New York City Bar Association
Report Offering Proposed Guidance on the Federal Income Tax Treatment of Post-Closing Contingent Consideration in Reorganizations as Reported by the Committee on Taxation of Business Entities, April 2, 2010

This report, which is submitted on behalf of the New York City Bar Association by its Committee on Taxation of Business Entities,[1] proposes certain guidance relating to the federal income tax treatment of contingent consideration (whether stock or boot) in a purported reorganization under Section 368(a).[2]

Mergers and acquisitions occur when, among other deal points, a buyer and a seller can agree on the value of the relevant businesses. What happens though when both parties want to get a deal done, but cannot agree on some aspect of the target company's value either because of target's unknown or contingent liabilities or because of a disagreement about future projections for the performance of the target's business? The answer, of course, is for the buyer to pay consideration contingent on future events. Consideration may be placed in escrow or held back for a period of time in the event of breaches of representations and warranties contained in the acquisition agreement. Also, the sellers may earn additional consideration in the event certain business targets (e.g., revenue, EBITDA, etc.) are satisfied after closing. Business people will come up with solutions to such problems when there is a mutual desire to get a transaction completed.

The federal income tax treatment of such contingent arrangements is fairly clear when the merger or acquisition is a taxable transaction (e.g., an acquisition of stock or assets for cash and promissory notes).[3] When the acquisition is intended to take the form of a reorganization pursuant to Section 368(a), however, there is relative uncertainty surrounding how such contingent arrangements should be treated for income tax purposes (e.g., how do you measure continuity of interest ("COI")), and does it matter whether the contingent consideration takes the form of equity or boot. The authorities that do address contingent consideration in reorganizations are outdated and, in our view, in need of being revisited.

I. Executive Summary

This report recommends that the proposals set forth below regarding the federal income tax treatment of post-closing contingent consideration in purported Section 368(a) reorganization transactions be adopted.

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[1] The authors of this report are Robert Heller, Joy Zhang, John Barrie, Christopher Peters, Mark Stone and Alan J. Tarr. Helpful comments were provided by Jill Darrow and Marc Teitelbaum.

[2] All section references are to sections of the Internal Revenue Code of 1986, as amended (the "Code") and the Treasury Regulations (the "Regulations") promulgated thereunder. Although boot may be received by target shareholder in the form of cash or other property (other than stock of the acquiring corporation or its parent), unless otherwise specified we assume that the form of boot in most transactions will be cash.

[3] For example, the installment sale regulations provide detailed rules regarding how basis is recovered in a taxable acquisition where additional consideration may be paid post-closing upon the occurrence of contingencies.

- We recommend that the existing guidelines contained in Revenue Procedure 84-42,[4] which relate to instances in which Section 368(a) reorganization treatment will not be negatively impacted when a portion of the stock potentially issued in the transaction is not issued at closing, be withdrawn. In its place, the only remaining question relevant to situations in which equity consideration may be issued after closing in a reorganization should be whether the post-closing contingent consideration arrangement[5] is rationally related to a valid non-tax business purpose.

- We recommend that the COI regulations be amended to provide that the determination as to whether a transaction satisfies the COI requirement be made at the closing of the transaction (or at the signing if the "signing date rule" described below applies) even where a portion of the stock or boot potentially issued in the transaction may be issued post-closing. For this purpose, rights to post-closing consideration should be valued at the relevant date taking into account appropriate discounts under existing principles of law.

- We propose that the rules of Treasury Regulation § 1.368-1T(e)(2) be clarified to ensure that the rights to post-closing contingent stock be, in certain situations, ignored for purposes of determining whether the transaction provides for "fixed consideration" when applying the "signing date rule" contained in those regulations.[6] Specifically, if the target shareholders are exposed to the economic benefits and burdens of the stock that may be issued in the future pursuant to a binding contract, the value of all stock issued or potentially issued in the transaction should be set at its signing date value (technically the value on the last business day before signing) for purposes of determining COI. We believe that the Regulations already provide as such, but believe clarification that the Regulations apply to future-looking contingent consideration would be helpful.

- Given the difficulty in valuing contingent rights to stock or boot, however, we also propose a safe harbor that provides that when measuring COI where post-closing consideration is possible, the COI requirement will be considered satisfied if the value of stock issued will, at every date on which consideration is issued, be at least 40% of the total consideration assuming the maximum amount of boot and the minimum amount of stock is issued at each testing date. As under the general

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[4] 1984-1 C.B. 52.

[5] Unless the context otherwise indicates, for purposes of this report, contingent consideration includes consideration that is payable as a result of satisfying (or failing to satisfy) a condition precedent and consideration which is subject to forfeiture upon satisfying (or failing to satisfy) a condition subsequent, whether or not the amount is placed in escrow.

[6] We note that Treasury Regulation § 1.368-1T(e)(2) expired on March 19, 2010. In Notice 2010-25, however, the Internal Revenue Service (the "IRS") announced that, provided that all parties to the reorganization elect to apply the proposed regulations that were identical to the expired temporary regulations, the rules of Treasury Regulation § 1.368-1T(e)(2) may still be relied upon by taxpayers until final regulations are promulgated. This report, therefore, continues to cite to Treasury Regulation § 1.368-1T(e)(2) as it existed prior to its expiration.

rule, values would be determined as of the closing date or the signing date, as applicable. If our proposed safe harbor is satisfied, the general COI rule would also be satisfied. We believe, however, that adding a specific safe harbor in the COI Regulations would provide taxpayers and practitioners with useful guidance.

II. Summary of Existing Law

A. *Contingent Stock Arrangements: Carlberg, Hamrick and Revenue Procedure 84-42*

Where contingent consideration in a transaction is payable solely in stock of the acquiring corporation (or its parent),[7] it is difficult to imagine how such an arrangement could in and of itself cause the transaction to fail to qualify as a tax-free reorganization. In *Carlberg v. United States*,[8] target shareholders received as merger consideration stock of the acquiror plus "certificates of contingent interests" (the "Certificates") issued by the acquiror. The Certificates represented the right to receive additional shares of acquiror stock in the event specified contingent liabilities of the target were satisfied. Specifically, the acquiring corporation set aside shares (the "Reserved Shares") and as such liabilities of target were satisfied for a certain amount within 10 years of issuance of the Certificates, the number of Reserved Shares would be reduced according to a formula. Once all such liabilities were satisfied, any remaining Reserved Shares would be issued to the holders of Certificates in redemption of those Certificates. Certificate holders did not possess the rights of shareholders, i.e., the Certificates carried no voting rights in the acquiror, no rights to dividends and no rights to proceeds upon the liquidation of the acquiror, and the acquiror did not treat the Certificates as outstanding stock for financial accounting purposes. The Certificates were, however, freely transferable.

The IRS argued that the Certificates were property other than stock issued in the merger as consideration and thus constituted boot. Because the value of the taxpayer's target stock exceeded the basis in her target shares, had the IRS prevailed, the taxpayer would have been required to recognize gain under Section 356. The taxpayer argued that the Certificates represented common stock of the acquiror, even though the precise number of shares of common stock represented by the Certificates were unknown at the time of the merger. The merger under the taxpayer's argument would have been governed by Section 354 and no gain or loss would have been recognized.

The *Carlberg* court held for the taxpayer citing the fact that the Certificates represented a continuity of interest in the target corporation's enterprise in the same manner as actual issued and outstanding stock would have. The Certificates, representing a contingent right to stock, were issued for valid business reasons (protecting the buyer from unresolved liabilities of the target corporation) and could only be redeemed for stock of the acquiror pursuant to their terms. The court saw no valid reason to treat the Certificates as other than stock for purposes of the reorganization provisions of the Code.

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[7] For ease of reference, this report refers to the acquiring corporation as the corporation that issues stock in a purported reorganization transaction even though in triangular reorganizations the parent's stock is issued.

[8] 281 F.2d 507 (8th Cir. 1960).

Hamrick v. Commissioner[9] involved a transaction that contained an earn-out. In *Hamrick*, an investor in a Section 351 exchange acquired stock of the transferee corporation with the right to be issued additional stock ("Earn-out Shares") if certain benchmarks were met (e.g., net earnings exceeded specified thresholds) within seven years of the original exchange. In addition to other arguments, the IRS contended that the right to receive stock in the future was not itself stock and therefore constituted boot received in a Section 351 exchange.[10] The court, citing *Carlberg*, held that the right to receive stock in these circumstances was the equivalent of stock.[11] Central to the court's conclusion was the existence of a business purpose for the arrangement (resolving valuation differences among the parties) and the fact that the right in question could only produce additional stock, namely the Earn-out Shares.

The *Carlberg* and *Hamrick* cases taken together stand for the proposition that a contingent right to receive additional stock in a Section 368 reorganization or Section 351 exchange will not constitute boot if the right exists for a valid business purpose and represents only the right to additional stock and nothing more. There is some notion in the cases that some time limit to the right must exist although neither case explicitly so holds. No other requirements for treating such a contingent right as stock received in a tax-free transaction, rather than boot, are suggested by either the *Carlberg* or *Hamrick* decision.[12]

In response to the rejection of the IRS's positions espoused in *Carlberg* and *Hamrick*, the IRS issued a revenue procedure setting forth certain guidelines for instances in which the IRS would favorably rule that a contingent right to stock or a right to stock placed in escrow would not cause an otherwise qualifying Section 368 reorganization or Section 351 transactions to so qualify.[13] Revenue Procedure 84-42 (the "Guidelines") deals with two situations, one in which

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[9] 43 T.C. 21 (1964), *acq. in result*, 1966-1 C.B. 2.

[10] Because Section 351 at the time also permitted securities to be received without the recognition of gain, the IRS also contended that the right to receive stock was not a security within the meaning of Section 351.

[11] The court also held that certain additional Earn-out Shares received by the inventor pursuant to an amendment to the original agreement of the Section 351 exchange were received as ordinary income because the amendment was in fact a new agreement based upon new consideration, i.e., the inventor's surrender of any cause of action he might have had against the other shareholders and the corporation.

[12] A portion of any stock issued after the closing of the transaction to target shareholders may, however, constitute imputed interest under Section 483. *See* Treas. Reg. § 1.483-4(b) Ex. 2.

[13] Rev. Proc. 77-37, 1977-2 C.B. 568. The IRS later updated these guidelines which now appear in Revenue Procedure 84-42, 1984-1 C.B. 521. Revenue Procedure 84-42 provides that, the use of a contingent stock arrangement does not prevent issuance of a favorable, tax-free reorganization ruling if the following requirements are satisfied:

In the case of a contingent stock arrangement, (1) all the stock must be issued within 5 years (the "5-year requirement"); (2) there is a valid business reason for not issuing all the stock immediately (the "valid business reason" requirement); (3) the maximum number of shares which may be issued in the exchange is stated ; (4) at least 50 percent of the maximum number of shares of each class of stock which may be issued is issued in the initial distribution (the "50% maximum requirement"); (5) the right cannot be assigned or transferred (the "restriction on transferability"); (6) the right can give rise to the receipt only of additional stock of the corporation making the underlying distribution (the "solely for stock" requirement); (7) the stock issuance will not be triggered by an event the occurrence or nonoccurrence of which is within the control of shareholders; (8) the stock issuance will not be triggered by the payment of additional tax or reduction in tax paid as a result of an IRS audit of the shareholders or

stock is escrowed to be released upon the occurrence of certain conditions, and the second in which a corporation agrees to issue additional stock upon the occurrence of certain contingencies. Some of the requirements for obtaining an IRS ruling contained in the Guidelines are based upon the *Carlberg* and *Hamrick* decisions.[14] But the Guidelines also contain more stringent requirements for obtaining a ruling than suggested by the *Carlberg* and *Hamrick* decisions. For example, the Guidelines require that at least 50% of the total consideration in the transaction be initially issued to selling stockholders (i.e., no more than half of the consideration can be subject to a holdback or escrow arrangement). In addition, the contingent stock arrangement cannot survive more than five years (plus any additional time to resolve disputes). Although it is true that these Guidelines merely serve as a pseudo-safe harbor and therefore do not necessarily have to be satisfied in all respects in order to conclude that contingent or escrowed stock is not boot, the absence of other authorities dictates that a prudent taxpayer adhere as closely as possible to the Guidelines.

B. *Continuity of Interest and the Signing Date Rule*

The *Carlberg* and *Hamrick* cases addressed whether rights to contingent stock consideration would be considered boot in a Section 368 reorganization or Section 351 transaction. The same issue arises when the question is whether the requisite continuity of shareholder interest is maintained in a purported Section 368 reorganization transaction where contingent consideration may be issued after closing. In order to qualify as a reorganization under Section 368, it is long-standing law that continuity of shareholder interest be maintained so as to distinguish a reorganization from a taxable sale. The Regulations provide that continuity of interest "requires that a substantial part of the value of the proprietary interest in the target corporation be preserved in the reorganization."[15] In practice, the continuity of interest requirement is measured by determining what percentage of the total consideration in the

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the corporation; and (9) the mechanism for the calculation of the additional stock to be issued is objective and readily ascertainable.

In the case of an escrow arrangement: (1) there is a valid business reason for establishing the arrangement; (2) the stock subject to such arrangement appears as issued and outstanding on the balance sheet of the issuing corporation and such stock is legally outstanding under applicable state law; (3) all dividends paid on such stock will be distributed currently to the exchanging shareholders; (4) all voting rights of such stock (if any) are exercisable by or on behalf of the shareholders or their authorized agent; (5) no shares of such stock are subject to restrictions requiring their return to the issuing corporation because of death, failure to continue employment, or similar restrictions; (6) all such stock is released from the arrangement within 5 years from the date of consummation of the transaction (except where there is a bona fide dispute as to whom the stock should be released) (the "5-year requirement"); (7) at least 50 percent of the number of shares of each class of stock issued initially to the shareholders is not subject to the arrangement (the "50% maximum requirement"); (8) the return of stock will not be triggered by an event the occurrence or nonoccurrence of which is within the control of shareholders; (9) the return of stock will not be triggered by the payment of additional tax or reduction in tax paid as a result of an IRS audit of the shareholders or the corporation; and (10) the mechanism for the calculation of the number of shares of stock to be returned is objective and readily ascertainable.

[14] For example, the guidelines require that there be a non-tax business purpose for the contingent consideration or escrow arrangement and also require that all of the contingent consideration (or all of the escrowed consideration) be in the form of additional stock of the acquiror.

[15] Treas. Reg. § 1.368-1(e)(1)(i).

transaction is stock of the acquiror, and what percentage is boot.[16] The issues addressed in *Carlberg* and *Hamrick* are, therefore, equally applicable to measuring continuity of interest.[17]

The general rule regarding the question of "when" to value transaction consideration for purposes of the continuity of interest requirement is that relative values of stock and boot consideration are required to be measured on the date a transaction closes.[18] Therefore, in certain circumstances the parties may not be certain, at the time of signing, whether a transaction will qualify as a Section 368 reorganization prior to closing. Temporary Regulations issued in 2007, however, provide that relative values of stock and boot consideration are measured at the signing date if the transaction agreement provides for "fixed consideration" (the "signing date rule").[19]

The signing date rule only applies if the transaction agreement provides for fixed consideration. On its face, therefore, the signing date rule would seem to not apply to cases where contingent consideration, in the form of stock, boot or a combination thereof, is provided for under the terms of the agreement. Specifically, the Regulations provide that a contract will be considered to provide for fixed consideration if the contract "provides the number of shares of each class of stock of the issuing corporation, the amount of money, and the other property (identified either by value or description), if any, to be exchanged for all the proprietary interests in the target corporation, or to be exchanged for each proprietary interest in the target corporation."[20] The Regulations go on to provide, however, that except in certain cases where adjustments to the consideration are based on the value of acquiror stock, "a contract that provides for contingent adjustments to the consideration will be treated as providing for fixed consideration if it would [provide for fixed consideration under the Regulations] without the contingent adjustment provision."[21] Escrowing consideration to secure the target's performance of pre-closing covenants or customary representations and warranties will also not cause a

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[16] The minimum percentage of stock consideration required in order to maintain continuity of interest is subject to some debate. Although case law may support a lower percentage, *see John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935), the Regulations clearly permit continuity of interest to be maintained when at least 40% of the total consideration is acquiror stock. See Treas. Reg. § 1.368-1T(e)(2)(v) Ex. 1.

[17] Of course, these issues are also relevant to whether a transaction satisfies the requirements of certain types of reorganizations such as B reorganization (where solely voting stock may be used as consideration) and Section 368(a)(2)(E) reorganizations (where control of the target corporation must be acquired for voting stock).

[18] *Cf.* 69 F.R. 48429 (preamble to the proposed regulations containing the signing date rule) ("In a transaction in which the shareholders of the target corporation receive both money and acquiring corporation stock, commentators have expressed concern that the transaction could fail to satisfy the COI requirement as a result of a decline in the value of the acquiring corporation's stock between the date the parties agree to the terms of the transaction (the signing date) and the date the transaction closes. Commentators have noted that attempts to mitigate this concern have led to complexity in structuring transactions intended to qualify as reorganizations.").

[19] Treas. Reg. § 1.368-1T(e)(2). Technically, the relative values of consideration are measured at the end of the business day prior to the date that a binding contract exists related to the transaction. For ease of reference, this date is referred to as the "signing date" herein.

[20] Treas. Reg. § 1.368-1T(e)(2)(iii)(A).

[21] Treas. Reg. § 1.368-1T(e)(2)(iii)(B).

contract to fail to provide for fixed consideration.[22] The signing date rule, therefore, may apply despite the existence of contingent consideration in a transaction.[23]

The signing date rule only addresses the relevant date on which to value the consideration issued in a purported reorganization. The rule itself does not address whether a transaction satisfies the COI requirement. For example, the Regulations make clear that if escrowed stock is forfeited because of a breach of representations or warranties by the target, although the signing date rule applies for purposes of valuing the stock not forfeited, COI is measured based on the signing date value of the amount of stock and boot actually issued in the transaction.[24] As a result, if a sufficient amount of stock is actually forfeited, COI will not be maintained regardless of the signing date value of the stock. If, however, the stock is not forfeited, and COI is satisfied based on signing date values, the COI requirement is satisfied even if such values change prior to closing.[25]

When adjustments are made to the stock and/or boot consideration received by target shareholders *after* closing, the question of how to measure COI remains even if the signing date rule applies for purposes of valuing the different types of consideration. Is a taxpayer required to wait to see how the contingencies play out in fact (the approach suggested by the Regulations)? Must the taxpayer make reasonable assumptions at closing as to how much acquiror stock will, in fact, be issued to target shareholders once all contingencies are satisfied? These issues are exacerbated when the contingent consideration may be issued years after the actual closing. For example, the statute of limitations may close. Thus, whether the signing date rule applies or not, substantial uncertainty exists when a transaction provides for potential post-closing adjustments to the consideration payable to target shareholders.

III. Proposals Regarding the Requirements under Revenue Procedure 84-42

A. *Analysis of Revenue Procedure 84-42*

As discussed above, Revenue Procedure 84-42 provides, for advance rulings purposes, the operating rules for the treatment of contingent stock rights in transactions that are intended to qualify as reorganizations under Section 368(a).[26] Although contingent stock and escrowed stock arrangements are functionally similar in that they both involve suspending judgment on the price to be paid by an acquiring corporation until the uncertainties have been resolved, the issue of whether such arrangements constitute boot was resolved on different grounds under early case law. In the case of escrowed stock, the courts had determined the boot issue favorably to the taxpayers by finding that the target shareholders acquired, in the original reorganization

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[22] Treas. Reg. § 1.368-1T(e)(2)(iii)(C).

[23] *See* Treas. Reg. § 1.368-1T(e)(2)(v) Ex. 12 (agreement providing for adjustments to the number of acquiror shares and boot based on the value of target stock provides for fixed consideration and, therefore, the signing date rule applies).

[24] *See* Treas. Reg. § 1.368-1T(e)(2)(v) Ex. 2.

[25] *See* Treas. Reg. § 1.368-1T(e)(2)(v) Ex. 1.

[26] *See supra* note 13.

exchange, ownership of the escrowed shares before the shares were contributed to the escrow, thus the target shareholders never received any contingent rights to stock,[27] whereas in the case of contingent stock rights, though the target shareholders did receive contingent rights to stock, such rights were nevertheless held to be the equivalent of stock under *Carlberg* and *Hamrick*.[28]

Although the Guidelines distinguish between transactions with escrowed stock and ones with contingent stock arrangements, in our view, for COI purposes, the two types of transactions should be analyzed in the same manner. The requirements in the Guidelines are intended to prevent specific perceived potential abusive arrangements involving transactions with contingent stock. Some of the more controversial requirements, and our reasons for proposing that they be eliminated, are outlined below.

- The "solely for stock" requirement of the Guidelines can perhaps be justified when the issue being addressed is whether the right to contingent stock itself potentially disqualify the transaction as a Section 368 reorganization. The Guidelines takes the accepted view that a future right to receive stock should not itself potentially result in a transaction failing to so qualify. In other words, for COI purposes, a right to contingent stock (whether the stock was previously escrowed or not) will not itself be treated as boot. There is no reason why a future right to receive stock and other property should not also be treated, at least with respect to the contingent right to receive stock, as similarly not boot for COI purposes. This is certainly true that future rights to receive a mix of consideration raise difficult valuation issues for purposes of determining COI. As we discuss in Part IV below, however, existing principles related to measuring COI can be applied to situations in which a transaction provides for future contingent consideration that is a mix of stock and other property. We believe, therefore, that a right to receive future contingent consideration should not itself be treated as boot simply because the consideration that may be received is not solely stock.[29]

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[27] The seminal case on escrowed stock is *McAbee v. Commissioner*, 5 T.C. 1130 (1945), *acq.* 1946-2 C.B. 4, which involved a stock-for-assets acquisition in which approximately 56% of the shares of the acquiring corporation issued in consideration for the acquisition were placed in escrow to secure the target's performance of certain post-acquisition obligations. The Tax Court found that the target shareholders acquired equitable title to the stock when it was placed in escrow for their benefit and the stock was thereafter held in escrow merely as security for the performance by the target of its obligations, and that the release of the stock from escrow was not a transaction in which gain or loss is to be recognized. *See also, United States v. Fletcher*, 562 F.3d 839 (7th Cir. 2009), *Chaplin v. Commissioner*, 136 F.2d 298, 299–302 (9th Cir. 1943); *Whitney Corp. v. Commissioner*, 105 F.2d 438, 441 (8th Cir. 1939) and *Bonham v. Commissioner*, 89 F.2d 725 (8th Cir. 1937).

[28] If an escrowed stock arrangement is structured in a manner that the acquiror is considered to retain ownership of the escrowed shares, then whether such escrow arrangement constitutes boot becomes an issue and would presumably be analyzed under the rules applicable to contingent stock arrangements, though guidance remains lacking in these circumstances. *See* Ginsburg & Levin, MERGERS, ACQUISITIONS, AND BUYOUTS, ¶606.1.1 (2009); Switzer and Wilcox, 771-3rd T.M., *Corporate Acquisitions — (A), (B), and (C) Reorganizations*, at III, C, 4, i.

[29] *See* Part IV, *infra*, for a proposal on how to measure COI when potential post-closing consideration may be in the form of a mix between stock and other property.

- The "5-year requirement", the "50% maximum requirement" and the requirement that the maximum number of shares potentially to be issued be stated in the transaction agreement have been criticized by commentators as lacking a basis of authority as such requirements are inconsistent with the case law. On the other hand, commentators also recognized that these requirements may be appropriate to prevent abuse in some circumstances.[30]

  It has been suggested that the government's concern here is the possibility that delayed stock payments may represent a disguised form of compensation, royalty, joint venture, or stock dividend. These concerns are, however, adequately addressed by a requirement that the contingent consideration arrangement have a business purpose, which, in most cases, would be to resolve different perceptions of relative value of the corporations that are parties to the reorganization. The transactions that fail to satisfy these Guideline requirements should not be disqualified as reorganizations particularly if the failure to meet the requirements had a valid business reason (e.g., the long delays that are often associated with settlement of liabilities).[31]

- It is the prevailing view of commentators that the prohibition against transferability is not necessary and should be eliminated.[32]

  This restriction presumably comes from the traditional distinction between property and contract, which is apparently founded on the distinction of *Carlberg* that a contingent right to receive additional shares of stock, a contract right, is different from a stock warrant, a property interest.[33] It can also be argued that this restriction would help prevent using contingent stock rights to bail out earnings and profits. A prohibition on transferability may also address the concern that being able to reduce a contingent right to consideration immediately to cash is akin to the actual receipt of cash and therefore should be considered boot for COI purposes.

  This issue, however, is no different than receiving stock that can be sold immediately for cash. Under Treasury Regulation § 1.368-1(e)(1)(i),[34] which

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[30] *See* Fleming, *Rethinking Contingent Price Reorganizations*, 9 J. Corp. Tax'n 3 (1982) 3, 50-51 (noting that if a contingent or escrowed stock feature is permitted to endure for an extended period of time and involve a number of shares, which dwarfs the initially issued consideration, then the transaction begins to look like one in which the acquired corporation's shareholders have received stock plus a right to ongoing stock dividends).

[31] *See, e.g.*, NYSBA Report 1051, *Report on Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations* (Feb. 4, 2004) (hereinafter "NYSBA Report 1051") (recommending reconsideration of the "5-year requirement" on the same ground).

[32] *See, e.g.*, NYSBA Report 1051, at 40 (strongly recommending eliminating this condition).

[33] *See* LeDuc, *The Treatment of Contingent Consideration in Tax-Free Corporate Acquisitions*, 29 CASE W. RES. L. REV. 88, 105 (1978).

[34] Treas. Reg. § 1.368-1(e)(1)(i) in its current form has been effective since Jan. 28, 1998. *See also,* Committee on Taxation of Corporations of the Association of the Bar of the City of New York, *Postreorganization Transactions*

disregards post-reorganization disposition of stock received in a potential reorganization to unrelated parties for purposes of the COI requirement,[35] a sale by a shareholder of stock received in the reorganization is no longer relevant to measuring COI. A sale of contingent stock rights should be treated no less favorably.

- With respect to escrowed stock, the Guidelines requires that dividends and voting rights pass through to the target shareholders and that the escrowed stock appear as issued and outstanding on the balance sheet of the issuing corporation and be legally outstanding under state law. These requirements are apparently premised on the theory that the escrowed stock is considered as having been issued to the target shareholders who are the tax owners of the stock held in escrow. As discussed in more detail below, there is no need to deem stock to be issued at closing in order to test for COI. "Sleeping COI" issues can be addressed under current principles of law. There seems to be no practical significance, therefore, for requiring that target shareholder be the owners of escrowed stock for tax purposes. These requirements, therefore, should be eliminated.

- The remaining requirements in the Guidelines,[36] all seem to attempt to address general concerns about potential abuse. We believe that a requirement that the terms of a contingent consideration arrangement are rationally related to a valid business reason would sufficiently address any general concerns about potential abuse.[37] The "valid business reason" requirement of the Guidelines, which merely requires a valid business reason to exist for the contingent consideration arrangement, is largely a meaningless test, especially when dealing with purported reorganization transactions between unrelated parties, because there is almost always a valid business reason for the parties to enter into a contingent consideration arrangement, e.g., the difficulty to agree on the value of one or both of the corporations involved in the transaction. Therefore, to prevent potential abuse, the specific terms of a contingent consideration arrangement should also be carefully scrutinized.

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and Continuity of Shareholder Interest, reprinted in 72 TAX NOTES 1401 (1996) (cited in 61 F.R. 67512, preamble to the proposed regulations published on December 23, 1996 relating to the COI requirement).

[35] *See, e.g.*, Treas. Reg. § 1.368-1(e)(1)(i), (8) Exs. 1(i) and 3.

[36] The remaining Guidelines are: (1) the stock issuance will not be triggered by an event the occurrence or nonoccurrence of which is within the control of shareholders; (2) the stock issuance will not be triggered by the payment of additional tax or reduction in tax paid as a result of an IRS audit of the shareholders or the corporation (3) the mechanism for the calculation of the additional stock to be issued is objective and readily ascertainable. With respect to escrow arrangements, an additional requirement is that no shares of stock are subject to restrictions requiring their return because of death, termination of employment or similar condition.

[37] *See* NYSBA Report 1051, at 40 (noting that it is appropriate to require taxpayers to demonstrate that the terms of the arrangement are rationally related to a specific, bona fide, non-tax business purpose).

B. *Proposal*

As suggested above, the Guideline's specific requirements are unnecessary to prevent any perceived abuses with contingent consideration arrangements. In purported reorganization transactions involving contingent consideration, the real issues to analyze related to the contingent consideration arrangement should simply be "to prevent transactions that resemble sales from qualifying as reorganizations,"[38] i.e., whether COI is satisfied and whether the arrangement is motivated by "business exigencies," i.e., whether a valid business reason exists for providing future, contingent consideration in a particular manner.

We therefore propose that a purported Section 368 reorganization should not be disqualified as a reorganization solely because of the existence of a right to receive future, contingent consideration if a valid business purpose exists for the arrangement, regardless of the type of consideration subject to the arrangement. When the transaction is between unrelated parties, a valid business reason should be presumed to exist unless factors strongly indicate otherwise. The remaining requirements contained in the current Guidelines should be withdrawn as they are unnecessary to prevent abuse.

IV. Continuity of Interest

The only question then left to ask about the contingent consideration arrangement is whether, given the type or types of consideration possibly to be issued, the COI requirement is satisfied. Assuming a business purpose for the arrangement, the treatment of a transaction where consideration may be owed post-closing upon the occurrence of certain contingencies as a reorganization turns on the proper application of the continuity of shareholder interest requirement. Existing law regarding the COI requirement does not adequately address post-closing contingencies. Two questions are raised by such transactions:

- First, how does the possibility of receiving more stock or more boot post-closing factor into the COI analysis? When should the COI determination be made? Should it be made at signing or closing? Should a taxpayer apply an open transaction concept and "wait and see" what the ultimate mix of consideration will be? How does this "wait and see" approach work if payments may be made over a long period?

- Second, what value should be placed on any stock or other non-cash property that may be issued post-closing given that valuations will likely fluctuate between the signing of the transaction, the closing of the transaction and the date in the future that stock or other property (or both) may be delivered?

A. *Continuity of Interest Principles*

Two general principles of existing law, when applied to post-closing contingencies, suggest an approach to measuring COI in a transaction with possible post-closing contingent

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[38] Treas. Reg. § 1.368-1(e)(1).

consideration while also providing taxpayers with certainty as to tax treatment. The first is the general policy underlying the COI requirement. The COI requirement is such a well-established doctrine in the law of tax-free reorganizations that many practitioners simply think of it as a 40% minimum stock consideration requirement. The policy behind a minimum stock requirement is more important, however, than what the actual minimum percentage is. Early case law established the COI requirement in an attempt to distinguish taxable sales from transactions where target shareholders merely exchanged their proprietary interest in the target corporation for an ownership stake in the acquiring corporation.[39] This policy is now explicitly referenced in the Section 368 regulations.[40] Although contingent post-closing consideration may raise complex measurement issues when analyzing the COI requirement as a "40% stock" requirement, the ultimate question is as simple when all consideration is received by target shareholders at the closing of the transaction: Have the target shareholders received a definite and substantial proprietary interest through an ownership interest in the acquiring corporation? As suggested by the *Carlberg* and *Hamrick* decisions, contingent rights to stock are a continuing proprietary interest even though they represent only a contingent right to receive stock in the future.

Of course, the ultimate COI policy, whether a transaction more resembles a sale or a realignment of shareholders' interests, leads to the practical question of how much of the consideration received by target shareholders needs to be equity in the acquiring corporation to distinguish the transaction from a taxable sale. This is where percentages of total consideration inevitably become the focus. Although there may be some uncertainty in this area given case law that suggests a lower percentage may suffice,[41] the signing date regulations contain helpful examples which provide that COI is satisfied if at least 40% of the consideration received by target shareholders is stock of the acquiring corporation.[42] Any framework for setting rules to test for COI where post-closing contingent consideration is possible would obviously need to take this 40% requirement into account.

The second relevant COI principle is embodied in signing date rule of Treasury Regulation § 1.368-1T(e)(2). Having a minimum fixed percentage of stock consideration leads to the next question: when are relative values of consideration tested? The signing date

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[39] *See, e.g., Le Tulle v. Scofield*, 308 U.S. 415 (1940) (stating that the reorganization statute "was not satisfied unless the transferor retained a substantial stake in the enterprise"); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935) ("The transaction here was no sale, but partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser."); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) ("Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes.").

[40] Treas. Reg. § 1.368-1(e)(1) ("The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. Continuity of interest requires that in substance a substantial amount of the value of the proprietary interests in the target corporation be preserved in the reorganization.").

[41] *See John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (reorganization status for a transaction in which 38% of total consideration consisted of acquirer stock).

[42] *See* Treas. Reg. § 1.368-1T(e)(2)(v) Ex. 1.

regulations answer this question in a typical transaction where the consideration is agreed to when the transaction agreements are signed but where fluctuations in stock market value will likely occur prior to closing. Those regulations are based on a simple premise: if target shareholders are exposed to fluctuations in the value of the stock of the acquiring corporation once the contract is signed, the time for valuing stock for COI purposes should be at that time (i.e., the signing date or technically, the end of the day prior to the signing date).[43] This principle is incorporated into the Regulations through the requirement that there be "fixed consideration" in order to be eligible to apply the signing date rule.[44] Importantly, certain contingencies are disregarded when determining whether a transaction contains fixed consideration. Specifically, contingencies are disregarded unless the contingent adjustments to the consideration "prevent (to any extent) the target corporation shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation stock after [the day prior to the signing date]."[45] This rule is consistent with general principles of tax ownership. Although the transaction has not yet closed and the target shareholders are not yet the owners of the acquiring corporation's stock (e.g., because closing conditions such as required shareholder votes and regulatory approval have not yet occurred), the economic benefits and burdens of the acquiring corporation's stock have been conveyed to the target shareholders at signing and, therefore, COI should be tested at this point.

The signing date regulations contain helpful examples as to how this approach to testing for COI applies where there are contingent consideration adjustments between signing and closing. These examples indicate that, although the value placed on acquiring corporation stock ultimately delivered to target shareholders is determined at signing if the economic benefits and burdens of the acquiring corporation's stock have been conveyed to target shareholders, whether the continuity of interest requirement is ultimately satisfied depends on the actual consideration received by the target shareholders at closing. In the examples, 40 shares of acquiring corporation stock (P) plus $60 of cash is the total consideration issued in the transaction. At signing, the fair market value of the P stock is $1 per share. Pursuant to the transaction agreement, 20 of the 40 shares of P stock are escrowed to secure customary target representations and warranties. In Example 1, the shares of P stock have fallen in value to $0.25 per share and none of the shares of P stock are returned at closing. The example concludes that the COI requirement is satisfied because the P shares are valued at their signing date value of $1 per share and, because 40 shares were delivered, 40% of the total consideration is considered to be in acquiring corporation stock.[46]

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[43] *See* T.D. 9225 (preamble to the 2005 signing date regulations) ("The signing date rule is based on the principle that, in cases in which a binding contract provides for fixed consideration, the target corporation shareholders generally can be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date.").

[44] Fixed consideration requires that the number of shares of acquiring corporation stock and the amount of money or other property to be delivered to target shareholder be fixed. Because, for example, the number of shares is fixed, target shareholders are exposed to fluctuations in the value of the acquiring corporation's shares prior to closing.

[45] Treas. Reg. § 1.368-1T(e)(2)(iii)(B)(2).

[46] *See* Treas. Reg. § 1.368-1T(e)(2)(v) Ex. 1.

In Example 2, the facts are the same except that the 20 shares of escrowed P stock are returned to P due to breaches of representations and warranties. Although the P stock is still valued at its signing date value of $1 per share, because only 20 shares were actually received by the target shareholders, only 25% of the total consideration received by the target shareholders is considered acquiring corporation stock. As a result, COI is not maintained and the transaction is not considered a reorganization.[47] The signing date regulations, therefore, take a "wait and see" approach to contingencies for purposes of testing COI in that taxpayers determine whether the COI requirement is satisfied based, in part, on the outcome of the contingencies.[48]

B. *COI Proposal # 1 - Clarification of the Signing Date Rule*

We propose that the signing date rule should be clarified to provide that contingent adjustments to the consideration in a purported reorganization should be ignored for purposes of determining whether a transaction provides for "fixed consideration" unless the contingent adjustments protect the target shareholders to any extent against a decrease in the value of the acquiring corporation's stock (or other non-cash property to be transferred by the acquiring corporation) or prevent the target shareholders to any extent from benefiting from an increase in the value of such consideration. Although we believe that the signing date rule as drafted is sufficiently broad to cover the effect of post-closing contingent consideration, clarification by revenue ruling or other guidance would be helpful in this regard.

The signing date rule adopts the sensible principle that the relative valuations of the mix of consideration should be determined when the target shareholders become exposed to fluctuations in the values of that consideration. We believe this principle should specifically be extended to situations where contingent adjustments to the total consideration occur post-closing. For example, a right to receive a fixed number of additional shares of acquiring corporation stock in the event specified EBITDA targets are met at some specified future date would not prevent the acquisition agreement from providing fixed consideration and those shares of stock should be valued at their signing date value for purposes of the COI determination. The issue of the number of shares of stock to be taken into account in determining COI is addressed below.

C. *COI Proposal # 2 - Determinations as to whether COI is satisfied should be made at closing.*

We propose that determinations as to whether a transaction satisfies the COI requirement be made at closing.[49] We believe that the "wait and see" approach suggested by examples in the

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[47] *See* Treas. Reg. § 1.368-1T(e)(2)(v) Ex. 2.

[48] Nothing in the signing date regulations indicates that this "wait and see" approach is not the law for transactions that provide for post-closing contingencies. The examples described in the text do not state when the contingency is settled, before or after closing. For the reasons we outline, we believe the signing date regulations should be amended to make clear that the "wait and see" approach to COI determinations demonstrated by Example 2 only apply to contingencies that are settled on or prior to the closing of the transaction.

[49] We note that issues similar to the issues addressed in this report relating to measuring COI in transactions with post-closing consideration arise in connection with transactions that are intended to qualify as reorganizations pursuant to Section 368(a)(2)(E). These reorganizations require that in a merger of a controlled corporation with the

signing date regulations is untenable in the context of post-closing contingent consideration adjustments. From a policy perspective, the reorganization rules should provide taxpayers with certainty at closing as to the status of a particular transaction as a reorganization under Section 368. Moreover, if reorganization status could not be determined at closing, potentially complex rules would have to be developed (possibly only with Congressional action) in order to address the fact that the tax treatment of a transaction may not be known for years after closing.[50] These rules would require addressing the fact that taxes for many years may have been improperly reported and the statute of limitations for at least some of the years may have expired. For these reasons we believe that the reorganization determination must be made at closing and the COI Regulations should be clarified to so provide.[51]

D. *COI Proposal # 3 - Facts and circumstances test as to valuation*

We believe that for COI measurement purposes, values should be placed at closing on the right to receive different types of contingent consideration, with the value of the right to receive additional acquiring corporation stock counting as a proprietary interest for COI purposes and the value of the right to receive other possible contingent payments counting as boot. This approach is consistent with suggestions made by other commentators.[52] An approach which requires valuation of the right to receive consideration in the future would necessitate making a determination as to the likelihood of receiving the consideration and the timing of that receipt. We believe that this facts and circumstances test is the better approach for measuring COI. Consistent with our views concerning the Guidelines, a right to receive stock should be treated in the same manner as stock and a right to receive non-stock consideration should be treated in the same manner as boot. Like stock and boot delivered at closing, relative values are placed on the

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target corporation, Section 368(c) control of the target corporation be acquired solely for voting stock. Section 368(c) control is generally an 80% ownership test and thus Section 368(a)(2)(E) mergers require that at least 80% of the merger consideration be voting stock of the issuing corporation. We believe that our COI-related proposals should also apply to the determination of whether the "control" test of Section 368(a)(2)(E) is satisfied in a transaction with post-closing consideration. Whether adopting our proposals relating to COI in the Section 368(a)(2)(E) context requires legislation or can be done by regulation is beyond the scope of this report.

[50] For example, if tax should have been owed in the taxable year of closing, presumably an interest charge similar to the interest charge on the "deferred tax liability" applicable to taxable installment sales should be applied. *Cf.* Section 453A.

[51] We note that making reorganization determinations at closing is consistent with the annual accounting principle of Section 451, which requires that gross income be included in the taxable year of receipt unless properly accounted for in a different period. *See Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940) (rescission in 1931, although intended to extinguish income in 1930 and 1931 could only extinguish income in 1931 because under the annual accounting principle, determinations of taxable income must be made at the close of the taxable year without regard to subsequent events). Transactions are held open only in "rare and extraordinary" circumstances. *See Burnet v. Logan*, 283 U.S. 404 (1931); Rev. Rul. 58-402, 1958-2 C.B. 15; *see also*, *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931) ("While, conceivably, a different system might be devised by which tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the [Sixteenth] amendment to adopt such a system in preference to the more familiar method [annual accounting system], even if it were practicable.").

[52] NYSBA Report 1051, fn 48 ("[W]e think that contingent rights to receive non-stock consideration represent a non-proprietary interest that should constitute boot based on the fair market value of the rights on the closing date").

mix of consideration (under the signing date rule, if applicable) and a COI determination is made at closing. The same rule should apply for future rights to receive stock or boot.

E. *COI Proposal # 4 - Safe harbor for measuring COI in transaction with post-closing consideration*

Notwithstanding our view expressed above regarding a facts and circumstances test for measuring COI when post-closing contingent consideration is provided for in the transaction, we believe that providing taxpayers with an alternative objective test for measuring COI is an important policy goal. Unlike valuing stock and boot delivered at the closing of a transaction where valuations depend simply on the value of the property as of a certain date, valuations of future, contingent rights to property not only depend on the value of the property as of a certain date, but also on the likelihood and timing of receipt. These additional variables are subjective and therefore more likely subject to differing viewpoints than more simple valuation issues. Because of the importance of providing taxpayers with certainty as to the tax treatment of business transactions, we believe that the COI regulations should be amended to include a safe harbor for testing COI at closing when post-closing contingent consideration arrangements are part of a purported reorganization transaction.

The safe harbor we propose is a rule of thumb that many practitioners currently apply. The safe harbor would provide that when measuring COI for transactions that provide for future, contingent consideration, the COI requirement will be considered satisfied if the stock portion of the consideration must always be 40% or greater at every point in time regardless of the outcome of contingencies.[53] The safe harbor would be applied in the following steps:

1. Determine when payments in consideration for the acquisition may be paid under the contract. Compensation and other payments that are not consideration for the acquisition should not be taken into account. In addition, only the principal amount of the contingent consideration is taken into account in computing COI. The portion that would be treated as interest under Section 483 or 1271 et seq. is not taken into account.

2. For each possible payment date (a "testing date"), determine the amount of the consideration potentially to be issued on the testing date. In the case of stock consideration, use the minimum number of shares of stock that may be paid at such time. In the case of boot, use the maximum amount.[54] Where the contingent consideration is part stock and part boot based on the same formula, testing is made at both the maximum and minimum consideration levels. For example, if 40 shares of stock and $60 of cash are paid on the second anniversary of closing if certain EBITDA targets are met, the safe harbor would require testing for COI assuming that no stock or cash is paid (the minimum consideration level) and assuming that the 40 shares of stock and $60 of cash is paid (the maximum consideration level).

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[53] As discussed above, the value of the stock would be determined as of the signing date if the transaction would be considered to provide for "fixed consideration" under the signing date rule.

[54] If the mix of cash and stock depends on an election by the issuing corporation or the target shareholder, the safe harbor would test for COI assuming that cash was elected to the maximum extent possible.

3. Generally, stock consideration should be valued as of the closing date of the transaction (or signing date if applicable as described above). However, where the contingent consideration arrangement computes a dollar amount of contingent consideration, with a fixed percent being paid in cash and the balance in stock generally based on a different valuation of the stock, that value must be used if the stock is included in the COI calculation on the testing date under the rule described in the second step above. The value of stock previously received is not changed.

The application of the safe harbor is demonstrated in the following examples:

Example 1: Target Corporation merges into Sub Corporation, a wholly-owned subsidiary of Acquiring Corporation, in exchange for Acquiring stock, cash, and contingent consideration. At closing, the shareholders of Target receive 400x shares of Acquiring stock (which have a fair market value of $10 per share at closing) and $4,000x in cash. At the end of year 1, Acquiring must pay up to an additional $2,000x in cash based on the earnings of Target/Sub. At the end of year 2, Acquiring must pay up to an additional $2,000x based on the earnings of Target/Sub, payable 40% in Acquiring stock and 60% in cash. The number of shares of Acquiring stock paid at the end of year 2 is based on the fair market value of Acquiring stock at the time the contingent consideration is paid. The applicable federal rate at closing is 5%.

Since consideration is paid at closing, at the end of year 1 and at the end of year 2, those are the testing dates.

At closing, the Target shareholders receive 400x shares of Acquiring stock with a deemed fair market value under the signing date rule of $4,000x and cash of $4,000x. At closing, the stock represents 50% of the consideration and, therefore, COI would be satisfied on this testing date. Because COI is present at this testing date, the next testing date must be measured.

At the end of year 1, the Target shareholders can receive additional cash based on the earnings of Target/Sub. Since the amount is payable in cash, the maximum amount of the consideration, $2,000x, is used. Such amount must be discounted to $1,905x to eliminate imputed interest. Through the end of year 1, the Target shareholders may receive an aggregate of $4,000x in Acquiring stock and $5,905x in cash. At of the end of year 1, the stock represents 40.38% of the consideration and, therefore, COI would be satisfied on this testing date. Because COI is present at this testing date, the next testing date must be measured.

At the end of year 2, the shareholders of Target may receive additional consideration payable in Acquiring stock and cash, ranging from no additional consideration to an additional $2,000x. Since the same formula is used for the contingent stock and contingent cash components, the safe harbor test must be applied at both the minimum and maximum consideration levels. At no additional consideration, the percentage remains 40.38% stock. If the $2,000x maximum consideration is earned, $800x will be paid in stock (based on the then FMV) and $1,200x will be paid in cash. Discounting back two years, that is $726x in stock and $1,088x in cash. Through the end of year 2, the Target shareholders may receive an aggregate of $4,726x in stock and $6,993x in cash. At this point, the stock percentage is 40.33%.

Since the stock percentage at each testing date is at least 40%, the merger meets the COI safe harbor test.

Example 2: P Corporation and T Corporation agree on a transaction in which T will be merged with and into P. Pursuant to the merger agreement, T shareholders will receive 60 shares of P stock plus $60 of cash for every T share. The value of a share of P stock at signing is $1. Half of the stock component of the consideration (i.e., 30 P shares per T share) is escrowed to secure customary target representations, warranties and covenants. Assume that if no indemnity claims are made within 18 months of closing, the 30 P shares are released to T shareholder. If indemnity claims are made within this time, and are ultimately successful, P shares placed in escrow are returned to P.

Under the proposed COI safe harbor, the testing dates are the closing date, when 30 P shares and $60 of cash are delivered and 30 P shares are placed in escrow, and the 18 month anniversary of the closing date, when the 30 escrowed P shares may be released from the escrow. Because the number of shares to be delivered to T shareholders on each testing date is fixed, the relevant value placed on the P shares for purposes of the safe harbor is the signing date value.

On the closing date, T shareholders will receive 30 shares of P stock deemed to be worth $30, and $60 of cash. Because the stock component of the consideration is 33.33% of the total consideration delivered at closing, the COI safe harbor would not be satisfied on this testing date and there is no need to test future testing dates.

Under our COI proposal, however, the merger still may satisfy the COI requirement if, based on the facts and circumstances, the value of the contingent right to receive the 30 shares of P stock that are placed in escrow is, at closing, worth at least $10 (the amount necessary to bring the total stock consideration to 40% of the total consideration). Depending on the contingency, the general COI test may be met. If it is determined based on relative values that the general COI test is satisfied, the fact that stock happens to be forfeited at the end of 18 months would be irrelevant. The transaction would still satisfy COI. Similarly, if it is determined that COI is not present at closing based on relative values, this determination would not change if at the end of 18 months no stock is forfeited.

Note also that under our proposed safe harbor, the ordering of potential contingent payouts may be relevant for purposes of determining whether the safe harbor is met. Although this may result in a transaction falling outside our proposed safe harbor for a technical reason, the transaction could still satisfy the COI requirement based on our general COI proposal regarding valuing rights to contingent consideration at closing. We therefore think any complexities resulting from our safe harbor are outweighed by the benefits of certainty the safe harbor provides taxpayers and practitioners.

V. Conclusion

The Committee has set forth its recommendations to implement the COI rules in transaction with contingent consideration. We believe these changes can be implemented by Regulations. We would be pleased to discuss them with you at your convenience.