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PRACTICAL U.S./DOMESTIC TAX STRATEGIES

WORLDTRADE EXECUTIVE
The International Business Information Source

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March 2010
Volume 10, Number 3

IRS Issues Stopgap Guidance on M&A Continuity of Interest Rules

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At the 11th hour, the IRS has patched a gaping hole in the regulatory structure governing mergers and other corporate reorganizations.

The new IRS guidance, in Notice 2010-25 (published in Internal Revenue Bulletin 2010-14 on April 5, 2010), retains for now the "binding contract" rule for measuring "continuity of interest" of equity ownership—a key requirement for obtaining tax-free treatment of a reorganization in which shareholders of an acquired corporation receive a mixture of cash and acquiring corporation stock as consideration. In light of this new guidance, merger participants should consider including appropriate language in their transactional documents.

Under the binding contract rule, the amount of equity ownership that is "continued" is generally measured under the deal terms on the date that a binding contract is entered into to complete the reorganization and not on the date of the transaction's closing. The rule effectively prevents deals from shifting from tax-free to taxable status because of a sudden drop in the market price of the acquiring corporation's stock. Since 2007, the rule has been contained in temporary regulations that expired under statutory sunset provisions on March 19, 2010.

Although the IRS cannot extend the legal effectiveness of the temporary regulations, Notice 2010-25 indicates that it will permit taxpayers to rely on identically-worded proposed regulations after the temporary regulations sunset. In order to satisfy the IRS conditions for such reliance, the acquiring corporation (or its parent corporation in the case of a triangular reorganization) and "any direct or indirect transferee of transferred basis property" from the acquired or acquiring corporation must elect to apply the proposed regulations. No formality is necessary for this election, however, because the Notice provides it will be satisfied if none of the parties adopts a position

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inconsistent with the proposed regulations. Nevertheless, merger participants should consider including appropriate language in their transactional documents to ensure that they receive the benefits of this election.

The Notice also resurrects the possibility—not present under the expired temporary regulations—that a fixed amount of stock consideration provided under a binding contract could be valued at closing. That alternative could be helpful in achieving tax-free treatment where the price of the acquirer's stock is rising. Merger participants that prefer to value the acquirer's stock consideration at closing should therefore also consider the addition of contractual language to negate the existence of a binding contract valuation election.