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The Effect of Transfer Restrictions On Continuity of Interest

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This article examines whether transfer restrictions must be accounted for when valuing acquiror stock for purposes of measuring continuity of interest. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author only and does not necessarily represent the views or professional advice of Gibson, Dunn & Crutcher LLP.

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Introduction

Parties to a reorganization under section 368 will sometimes enter into agreements that restrict the ability of the target shareholders to dispose of the acquirer stock they receive in the transaction for some specified period of time. These are typically referred to as lockup agreements and are entered into for a variety of reasons, including to ensure an element of stability in the stock price, to achieve certain accounting objectives and to prevent hostile takeover attempts. It is clear from both an economic and a tax standpoint that a lack of transferability reduces the value of acquirer shares.[1] What is less clear is whether such reduction should be accounted for when measuring continuity of interest (COI). For planning purposes, the conservative approach is to factor in the discount attributable to the lockup in order to establish the worst-case scenario — that is, to determine the lowest possible value of the acquirer shares to be issued in the merger and to ensure that such value does not dip below 40 percent of the aggregate merger consideration. However, it is not at all clear that such calculations are required under the law. This article examines whether it might be possible to take a more aggressive posture and ignore such lockup agreements when measuring COI.

Lockups and the COI Test in General

Continuity of interest is a nonstatutory, judicially created requirement to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations.[2] COI requires that a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.[3] Examples in the regulations indicate that continuity will be preserved when at least 40 percent of the deal consideration received by target shareholders in exchange for their stock constitutes stock in the acquirer (or in the parent of the acquirer, depending on the type of reorganization).[4] The regulations relating to the COI test are silent as to the method used to calculate the value of the merger consideration and, in particular, do not specifically address whether discounts on acquirer stock must be applied to account for any restrictions on transfer of such stock.[5]

The issue of valuing stock and applying appropriate discounts for lack of transferability arises most often in the estate and gift tax arenas, in which stock transferred at death or during life may be subject to tax based on such value. The issue of stock valuation arises less often in the context of corporate reorganizations, where the parties to the reorganization will simply agree on stock value and where, at least for purposes of determining the amount realized, the IRS will not have a strong basis to challenge such valuation where the parties are bargaining at arm's length. When allocating value between stock and other property, however, the parties will generally both prefer to allocate more of the total value to the stock, particularly when the reorganization is an asset deal and the consequences of failing COI include a corporate-level tax liability that the buyer can inherit. The IRS has not yet challenged COI based on stock valuation principles, nor

[1]*See*, *e.g.*, Rev. Rul. 59-60, 1951-1 C.B. 237, section 8 (restrictive agreements are one of many factors to consider in the valuation of a company). *See also* Internal Revenue Manual 4.48.4.2.2 (July 1, 2006) (business valuation guidelines for IRS personnel indicate that personnel should identify "restrictions, agreements and other factors that may influence value" in developing valuation conclusions).

[2]*See*, *e.g.*, *Paulsen v. Commissioner*, 469 U.S. 131 (1985), and the cases cited therein. *See also* reg. section 1.368-1(e)(1).

[3]Reg. section 1.368-1(e)(1).

[4]Temp. reg. section 1.368-1T(e)(2)(v), examples 1, 6, and 12.

[5]There are temporary regulations that discuss *when* merger consideration is to be valued, but not the method used to arrive at such value. *See* temp. reg. section 1.368-1T(e)(2).

has this issue been addressed by commentators. Nonetheless, not all practitioners are convinced that the IRS will continue to fall in line. The conservative view is that lockups should be taken into account when measuring COI.

The estate tax regulations contain specific rules for valuing stock that have been held to apply to valuation issues arising in an income tax context and which tax practitioners typically defer to when measuring COI.[6] Reg. section 20.2031-2(b) provides that if there is a market for a stock on a stock exchange, the average between the highest and lowest quoted selling prices on the valuation date is the fair market value of the stock. Nonetheless, wary practitioners will make sure that an appraiser is hired to value acquirer stock subject to lockups in a purported reorganization, whether such stock is of a privately held company or is publicly traded, and that an appropriate discount is applied. When the acquirer is a publicly traded company, the trading price of such stock will usually be the best indication of value. Circumstances may exist, however, that warrant modifying such prices to arrive at a more accurate valuation, including when such stock is subject to transfer restrictions. Reg. section 20.2031-2(e) provides that for estate tax purposes, ''If it is established that the value of any bond or share of stock determined on the basis of selling or bid and asked prices as provided under paragraphs (b), (c), and (d) of this section does not reflect the fair market value thereof, then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value.'' Generally speaking, this principle should also apply to valuing stock for purposes of measuring COI.

As stated above, the conservative approach is to account for lockups when measuring COI. However, one might take a more aggressive stance and argue that the proper approach for measuring COI is to not apply a discount for such lockups. An argument that transfer restrictions should not be taken into account can be derived from the policy objectives behind the COI test: to ensure that, after an acquisitive reorganization, the target shareholders continue to own a substantial part of the value of their proprietary interests in the target by virtue of their ownership of acquirer stock, such that a mere reshuffling of interests has occurred that should not result in tax. To the extent the target shareholders are not allowed to sell their shares of acquirer stock, this preserves their proprietary interests in the corporate enterprise and arguably should not decrease the value of such stock for purposes of measuring continuity. In fact, prior to regulations proposed in December 1996 and adopted in January 1998,[7] the law *required* target shareholders to retain their proprietary interest in acquirer stock for some minimum period of time, unless they could prove there was no preconceived plan to sell, in order to include such acquirer stock in the continuity of interest calculation.

Pre-1998 Law

In Rev. Rul. 66-23, the issue was whether COI was satisfied when a shareholder of the target corporation received stock in the acquirer corporation subject to a court order to dispose of all of the stock within seven years.[8] The shareholder had no preconceived plan to sell the acquirer stock, although it knew it had to dispose of all shares within seven years. The IRS ruled that COI could be satisfied when the target shareholder had ''unrestricted rights of ownership for a period of time sufficient to warrant the conclusion that such ownership is definite and substantial,'' adding that five years of unrestricted ownership is generally a sufficient period of time. Alternatively, the IRS held that even if the shares were disposed of within five years, such disposition would not affect continuity provided there was no preconceived plan to dispose of the shares at the time of the reorganization. The ruling noted the taxpayer's unrestricted rights in the stock and its ability to freely dispose of it as factors supporting continuity. Stock that is subject to a lockup agreement obviously would not fit this description. Nonetheless, the point in the ruling about unrestricted ownership seems to be merely that a sale in year 7 was not preordained — that is, the taxpayer was free to sell, or not, at any time before that. The focus in Rev. Rul. 66-23, and the authorities that followed, was whether a future sale of acquirer stock was preordained such that it should be stepped together with the initial transaction whereby the shareholder exchanged its target shares for such acquirer stock.[9] If the steps were integrated, it would be viewed under the tax law as a sale of the target shares for nonqualifying consideration under the COI test, making the initial exchange taxable. To the extent that lockup agreements limit the possibility of a future sale, these presumably should have been viewed favorably under pre-1998 law or at least should not have resulted in a discount when measuring COI.

In *Novacare, Inc. v. United States*,[10] the Court of Federal Claims applied pre-1998 law in analyzing postmerger sales and provided an apt summary of the case law that existed up until that time. In that case, Novacare's wholly owned subsidiary merged with and into Rehab Systems Co. (RSC). Within a little over a year of the closing of the merger, the RSC shareholders had disposed of roughly 87

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[6]*See, e.g., Robinson v. Commissioner*, T.C. Memo. 1985-275 (1985); *Meyer v. Commissioner*, 46 T.C. 65, 106 (1966), *modified on other grounds*, 383 F.2d 883 (8th Cir. 1967).

[7]Prop. reg. section 1.368-1(e) (Dec. 20, 1996) (effective prospectively on final promulgation), which occurred on January 29, 1998, in T.D. 8760.

[8]1966-1 C.B. 67.

[9]*See*, *e.g.*, *Novacare, Inc. v. United States*, 52 Fed. Cl. 165 (Fed. Cl. 2002), *Doc 2002-7410*, *2002 TNT 65-6*; *McDonald's of Zion v. Commissioner*, 76 T.C. 972 (1981), *rev'd sub nom. McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520 (7th Cir. 1982); *Penrod v. Commissioner*, 88 T.C. 1415 (1987); *Christian Est. v. Commissioner*, T.C. Memo. 1989-413. *See also* Rev. Proc. 86-42, 1986-2 C.B. 722, in which the IRS required taxpayers to represent, as a prerequisite to receiving a private letter ruling under section 368, that there was no plan or intention on the part of target shareholders to dispose of several shares of acquirer stock such that the target shareholders' ownership of acquirer stock would be reduced below the COI threshold.

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percent of the Novacare shares received in the merger. Three years later, Novacare disposed of its shares of RSC and calculated its tax consequences by assuming that the merger with RSC was a tax-free reorganization, resulting in a carryover basis in its shares of RSC and gain on the sale. However, Novacare later filed a refund claim based on the conclusion that the merger with RSC had actually been a taxable cash purchase, resulting in a stepped-up basis in the RSC shares and a loss on the subsequent disposition of such shares. Novacare's argument was that the postmerger sales of Novacare stock by the RSC shareholders should be stepped together with the merger transaction, thus destroying COI. The IRS argued that without proof that the shareholders intended to sell their shares at the time of the merger, the two steps should not be integrated.

The court, referring to a sequence of cases that applied the step transaction doctrine to analyze the effect of postmerger sales on COI, held that the subsequent sale by the RSC shareholders should not be stepped together with the merger, based on the end result and interdependence tests.[11] According to the court, under the end result test ''courts will apply the step-transaction doctrine when it appears that formally distinct steps 'were really components of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result.'''[12] The end result test focuses on subjective intent. The interdependence test, on the other hand, is supposed to rely less on intent and more on an objective inquiry as to whether each of the separate transactions would have been likely to occur in the absence of each other in normal business settings. Applying the end result test, the court found that genuine issues of material fact existed regarding whether the RSC shareholders intended to effectuate a cash purchase of their shares as the end result of the transaction. Regarding the interdependence test, the court likewise held that there were open factual issues as to whether guarantees of salability granted to the RSC shareholders were integral to the transaction and whether the postmerger sales were a direct result of such guarantees. As a result of these findings, the court denied both parties' motions for summary judgment.

In *NovaCare*, some RSC shareholders signed lockup agreements that prohibited transfer of the acquirer shares received in the merger for a period of time necessary to achieve certain accounting treatment for the parties. The lockup period lasted just over two months, and on the day immediately following that period the RSC shareholders sold or transferred as gifts 33 percent of the shares received in the merger. Although the court did not focus on the lockup agreements in its analysis, it is easy to imagine a negative implication of the agreements under these facts: The fact that so many shares were disposed of immediately after could be viewed as evidence of an intent to dispose of such shares that existed at the time of the merger. In the absence of such conspicuous transfers, however, a lockup agreement does nothing more than prevent postmerger sales. Such an agreement should have served as evidence under pre-1998 law that the target shareholders did not intend to sell their shares (at least not during the lockup period), thereby precluding use of the end result test as a means of disrupting continuity. Similarly, lockup agreements should have served as a barrier in claiming the mutuality between a merger transaction and postmerger sales for purposes of applying the interdependence test.

The 1998 Continuity of Interest Regulations

The issue of postmerger sales has been mostly displaced by reg. section 1.368-1(e)(1), adopted on January 29, 1998, which provides that ''a mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related (as defined in paragraph (e)(4) of this section) to the issuing corporation is disregarded.''[13] Accordingly, it can no longer be said that lockups should be viewed favorably for COI purposes because they prevent application of the step transaction doctrine. Treasury has explicitly provided that this is no longer a risk. Nonetheless, does this change in law mean that lockups should now be viewed negatively for COI purposes (that is, as reducing the value of acquirer stock, thereby making the 40 percent threshold harder to attain)? There are at least a few arguments for why this should not be the case.

One way in which lockups still serve to preserve COI is by preventing postmerger sales or redemptions of acquirer shares by target shareholders back to the acquirer (in the case of redemptions) or to persons related to the acquirer (in the case of sales), as such sales and redemptions continue to be subject to the step transaction principles discussed above. Reg. section 1.368-1(e)(i) states that a ''proprietary interest in the target corporation is not preserved if, in connection with the potential reorganization, it is acquired by the issuing corporation for consideration other than stock of the issuing corporation, or stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed.''[14] The same regulatory provision states that postmerger sales are disregarded, but not to the extent such sales are to persons related to the issuing corporation.[15] As lockup agreements would in many instances prevent such transactions, one would think this would mitigate viewing such agreements negatively for COI purposes.

The COI test must be satisfied not only in the context of reorganizations, but also to achieve a tax-free corporate division under section 355 (spinoffs, split-offs, and split-ups; collectively, spinoffs).[16] The basic policy justification for the COI requirement is the same in both arenas:

[11] *Id.*, at 175-176, citing *McDonald's Restaurants of Illinois, Inc. v. Commissioner*, 688 F.2d 520; *Penrod v. Commissioner*, 88 T.C. 1415 (1987); *Estate of Elizabeth Christian*, 57 T.C.M. 1231 (1989).

[12] *Id.*, at 174, citing *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516.

[13] *See* reg. section 1.368-1(e)(8), Example 1.

[14] *See* reg. section 1.368-1(e)(8), examples 4 and 5.

[15] Reg. section 1.368-1(e)(i).

[16] Reg. section 1.355-2(c).

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to prevent transactions that resemble sales from qualifying for tax-free treatment available to corporate reorganizations.[17] However, the 1998 COI regulations, which provide that postmerger sales will not disrupt continuity, are relevant solely for reorganizations. The preamble to such regulations explicitly provides that they do not apply to section 355 transactions.[18] Therefore, pre-1998 COI law continues to apply regarding spinoffs, and there is still the risk that post-spin sales may be integrated with the spin to disrupt continuity.[19] Accordingly, subjecting the shares of either the distributing or controlled corporation in a spinoff to transfer restrictions, such as a lockup agreement, should not negatively affect COI, as it would prevent a subsequent sale of such shares by the distributees for nonqualifying consideration.

Extending this rationale one step further, if lockups would not negatively affect COI in the section 355 arena, one would also think they would not negatively affect COI when applied to reorganizations, as in each case we are applying the same basic test to achieve the same policy objectives. Granted, Treasury may have declined to extend the 1998 regulations, which allow for postmerger sales to spinoffs, because it views the COI requirement as additional protection against the use of a spinoff as a device to distribute earnings and profits at capital gains rates.[20] The device test is not present in reorganizations, but this difference would not seem to justify the disparate treatment of lockups in reorganizations and spinoffs. Whether or not COI happens to serve a dual purpose regarding spinoffs, the policy objectives behind COI are the same in both arenas, and the application of the test should therefore be consistent. If lockups are disregarded for purposes of measuring COI in spinoffs, intuitively they should be disregarded when measuring COI in reorganizations as well.

The 2007 Regulations

Another argument for disregarding lockups when valuing acquirer shares can be derived from the treatment of escrowed shares in regulations issued in 2007 dealing with when merger consideration should be valued for purposes of COI.[21] Those regulations provide an example wherein target shareholders receive 40 shares of acquirer stock that is publicly traded and valued at $1 per share on the relevant valuation date and $60 of cash in a purported reorganization.[22] Twenty shares of the acquirer stock, however, are placed into escrow as of such valuation date to secure customary target representations and warranties. The example concludes that there has been an exchange of $40 worth of acquirer stock and $60 of cash and that therefore the COI test has been satisfied. Even though the target shareholders will not receive the escrowed shares until some time after closing, and maybe not at all in the event an indemnity is triggered, such shares are given the same value as the nonescrowed shares for purposes of testing COI. Target shareholders are unable to sell their escrowed shares during the term of the escrow to the same extent as if such shares were subject to a lockup agreement for the same period of time. If no discount is applied to acquirer shares subject to an escrow for purposes of testing COI, it stands to reason that no discount should be applied to shares subject to a lockup.

A Countervailing View

Although there does not appear to be any existing commentary on the impact of lockups when measuring COI, one can glean a countervailing viewpoint to the one expressed in this article from some commentators' proposed treatment of contingent consideration for COI purposes.

There is uncertainty in the law regarding how to account for contingent consideration in the context of a purported reorganization. The case law generally provides that contingent rights to receive stock in the future will not be treated as boot and therefore will not cause an otherwise qualifying reorganization to so qualify.[23] After its position that such rights should constitute boot had been struck down in both the *Carlberg* and *Hamrick* cases, the IRS issued Rev. Proc. 88-42, which generally provides requirements that must be met for a taxpayer to receive a favorable ruling on a reorganization that contains contingent stock.[24] These authorities all deal with whether contingent rights to stock issued in a purported reorganization will be treated as taxable boot or whether such rights can be received tax free under section 354. They do not, however, discuss whether and how such rights should be factored into the COI analysis. The 2007 regulations contain an example that suggests a ''wait and see'' approach. In temp. reg. section 1.368-1T(e)(2)(v), Example 2, continuity is reduced when escrowed shares are forfeited by the target shareholders after a merger, suggesting that a taxpayer cannot know the impact of contingent or escrowed shares on COI until the outcome of the contingency or escrow arrangement has been finally determined. This is a startling position (considering the rule throughout the tax law that transactions

[17] *Id.*; reg. section 1.368-1(e)(1).

[18] *See* T.D. 8760, 63 *Fed. Reg.* 4,174 (Jan. 28, 1998).

[19] *See, e.g.*, *Farr v. C.I.R.*, 24 T.C. 350 (1955) (holding that COI was satisfied in a split-off transaction under the predecessor to section 355 despite a subsequent sale of stock by the distributee, based on factual determination that such sale was not interdependent with the split-off); *see also Novacare, Inc. v. United States*; *McDonald's Restaurants of Illinois, Inc. v. Commissioner*; *Penrod v. Commissioner*; *Estate of Elizabeth Christian*.

[20] *See* section 355(a)(1)(B) and reg. section 1.355-2(d) for rules regarding the device test applicable to spinoffs.

[21] Reg. section 1.368-1T(e)(2), generally referred to as the signing date rules.

[22] Reg. section 1.368-1T(e)(2)(v), Example 1.

[23] *See Carlberg v. United States*, 281 F.2d 507 (8th Cir. 1960); *Hamrick v. Commissioner*, 43 T.C. 21 (1964), *acq. in result*, 1966-1 C.B. 2.

[24] 1984-1 C.B. 521, *amplifying* Rev. Proc. 77-37, 1977-2 C.B. 568. The requirements in Rev. Proc. 88-42 are more stringent than the case law, which generally only requires that the contingent right exist for a valid business purpose and represents only the right to additional stock and nothing more.

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should be held open only in rare and extraordinary circumstances[25]) with which commentators have taken exception.

The New York State Bar Association (NYSBA) Tax Section has published a report arguing that contingent consideration should be valued as of the signing date, with applicable discounts applied to account for the likelihood that such consideration will not be paid.[26] The New York City Bar Committee on Taxation of Business Entities has very recently taken the same view, stating, "We recommend that continuity of interest for a reorganization be measured at closing (or pursuant to the signing date rule, if it applies), taking into account the fair market value of the contingent consideration (including the relevant discount as a result of the contingency)."[27] Thus, NYSBA and the New York City Bar have suggested that discounts should apply when measuring contingent consideration for COI purposes, taking what might be called a true fair market value approach. One would think that if measuring the true fair market value of contingent consideration was the appropriate valuation method, then that method would be equally appropriate when valuing acquirer stock subject to a lockup agreement. The justification for the discount may differ somewhat in each of the scenarios (contingent consideration is discounted based on the likelihood that it might not get paid, whereas acquirer stock subject to a lockup agreement is discounted based on the fact that it cannot be sold, but it is difficult to see a policy justification for applying a true fair market value approach to some forms of consideration and not to others.

Conclusion

Until the IRS or Treasury issues guidance that addresses how to treat lockup agreements for purposes of measuring COI, the conservative approach remains to apply a discount to the value of acquirer shares on account of such lockups. In practice, most purported reorganizations have a large enough cushion regarding the 40 percent requirement that this will not be an issue. However, in closer cases, there are a multitude of arguments that one can make for the proposition that such lockups can properly be ignored when measuring COI.

[25]*See, e.g.*, reg. section 1.1001-1(a) and 1.1001-1(g)(2)(ii); temp. reg. section 15A.453-1(d)(2).

[26]"Report on Treatment of Variable Stock Consideration in Tax-Free Corporate Reorganizations" (Feb. 4, 2004), *Doc 2004-2438*, *2004 TNT 25-12*. Note that this report was written before the adoption of the signing date rules, when COI was measured as of the effective time of a reorganization. NYSBA had written an earlier paper arguing that the valuation date should be as of signing, not closing, and that position was reiterated here.

[27]For the New York City Bar report, see *Doc 2010-7601* or *2010 TNT 66-15*.

Compulsory Payment Rules and Flow-Through Elections

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In ECC 200920051, the IRS suggested that an Italian election to treat two entities as transparent for Italian tax purposes resulted in a noncompulsory — and therefore noncreditable in the United States — foreign tax payment. This article discusses the impact of that ruling.

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The IRS has taken a step toward vigorous — aggressive even, some might say — enforcement of the compulsory payment rule for foreign tax credits. In ECC 200920051 (Apr. 7, 2009), *Doc 2009-11181*, *2009 TNT 93-60*, the IRS suggests that an Italian election to treat two entities as transparent for Italian tax purposes resulted in a noncompulsory (therefore noncreditable in the United States) foreign tax payment.

The compulsory payment rule (also called the noncompulsory or voluntary payment rule) essentially provides that taxpayers must make all reasonable efforts to reduce their foreign taxes, over time, to the maximum extent possible.[1] If an election or option under foreign law merely shifts a foreign tax liability to a different year or years, choosing or failing to choose it does not make a tax noncompulsory. (The IRS has distinguished situations in which an election instead changes the amount, rather than merely the year. See FSA 200049010 (Aug. 22, 2000), *Doc 2000-31670*, *2000 TNT 238-52*.) Lastly, a taxpayer is not required to change "its form of doing business, its business conduct, or the form of any business transaction" in order to comply with the compulsory payment rule. Reg. section 1.904-2(e)(5).

In a recent e-mailed chief counsel advice, the IRS suggests using the compulsory payment rule in a somewhat unusual way, to address moving foreign taxes to a different taxpayer (and thus separating the U.S. foreign tax credit from U.S. recognition of the associated foreign income) rather than an actual aggregate increase in the foreign tax. ECC 200920051 involves a U.S. taxpayer that owns two Italian controlled foreign corporations (A and B, or Italian disregarded entities (DEs)) and checks the box to disregard them for U.S. purposes. The taxpayer then contributes its interests in two other CFCs (C and D, or lowest-level CFCs) pro rata to A and B. The lowest-level CFCs elect to be treated as flow-through entities

[1]Reg. section 1.901-2(e)(5); *see also* reg. section 1.901-2(a)(1). ("A foreign levy is a tax if it requires a compulsory payment.")

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