Continuity of Interest and Valuing Acquirer Stock

By Donald P. Board • Wood LLP

The purpose of the reorganization provisions is to defer the taxation of transactions that "effect only a readjustment of continuing interest in property under modified corporate forms." [Reg. §1.368-1(b).] That sounds broad and even relatively simple. But an enormous amount of statutory, regulatory and judicial energy has been devoted to the question of *which* transactions provide a "continuing interest" that justifies an exemption from current tax.

From the beginning, the most important continuity issue has been continuity of *proprietary* interest. For this species of continuity to be maintained, "a substantial part" of the value of the proprietary interests in the target corporation must be preserved in the reorganization. [Reg. §1.368-1(e)(1).] A proprietary interest in the target is preserved if it is exchanged for a proprietary interest in the acquiring corporation or its controlling parent (in either case, the "issuing corporation").

For most types of transactions, the Code specifies how much stock must be exchanged to preserve a "substantial portion" of the proprietary interests in the target. For example, a transaction can qualify as a "C" reorganization if the acquiring corporation acquires the target's assets "solely" for voting stock of the issuing corporation, although Code Sec. 368(a)(1)(C) disregards the acquirer's assumption of target liabilities for this purpose. If the deal includes any non-qualifying consideration, the reorganization will fail unless the voting stock represents at least 80 percent of the value of the target's property. [Code Sec. 368(a)(2)(B).]

In the most important type of transaction, however, Congress has left the continuity issue to the courts. In statutory mergers and consolidations paid for with acquirer stock, it is generally accepted that the shares must constitute at least about 40 percent of the total consideration. Code Sec. 368(a)(1)(A) is silent on this fundamental point, but practitioners and the IRS having making do with case law for over 80 years. [*See, e.g.*, *John A. Nelson Co.*, SCt, 36-1 USTC ¶9019, 296 US 374, 56 SCt 273 (approving acquirer's payment of 38.5 percent preferred stock and 61.5 percent cash).]

These quantitative thresholds look to the *value* of the issuing corporation's shares as a percentage of the total deal consideration. Hence, the tax treatment of a purported reorganization can sometimes depend on the conventions and methods employed to determine how much the issuing corporation's shares and the other property are worth.

Timing is Everything

Assets values go up and down, so the *date* on which the issuing corporation's shares or other property is valued can prove decisive. The IRS's historical position was that the value of the consideration should be determined as of the *effective date* of the transaction. [*See* Rev. Proc. 77-37, 1977-2 CB 568.]

This "closing-date rule" makes perfect theoretical sense. However, it exposes the parties to the practical risk that their intended tax treatment will be lost if the relative value of the issuing corporation's stock *declines* in the interval between signing the acquisition agreement and closing the deal. Acquirer stock that represents a healthy 45 percent of the consideration when the papers are inked may limp in at only 30 percent when it's time to close.

In 2011, the Treasury and the IRS addressed this concern in deals involving *fixed* consideration (as defined in Reg. §1.368-1(e)(2)(iii)(A)). Under the "signing-date rule," the consideration is valued as of the close of the last business day before the parties enter into a *binding commitment* to do the deal. [*See* Reg. §1.3681(e)(2)(i).] If the continuity-of-interest numbers work at signing, there is no need to worry about relative values at closing.

Progression Towards the Mean

At about the same time that the IRS adopted the signing-date rule, it solicited comments concerning the mechanics of valuing publicly traded shares. For decades, the principal valuation guidance has lain a-moldering in the estate tax regulations, of all places. Under Reg. §20.2031-2(b)(1), the fair market value of publicly traded stocks and bonds is the average of the highest and lowest selling prices on the fatal date.

When the IRS reviewed the comments, it discovered that real actors in the business world want to base their valuations on the average of *multiple* trading days. That includes publicly traded issuing corporations negotiating the terms of reorganization agreements. However much they may revere the securities markets, publicly traded companies do not want to hazard everything on a single roll of the dice.

On January 23, 2018, the IRS issued Rev. Proc. 2018-12 [2018-6 IRB 1], where it acknowledged that popular averaging methods often produce more reliable estimates of the fair market value of an issuing corporation's stock. The IRS has therefore concluded that taxpayers should be able to employ averaging methods when testing for continuity of proprietary interest.

Taxpayers may now select from among three "Safe Harbor Valuation Methods." [*See* Rev. Proc. 2018-12, §4.01.] Each method calculates a slightly different mean value for the issuing corporation's stock over a series of consecutive trading days (Measuring Period). The three means are: (1) the average daily closing price;

(2) the average daily high-low mean price; and (3) the average daily volume-weighted price.

Under Rev. Proc. 2018-12, §4.02, taxpayers can select the length of their Measuring Period, but it must be between five and 35 days. If the signing-date rule applies to a transaction, the Measuring Period must end on the date that the parties enter into their binding commitment, or on a date no more than three days before that date. If the transaction is subject to the closing-date rule, the same rule applies, but this time using the closing date.

For the revenue procedure to apply, the shares of the issuing corporation must be traded on a national securities exchange that has been registered with the SEC under Section 6 of the Securities Exchange Act of 1934. The reorganization agreement must be a binding contract that identifies: (1) the Safe Harbor Valuation Method that the parties have selected; (2) their chosen Measuring Period; and (3) the national securities exchange on whose trading data they wish to rely. [Rev. Proc. 2018-12, §3.]

What's Not to Like?

It is hard to find fault with Rev. Proc. 2018-12. Allowing taxpayers to value the issuing corporation's stock by averaging a series of trading prices seems like a sensible accommodation to commercial practice and convenience. Currently, these mean valuations can only be used when testing for continuity of proprietary interest. Nevertheless, Rev. Proc. 2018-12 is a step in the right direction.

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