Continuing the Continuity-of-Interest Dance

By Robert W. Wood • Wood & Porter • San Francisco

The continuity-of-interest requirement is simple: A substantial part of the value of the proprietary interests in a target corporation must be preserved in the reorganization. Sounds easy, and we often assume its presence like sauce at a barbecue. It is one of the important tickets to tax-free reorganization treatment. The target shareholders must end up with a stake in the acquiring company.

Yet practitioners have historically struggled not only with the question of how *much* continuity is enough, but especially with the question of precisely *when* one measures it. After all, what happens if there are changes in the value of the acquiring corporation's stock between signing and closing? Proposed regulations in 2007 sensibly took the position that the consideration to be exchanged for the proprietary interests in the target should be valued on the last business day before the first date of the binding contract.

That nicely ensures that any changes in the value of the acquiring corporation's stock that take place between signing and closing will not affect the critical continuity-of-interest determination. Yet the proposed regulations made clear that

this favorable signing-date rule applies only to contracts that provide for fixed consideration. This is so regardless of whether the agreement specifies the maximum amount of money or other property (or the minimum amount of issuing corporation stock) that will be exchanged in the transaction.

The 2007 proposed regulations also removed certain assumptions under the shareholder election rule. The idea was to allow the determination of continuity of interest to depend on the *actual* consideration exchanged, not on what *might* have been exchanged.

New Notice

In Notice 2010-25, IRB 2010-14, 1, Tax Analyst Document No. 2010-5922, the IRS allows taxpayers to continue relying upon the signing date rule set forth in the 2007 proposed regulations. That reliance is allowed until final regulations are issued. However, the target corporation, the issuing corporation, the controlling corporation of the acquiring company (if stock of that parent is provided as consideration in the deal), and any direct or indirect transferee of transferred basis property from any of these parties, must *all* elect to apply at the provisions of the proposed regulations.

That may sound onerous. Fortunately, though, the "election" is satisfied as long as none of the specified parties adopts treatment that is inconsistent with that election.