September 9, 2026

Hot Topics in Tax: Tax Considerations (and Complexities) Relating to Contingent Value Rights

GIBSON DUNN

MCLE Information

The information in this presentation has been prepared for general informational purposes only. It is not provided in the course of an attorney-client relationship and is not intended to create, and receipt does not constitute, an attorney-client relationship or legal advice or to substitute for obtaining legal advice from an attorney licensed in the appropriate jurisdiction.

- This presentation has been approved for **0.5 general credit**.
- Participants must submit the form by **Wednesday, September 16** in order to receive CLE credit.

CLE Form Link:
https://gibsondunn.qualtrics.com/jfe/form/SV_5u9wUNBAZdmvKwC

Most participants should anticipate receiving their certificate of attendance in 4-6 weeks following the webcast.

All questions regarding MCLE Information should be directed to **CLE@gibsondunn.com**.

Today's Panelists

Pamela Lawrence Endreny

Pamela Lawrence Endreny is a partner in the New York office of Gibson Dunn and a Co-Chair of the firm's Tax Practice Group. Pamela represents clients in a broad range of U.S. tax matters. Her experience includes mergers and acquisitions, spin-offs, investment funds, joint ventures, financings, and capital markets transactions.

Jennifer Sabin

Jennifer Sabin is a partner in the New York office of Gibson, Dunn & Crutcher. She represents clients in a broad range of domestic and international tax matters, including taxable and tax-free mergers and acquisitions (public and private), spin-offs, joint ventures, financings, capital markets transactions, and restructurings. Her practice also includes transactions undertaken by private equity, hedge funds, and asset managers.

Ryan Rott

Ryan Rott is of counsel in the New York office of Gibson Dunn. He represents clients on a variety of domestic and international tax matters. Ryan advises on the tax aspects of private and public mergers and acquisitions, spin-offs, joint ventures, restructurings and financing transactions. He also has experience advising on initial public offerings using unique structures and strategies.

Agenda

Today's Goals

- CVRs are financial instruments that help bridge valuation gaps, particularly in acquisitions in industries where value depends on future events, and they can be an important part of finalizing a deal.

- Despite the proliferation of CVRs in the market, the U.S. federal income tax treatment of a CVR is not clear. No authority directly addresses it.

- **In the next 30 minutes**: what a CVR is and the role it plays in a transaction, the menu of potential treatments for U.S. tax purposes, and the considerations that arise when CVRs are used in tax-deferred transactions.
- Intended as a resource for practitioners who may encounter CVRs.

What is a Contingent Value Right?

What is a Contingent Value Right?

- A CVR is a contractual right, issued as part of consideration, typically in a merger or acquisition, to receive additional payments if specified future events occur.
- A CVR is separate from the cash or stock delivered at closing and survives as an obligation of the issuer.

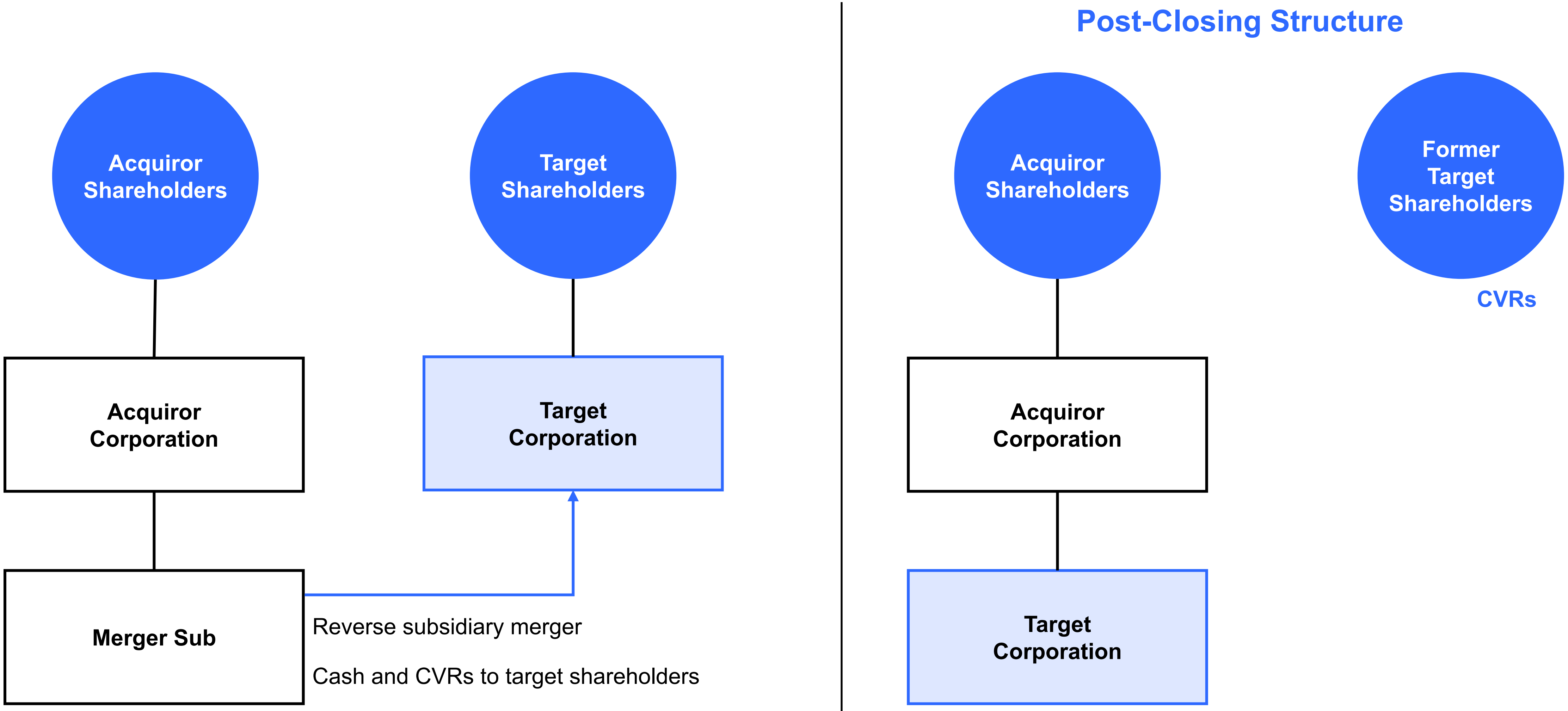
- CVRs have served various purposes over the years. An earlier generation provided price protection, assuring target shareholders of a floor value for stock consideration.
- Issuers now use them principally in deals involving businesses that are difficult to value.

- A CVR allows the parties to sign without agreeing on value: the acquiror pays for the contingency only if it materializes, and the target shareholders keep the upside.
- Common in life sciences, where much of the value turns on future events such as a compound receiving regulatory approval or reaching commercialization.

Terms of a Typical CVR

- A CVR is created by a separate agreement between the corporate issuer and a rights agent acting on behalf of the holders.
- The issuer agrees to pay a stated amount per CVR to the extent specified contingencies come to pass within a certain timeframe; if they do not, the CVR expires without payment.
  - Common contingencies include receipt of royalties or sales proceeds, a compound or process achieving regulatory approval, prevailing in litigation, receiving tax refunds, or meeting financial metrics.
  - The issuer’s obligation to pursue the milestone is heavily negotiated.
- Payments may be made in cash, in issuer stock, or in a mix of both, and the form of consideration may be mandatory or elective.
- Most CVR agreements prohibit assignment or transfer by the holder.
  - Less commonly, the CVR is separately assignable or listed for trading on a public securities market, a distinction that drives much of the tax analysis that follows.

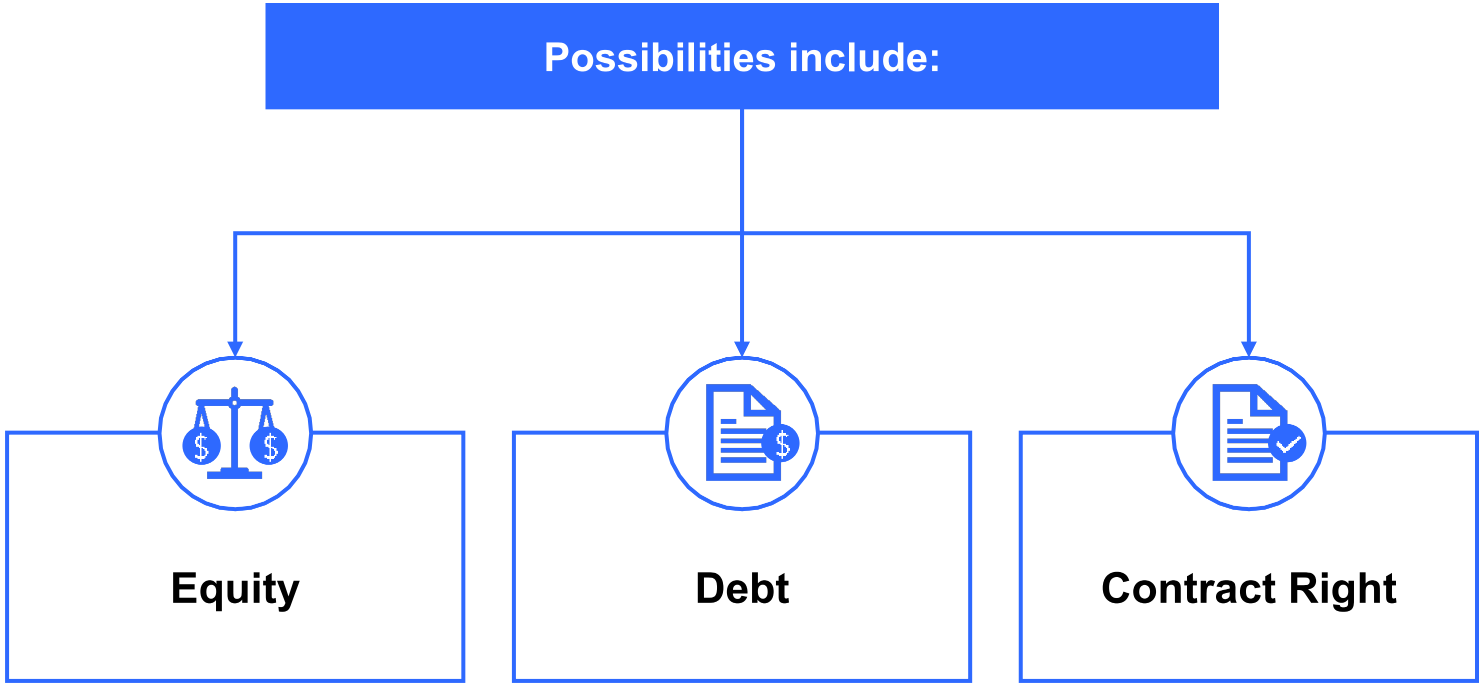
Example: Simple CVR Transaction



What is the Tax Treatment of a CVR?

Characterization: The Threshold Question

No authority addresses the characterization of a CVR.



Characterization: Equity, Debt, or Contract Right?

Not equity

- A CVR is not stock in form and carries none of the incidents of stock ownership — no vote, no right to dividends, and no right to share in the assets of the issuer on liquidation.
- Contrast tracking stock, which is stock in form and carries the vote and the liquidation rights of the issuer's regular stock; only its dividend rights track a specified business.

Not debt

- Indebtedness is "an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date." *Gilbert v. Commissioner*, 248 F.2d 399 (2d Cir. 1957).
- A CVR is contingent as to both amount and timing, so there is no unqualified obligation and no fixed maturity date.

Most likely: a contract right

- A contract right against the issuer, given in exchange for the shareholder's target stock and promising additional consideration for that stock.
- Payments turn on metrics that measure what the target stock was worth, like the economics of a negotiated earn-out.
- Or a cash-settled call on the target's success? Price protection CVRs are the mirror image, treated as puts. Rev. Rul. 88-31.

The Open Transaction Doctrine

Does the open transaction doctrine apply?

- In *Burnet v. Logan*, 283 U.S. 404 (1931), the taxpayer sold stock of a coal mining company for cash plus the right to a payment for every ton of coal later mined by an affiliate. The Court held that the contingent right had no ascertainable fair market value, so the sale remained open: the taxpayer recovered basis first and reported gain only as payments came in.
- The doctrine defers the measurement of gain, and it preserves the character of the underlying sale.

- *Cf. Tribune Publishing Co. v. United States*, 836 F.2d 1176 (9th Cir. 1988) (open transaction doctrine did not apply to an obligation received in an exchange despite its uncertain value; the Ninth Circuit read *Burnet v. Logan* to reach only cases in which it is uncertain whether the taxpayer will realize any profit at all).

Closed Transaction: Installment Method and Cash Equivalency

- If treated as a closed transaction:
  - the target shareholder may report receipt of the CVR under the installment method of accounting unless the target stock, or the CVR itself, is publicly traded.
    - Because the total consideration is not fixed, the contingent payment rules apply, and basis is generally recovered ratably over the maximum payment period.
- If not an installment sale, what about cash equivalency doctrine?
  - Before installment sales, some authorities held that as a matter of tax accounting, an individual cash-method taxpayer would not need to take into account a contractual promise (if not embodied in a note or negotiable instrument).
  - *But see* Warren Jones Co. v. Comm'r, 60 T.C. 663 (1973) (nonacq.), *rev'd*, 524 F.2d 788 (9th Cir. 1975) (holding that a seller must include a land contract in income because the contract could be sold, even if at a materially reduced price).

Open or Closed: Availability and Consequences

Is open treatment available?

- The Service's position: open transaction treatment applies only in rare and extraordinary circumstances, where fair market value cannot reasonably be ascertained. Treas. Reg. §§ 1.1001-1(g)(2)(ii), 15A.453-1(d)(2)(iii); Rev. Rul. 58-402.
- Rev. Rul. 58-402: the concern is conversion of ordinary income into capital gain.
- Not available if the CVR is separately transferable.

If open

- Later payments constitute additional consideration for the target stock sold, subject to tax only to the extent they exceed the adjusted basis of that stock.
- Character follows the target stock sold (generally capital gain), subject to an imputed interest component under section 483.

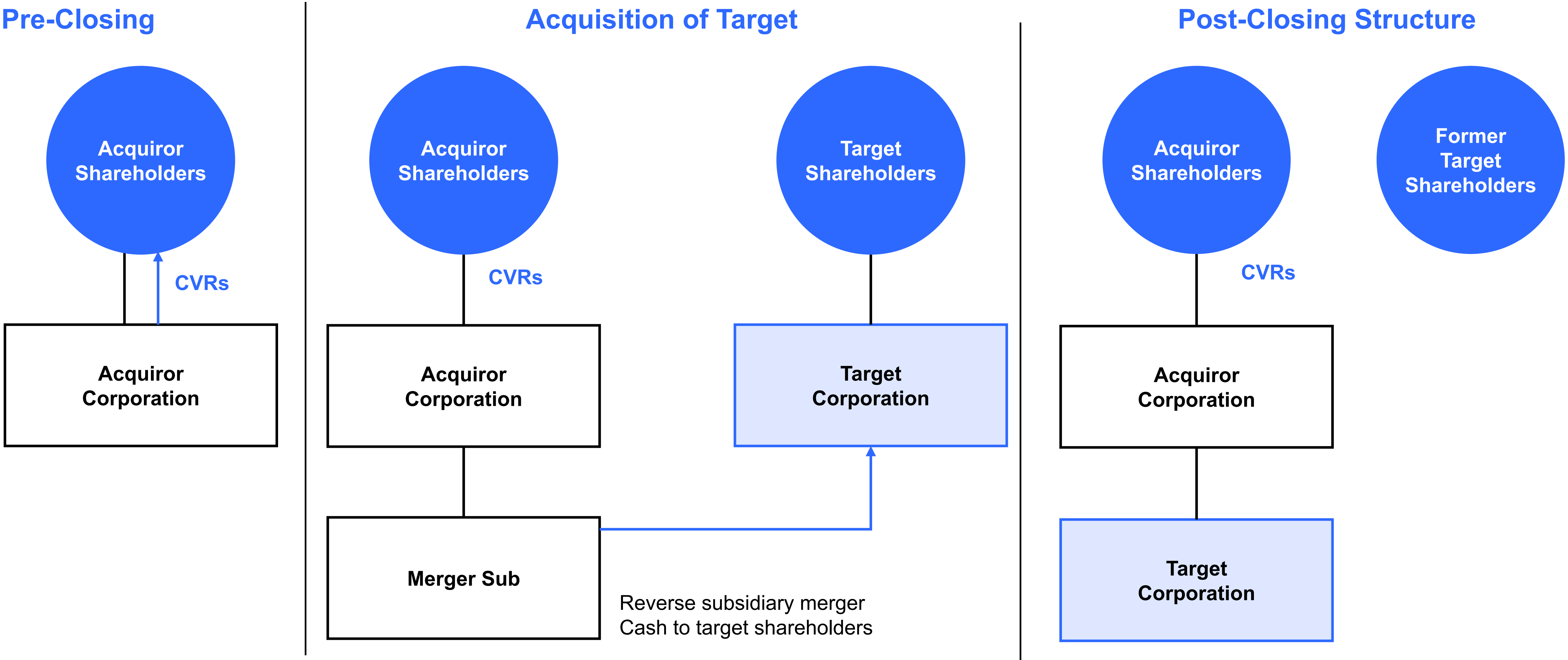
If closed

- The holder includes the value of the CVR in amount realized and takes a basis in the CVR equal to that amount.
- Payments are generally recovered against basis first; the alternatives are current income on each payment with a loss at the end of the term, or ratable recovery.
- Character of payments exceeding basis is unclear. Does the origin-of-the-claim doctrine supply the answer?

Finding Capital Gain? Section 1234A

- Could section 1234A provide a position to report capital gain?
- Section 1234A(1) provides:
  - “gain or loss attributable to the cancellation, lapse, expiration, or other termination of a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain or loss from the sale of a capital asset.”
- The CVR is a right with respect to the target stock, which was a capital asset in the holder’s hands.
- Section 1234A has been applied on the settlement or termination of a contract, which fits the expiration of a CVR or a final milestone payment.
  - But a milestone payment may instead be a scheduled payment on the CVR rather than a termination of it.
  - Would the analysis change if a separate CVR were issued for each payment, so that each payment terminates its own instrument?

Example: Pre-Closing CVR Distribution



Distributed CVRs: Characterization

The transaction

- The acquiror distributes CVRs to its own shareholders immediately before the closing.
- Business reasons mirror the use of CVRs as acquisition currency: the pre-closing shareholders keep the upside on a contingency they will not share with the target's holders.
- These CVRs typically are not transferable.
- Characterization presents the same three possibilities — equity, debt, or a contract right.

Still not equity: compare tracking stock

- A distributed CVR is not tracking stock: not stock in form, no vote, no liquidation rights in the issuer's assets.
- If it were, section 305(a) generally would make the distribution tax-free — basis allocated by relative value, holding period tacked — and section 311(a)(1) would protect the issuer.
- Later payments would be tested under section 301 or section 302.

Still not debt: compare CPDI rules

- Still no sum certain payable at a fixed maturity date.
- Section 1275(a)(4) treats a corporation's debt obligation distributed with respect to its stock as if issued for property.
- The CPDI rules would then apply: current imputed interest, with each contingent payment treated as made in retirement of the instrument resulting in capital gain plus imputed interest. Treas. Reg. § 1.1275-4(c).

Current Distribution or Mere Promise?

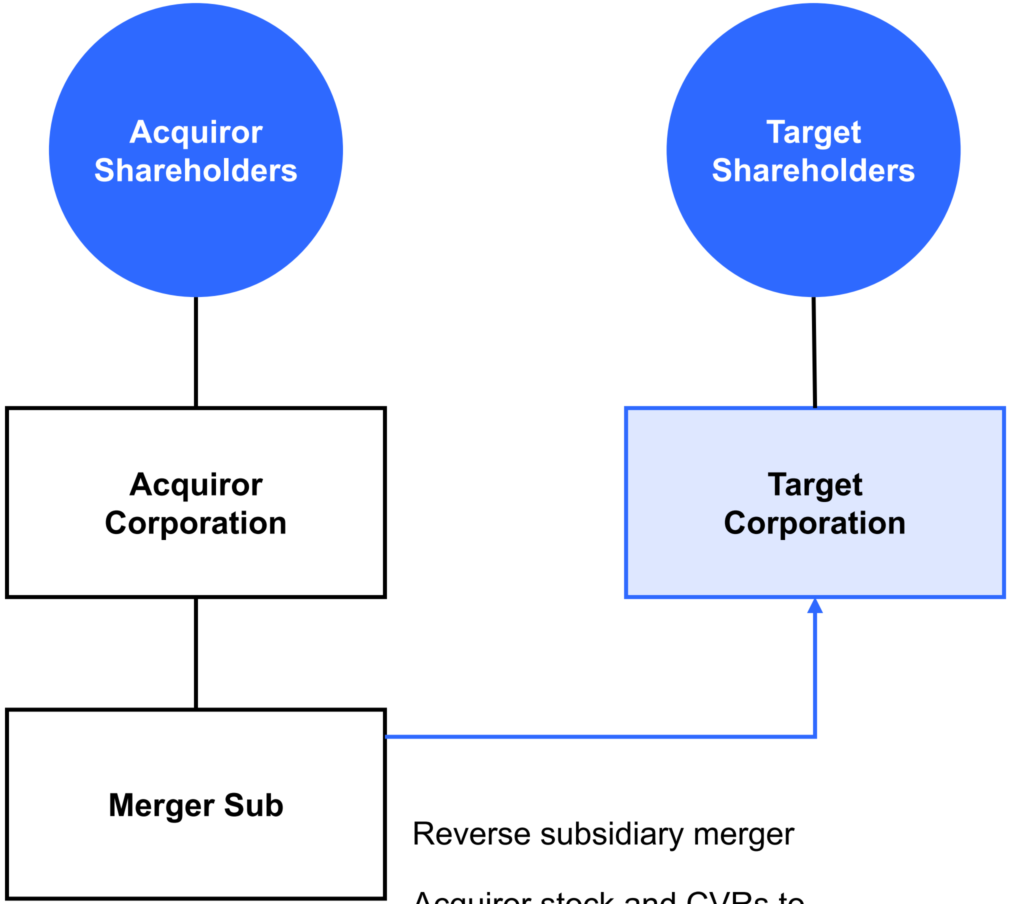
Is a CVR a distribution or a mere promise?

- If a mere promise, then the distribution is disregarded and payments are distributions under section 301 when made.
- Distribution in form of debt generally treated as property for purposes of section 317(a). Section 312(a)(2); Treas. Reg. §§ 1.301-1(a), -1(j); 1.317-1; *Bazley v. Comm'r*, 331 U.S. 737 (1947).
- Examples pointing toward a distribution: *Moser v. Comm'r*, 914 F.2d 1040 (8th Cir. 1990) (journal entry with obligation demonstrated dividend); *Roe v. Comm'r*, 192 F.2d 398 (5th Cir. 1951) (distribution occurred when the corporate resolution was adopted and established accounts payable); public disclosures, typically.
- Examples pointing toward a mere promise: *Stephens v. Comm'r*, 60 T.C. 1004 (1973), aff'd per curiam, 506 F.2d 1400 (6th Cir. 1974) (future obligation not current distribution); *Vinnell v. Comm'r*, 52 T.C. 934 (1969) (payments over ten years); FAA 20055202F (obligation contingent as to both amount and timing).

Considerations Relating to the Use of CVRs in a Tax-Free Reorganization

Example: CVRs in Section 368 Reorganizations

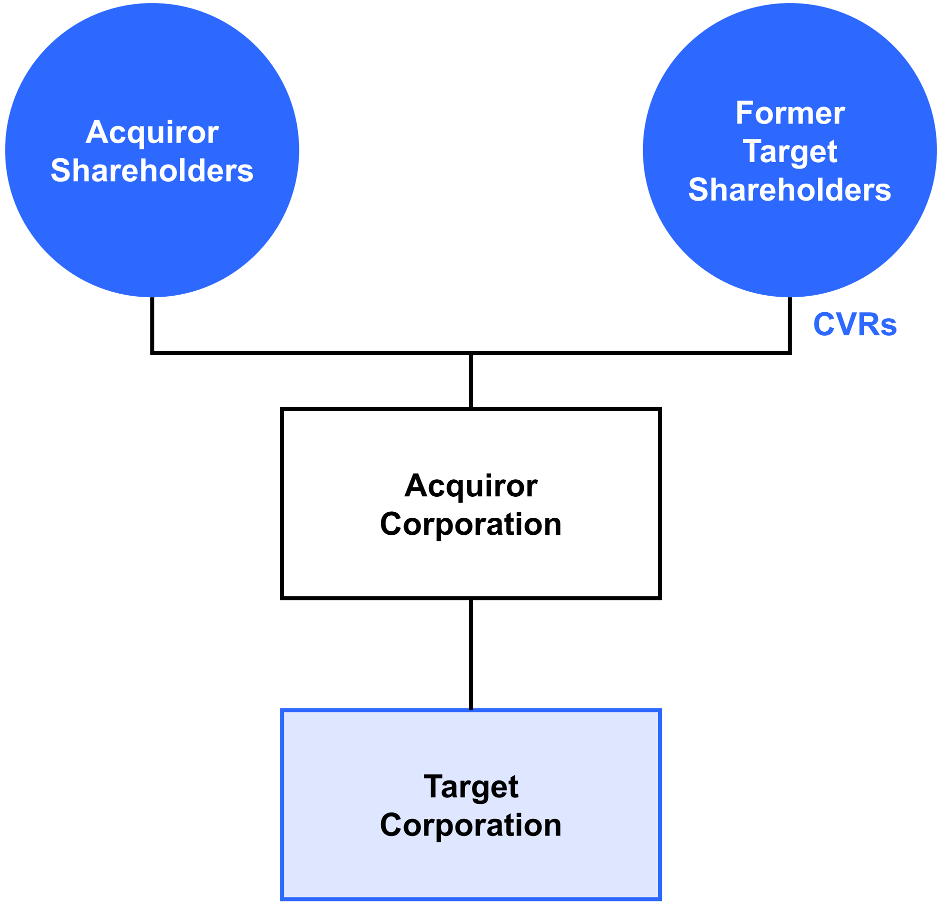
Acquiror Stock + CVRs Issued to Target Shareholders



Reverse subsidiary merger

Acquiror stock and CVRs to target shareholders

Post-Closing Structure



CVRs in a Tax-Free Reorganization

- A CVR issued in a transaction intended to qualify as a section 368(a) reorganization raises the question whether it is boot, which in turn impacts requirements such as continuity of interest.
- A CVR that can be settled only in additional shares of acquiror stock raises fewer concerns under section 368.
  - Rev. Proc. 84-42, 1984-1 C.B. 521, sets out the conditions for a ruling that contingent stock is not boot in a reorganization.
  - A CVR that may be paid in cash rather than stock therefore falls outside the procedure's standards.

Reorganization Requirements: Continuity of Interest

Treasury Regulations:

> Continuity of interest requires that… a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization. A proprietary interest in the target corporation is preserved if, in a potential reorganization, it is exchanged for a proprietary interest in [the acquiror]…, it is exchanged by the acquiring corporation for a direct interest in the target corporation enterprise, or it otherwise continues as a proprietary interest in the target corporation. Treas. Reg. §1.368-1(e)(1)(i).

- Continuity is established under regulations if 40% of the consideration is acquiror stock
  - But see, e.g., John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935) (38% stock satisfied)).

Continuity Timing: Signing Date and Open Questions

- Continuity may be measured on the signing date if the agreement provides for fixed consideration. Treas. Reg. § 1.368-1(e)(2)(i).
  - Consideration is not fixed if the contract provides for contingent adjustments that prevent, to any extent, the target shareholders from bearing the economic benefits and burdens of ownership of the acquiror stock after the signing date. Treas. Reg. § 1.368-1(e)(2)(iii)(C)(2).
- The regulation is aimed at contingencies based to the value of the acquiror between signing and closing.
  - A typical CVR issued to target shareholders is instead centered on the target's own assets or milestones, not the risk the regulation addresses.
- If the signing date rule does not apply, is continuity measured at closing, or as payments are made on the CVR?
  - The answer may turn on the treatment of the receipt of the CVR — the open or closed transaction question again.
- The same analysis impacts a reverse subsidiary merger under section 368(a)(2)(E), which requires target shareholders to surrender stock constituting 80% control in exchange for voting stock.


GIBSON DUNN