the Ceiling Price.[57] The relevant regulations do not provide guidance as to how the relevant "value" in each case is to be determined.

Taxpayers commonly use a variety of different valuation methodologies in an effort to establish a reasonable proxy for the "value" of a stock as of a certain date. Such methodologies include averaging the high and low prices of the stock on the relevant date, using the closing price of the stock at the end of trading on the relevant date, or using the "volume weighted average price" of the stock (a measurement provided by Bloomberg that averages trades on a particular day). As we noted in the November 2004 Report, using average values is a more

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[56] Treas. Reg. § 1.368-1(e)(2)(i).

[57] Prop. Treas. Reg. § 1.368-1(e)(2)(vi)(A), (B).

stable and representative measure of the value of a particular stock on a certain date.[58] Although each of these is a commonly accepted method of measuring stock value, taxpayers cannot be certain that any of these would survive scrutiny by the Service. Because both the Final COI Regulations and the Proposed COI Regulations are intended to provide taxpayers with certainty in the context of determining, at the signing date, whether corporate transactions will qualify as tax-free reorganizations, we recommend that Treasury and the Service remove the ambiguity surrounding the calculation of stock value. To that end, guidance as to how taxpayers should value P stock for purposes of measuring COI would be welcome.

VII. The Final COI Regulations: Contract Modifications vs. Contingent Adjustments

With respect to the Final COI Regulations, we recommend that Treasury and the Service resolve an apparent discrepancy between the rules that apply to contract modifications and those that apply to contingent adjustments to consideration, where such modifications and contingent adjustments have an equivalent effect on the Stock-Cash Ratio.

With respect to contract modifications, Treas. Reg. § 1.368-1(e)(2)(ii)(B) generally provides that, for purposes of the Signing Date Rule, the signing date of a binding contract that is later modified is the date of such modification. Under Treas. Reg. § 1.368-1(e)(2)(ii)(B)(2), however, if the transaction would have satisfied the COI Requirement under the terms of the original contract and such modification (1) has the sole effect of increasing the number of shares of P stock to be paid to the T shareholders, (2) has the sole effect of decreasing the amount of boot to be paid to the T shareholders, or (3) decreases the amount of boot and increases the number of shares of P stock to be paid to the T shareholders, the modification will not be treated as such, and thus, the original signing date will remain unchanged.

[58] November 2004 Report, at 22.

> ***Example 14A. Contract modification.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive fixed consideration of $60 of cash plus 40 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. After the signing date, and before the closing date, P and T amend the contract to increase the stock consideration by 20 shares. As of the end of the day before the date of the contract modification, P stock is trading at $0.40 per share. Because the modification has the sole effect of increasing the number of P shares to be paid to T shareholders and the original contract terms satisfied the COI Requirement, the modification will not be treated as such for purposes of the Signing Date Rule. Satisfaction of the COI Requirement will therefore be measured based on the pre-signing date value of $1 per share, and the COI Requirement will be satisfied.

In Example 14A, the value of the P stock on the date prior to the modification date was only $0.40, which would not satisfy the COI Requirement if measured based on that value. Because the modification has the sole effect of increasing the number of shares of P stock to be paid to the T shareholders, however, COI is measured based on the original pre-signing date value.

With respect to contingent adjustments to consideration in the original contract, Treas. Reg. § 1.368-1(e)(2)(ii)(C)(2) provides that a contract will not be treated as providing for "fixed consideration," and thus will not qualify under the Signing Date Rule, if it "provides for contingent adjustments to the consideration that prevent (to any extent) the target corporation shareholders from being subject to the economic benefits and burdens of ownership" of P stock after the pre-signing date.

> ***Example 14B. Contingent adjustment to consideration.*** P and T sign a binding contract pursuant to which T will be merged with and into P. Pursuant to the contract, T shareholders will receive $60 of cash plus 40 shares of P stock. At the pre-signing date, P stock is trading at $1 per share. If the price of P stock declines in value to $0.40 per share, the T shareholders will receive an additional 20 shares of P stock. On the closing date, P stock is trading at $0.40 per share. T shareholders receive $60 of cash and 60 shares of P stock. Because the contract provides for contingent adjustments to consideration paid to T shareholders based on fluctuations in the value of P stock, the transaction does not provide for "fixed consideration" and therefore does not qualify for the Signing Date Rule. COI is measured based on the closing date value of P stock, and the COI Requirement is not satisfied.

In Example 14B, where the T shareholders are entitled to additional shares of P stock as the price of the P stock decreases, the transaction does not qualify for the Signing Date Rule. However, had the parties provided for "fixed consideration" in the original contract and, when the value of the P stock had declined to $0.40 per share, modified the contract to increase the number of shares paid to the T shareholders (Example 14A), the transaction would have qualified for the Signing Date Rule, as explained above. The economic results of Examples 14A and 14B are identical: in both cases, the T shareholders are entitled to $60 of cash consideration and 60 shares of P stock. In each instance, the parties adjust the number of shares of P stock paid to the T shareholders in accordance with the price of the P stock at a certain date: in Example 14A, by way of amendment and, in Example 14B, pursuant to the terms of the original contract. Yet in Example 14A the COI Requirement is satisfied and in Example 14B it is not.

We believe the distinction between a contract modification that provides for additional stock consideration, less cash consideration, or both, and an identical contingent adjustment mechanism in a contract providing the same is anomalous. If parties to a transaction may amend their agreement by way of a modification to provide for certain adjustments to stock and cash consideration without jeopardizing their ability to measure COI based on the pre-signing date value of the P stock, they should be afforded the flexibility to provide for the same contingent adjustments in the original contract. We recommend that Treasury and the Service amend the rules with respect to contingent adjustments to ensure parity in the treatment of otherwise identical transactions.