

applicable for taxable years beginning on or after March 20, 2007. A taxpayer may apply § 1.199–(6)(c) to taxable years beginning after December 31, 2004, and before March 20, 2007.

■ **Par. 7.** Section 1.199–8T is amended by revising paragraphs (i)(1), (i)(2), (i)(3), and (i)(4) to read as follows:

§ 1.199–8T Other rules (temporary).

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(i) *Effective dates.* (1) through (4) [Reserved]. For further guidance, see § 1.199–8(i)(1) through (4).

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Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

Approved: March 14, 2007.

Eric Solomon,

Assistant Secretary of the Treasury.

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9316]

RIN 1545–BG14

Corporate Reorganizations; Guidance on the Measurement of Continuity of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations that provide guidance regarding the satisfaction of the continuity of interest requirement for corporate reorganizations. These regulations affect corporations and their shareholders. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section in this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective March 20, 2007.

Applicability Date: For dates of applicability, see § 1.368–1T(e)(8)(ii).

FOR FURTHER INFORMATION CONTACT: Lisa S. Dobson at (202) 622–7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background and Explanation of Provisions

The Internal Revenue Code of 1986 (Code) provides general nonrecognition

treatment for reorganizations described in section 368 of the Code. In addition to complying with the statutory and certain other requirements, to qualify as a reorganization, a transaction generally must satisfy the continuity of interest (COI) requirement. COI requires that, in substance, a substantial part of the value of the proprietary interests in the target corporation be preserved in the reorganization.

On August 10, 2004, the IRS and Treasury Department published a notice of proposed rulemaking (REG–129706–04) in the **Federal Register** (69 FR 48429) (2004 proposed regulations) identifying certain circumstances in which the determination of whether a proprietary interest in the target corporation is preserved would be made by reference to the value of the issuing corporation's stock on the day before there is an agreement to effect the potential reorganization. On September 16, 2005, the IRS and Treasury Department published final regulations in the **Federal Register** (TD 9225, 70 FR 54631) (2005 final regulations) which retained the general framework of the 2004 proposed regulations but made several modifications in response to the comments received regarding the proposed regulations. Specifically, the 2005 final regulations provide that in determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for the proprietary interests in the target corporation pursuant to a contract to effect the potential reorganization is valued on the last business day before the first date such contract is a binding contract (the signing date), if the contract provides for fixed consideration (the signing date rule).

After consideration of comments relating to the 2005 final regulations, the IRS and Treasury Department are revising those regulations as set forth in this Treasury decision. These temporary regulations provide guidance for measuring whether the COI requirement is satisfied. The following sections specifically describe the revisions.

A. Applicability of the Signing Date Rule

For purposes of determining whether COI is satisfied, the 2005 final regulations require the consideration to be exchanged for the proprietary interests in the target corporation to be valued on the last business day before the first date such contract is a binding contract, if such contract provides for fixed consideration. As noted in the preamble to the 2005 final regulations, the signing date rule is based on the

principle that, where a binding contract provides for fixed consideration, the target corporation shareholders can generally be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date. However, if the contract does not provide for fixed consideration, the signing date value of the issuing corporation stock is not relevant for purposes of determining the extent to which a proprietary interest in the target corporation is preserved.

These temporary regulations continue to apply the signing date rule where the contract provides for fixed consideration. If the contract does not provide for fixed consideration, the temporary regulations provide that the signing date rule is not applicable. Further, these temporary regulations clarify that where fixed consideration includes other property that is identified by value, that specified value is the value of such other property to be used in determining whether COI is satisfied.

B. Definition of Fixed Consideration

As noted above, the temporary regulations provide that the signing date rule only applies to contracts that provide for fixed consideration. These temporary regulations modify the definition of fixed consideration.

The 2005 final regulations provide four circumstances in which a contract will be treated as providing for fixed consideration. Generally, under the 2005 final regulations, a contract provides for fixed consideration if (1) the contract states the number of shares of the issuing corporation plus the amount of money and any other property to be exchanged for all proprietary interests in the target corporation; (2) the contract states the number of shares of the issuing corporation plus the amount of money and any other property to be exchanged for each proprietary interest in the target corporation; (3) the contract states the percentage of proprietary interests in the target corporation to be exchanged for stock of the issuing corporation; or (4) the contract states the percentage of each proprietary interest in the target corporation to be exchanged for stock of the issuing corporation.

These temporary regulations combine the first two circumstances into one sentence that defines fixed consideration. No substantive change to these two definitions of fixed consideration is intended with this amendment.

The target corporation shareholders are generally subject to the economic fortunes of the issuing corporation as of

the signing date only if the contract specifies the number of shares of the issuing corporation to be exchanged for all or each proprietary interest in the target corporation. Accordingly, the temporary regulations provide that the signing date rule is applicable in these situations. The IRS and Treasury Department request comments regarding whether it is appropriate to include in the definition of fixed consideration a contract that specifies a fixed percentage of the shares of the issuing corporation to be exchanged for all or each proprietary interest in the target corporation.

The temporary regulations eliminate the third and fourth circumstances described in the 2005 final regulations from the definition of fixed consideration. Because these types of transactions do not specify the number of shares of the issuing corporation to be received in the exchange, the target corporation shareholders are not subject to the economic fortunes of the issuing corporation as of the signing date. These provisions were removed because, in such situations, applying the signing date rule may produce inappropriate results.

A commentator noted that a transaction in which a fixed percentage of target corporation shares is exchanged for issuing corporation shares could inappropriately be precluded from satisfying COI due to the application of the signing date rule. For example, if the number of the issuing corporation shares to be received by the target corporation shareholders depends on the value of the issuing corporation shares on the closing date, and the issuing corporation shares appreciate significantly between the signing date and the closing date, the signing date rule could prevent a transaction from satisfying COI notwithstanding the fact that a substantial part of the value of the proprietary interests in the target corporation is exchanged for proprietary interests in the issuing corporation.

Further, the temporary regulations continue to treat a contract that provides for a shareholder election between shares of the issuing corporation stock and the money or other property to be exchanged for the proprietary interests in the target corporation as a contract that provides for fixed consideration in the circumstances described below.

C. Shareholder Elections

The 2005 final regulations contain a rule generally stating that a contract that permits the target corporation shareholders to elect to receive stock and/or money and/or other property

with respect to their target corporation stock will be treated as providing for fixed consideration if the contract also provides the minimum number of shares of the issuing corporation stock and the maximum amount of money or other property to be exchanged for all of the proprietary interests in the target corporation, the minimum percentage of the number of shares of each class of proprietary interests in the target corporation to be exchanged for stock of the issuing corporation, or the minimum percentage (by value) of the proprietary interests in the target corporation to be exchanged for stock of the issuing corporation. The 2005 final regulations further include two special rules prescribing certain assumptions to be made in the determination of whether COI is satisfied in shareholder election cases. For example, in the case in which the contract states the minimum number of shares of the issuing corporation stock and the maximum amount of money or other property to be exchanged for all of the proprietary interests in the target corporation, the determination of whether a proprietary interest in the target corporation is preserved is made by assuming the issuance of the minimum number of shares of each class of stock of the issuing corporation and the maximum amount of money or other property allowable under the contract and without regard to the number of shares of each class of stock of the issuing corporation and the amount of money or other property actually exchanged for proprietary interests in the target corporation.

These temporary regulations treat certain transactions that allow for shareholder elections as providing for fixed consideration regardless of whether the agreement specifies the maximum amount of money or other property, or the minimum amount of issuing corporation stock, to be exchanged in the transaction. As noted above, if the target corporation shareholders can generally be viewed as subject to the economic fortunes of the issuing corporation as of the signing date, it is appropriate to treat the contract as providing for fixed consideration and to apply the signing date rule. The IRS and Treasury Department believe that these circumstances exist in cases where the target corporation shareholders may elect to receive issuing corporation stock in exchange for their target corporation stock at an exchange rate based on the value of the issuing corporation stock on the signing date. For example, if the issuing corporation

stock has a value of \$1 per share on the last business date before the first date on which the contract is binding, and the agreement provides that the target corporation shareholders may exchange each share of target corporation stock for either \$1 or issuing corporation stock (based on the signing date value), the target corporation shareholders that choose to exchange their target corporation stock for stock of the issuing corporation are subject to the economic fortunes of the issuing corporation with respect to such stock as of the signing date. Accordingly, the IRS and Treasury Department believe that it is appropriate in such a case to apply the signing date rule to value the stock of the issuing corporation for purposes of testing whether the transaction satisfies the COI requirement.

Additionally, the IRS and Treasury Department are concerned that the assumptions in the shareholder election rule in the 2005 final regulations may create confusion about whether COI is satisfied based on the delivery of stock that does not in fact preserve the target corporation shareholders' proprietary interest in the target corporation when such result was not intended. For example, the rule might appear to suggest that stock that is redeemed in connection with the potential reorganization will nonetheless be treated as preserving the target corporation shareholders' proprietary interests in the target corporation, although this result would be contrary to Treas. Reg. 1.368-1(e)(1). Further, these assumptions could prevent a transaction from satisfying COI even though a substantial part of the value of the proprietary interests in the target corporation is actually exchanged for proprietary interests in the issuing corporation.

Because of this potential for confusion, and because these assumptions are not relevant to the revised shareholder election provision, the temporary regulations remove the assumptions so that the determination of whether COI is preserved depends on the actual consideration exchanged. Example 9 of the Temporary Regulations has been modified to illustrate the revised rules regarding shareholder elections.

D. Contract Modifications

The 2005 final regulations generally provide that a modification of the contract results in a new signing date. However, the 2005 final regulations provide that a modification that has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target

corporation shareholders will not be treated as a modification if the execution of the transaction pursuant to the original agreement would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification. One commentator suggested that this rule be broadened to include modifications that decrease the money or other property that will be delivered to the target corporation shareholders. These temporary regulations reflect this broadening.

Further, the IRS and Treasury Department believe that the signing date rule should also apply to provide certainty regarding the value of the issuing corporation stock used for purposes of testing COI if the transaction fails to qualify as a tax-free reorganization. For this reason, the IRS and Treasury Department believe that the exception to the modification rule should also be available for certain types of modifications if the transaction fails to satisfy COI at the time of the execution of the contract. Accordingly, these temporary regulations provide that certain contract modifications will not result in a new signing date if the terms of the original contract would have prevented the transaction from qualifying as a reorganization.

E. Contingent Consideration

The 2005 final regulations provide that contingent consideration will generally prevent a contract from being treated as providing for fixed consideration. However, the 2005 final regulations provide for a limited exception to that general rule. The exception applies to cases in which the contingent consideration consists solely of stock of the issuing corporation and the execution of the potential reorganization would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if none of the contingent consideration was delivered to the target shareholders. The IRS and Treasury Department received a number of comments regarding the effect of contingent consideration on the application of the signing date rule.

A number of commentators suggested that the scope of the exception should be expanded to include cases in which the delivery of the contingent consideration to the target corporation shareholders does not decrease the ratio of the value of the shares of issuing corporation stock to the value of the money or other property (determined as

of the last business day before the first date there is a binding contract) to be delivered to the target corporation shareholders relative to the ratio of the value of the shares of the issuing corporation stock to the value of the money or other property (determined as of the last business day before the first date there is a binding contract) to be delivered to the target corporation shareholders if none of the contingent consideration were delivered to the target corporation shareholders. These temporary regulations modify and expand the applicability of the signing date rule to certain transactions that provide for contingent adjustments (i.e., increases or decreases) to the consideration.

As described above, the signing date rule is based on the principle that, where a binding contract provides for fixed consideration, the target corporation shareholders can generally be viewed as being subject to the economic fortunes of the issuing corporation as of the signing date. The IRS and Treasury Department believe that where this principle holds true, the signing date rule should apply regardless of whether the transaction potentially qualifies as a reorganization, and regardless of whether the contract provides for certain contingent adjustments to the otherwise fixed consideration. Accordingly, these temporary regulations provide that, generally, a contract that otherwise qualifies as providing for fixed consideration will be treated as providing for fixed consideration even if it provides for contingent adjustments to the consideration, and regardless of whether the transaction would have satisfied COI in the absence of any contingent adjustments. However, if the terms of the contingent adjustments potentially prevent the target corporation shareholders from being subject to the economic fortunes of the issuing corporation as of the signing date, the contract will not be treated as providing for fixed consideration.

Accordingly, these temporary regulations provide that a contract will not be treated as providing for fixed consideration if it provides for contingent adjustments to the consideration that prevent (to any extent) the target shareholders from being subject to the economic benefits and burdens of ownership of the issuing corporation as of the signing date. For example, a contract will not be treated as providing for fixed consideration if it provides for contingent adjustments in the event that the value of the stock of the issuing corporation, the value of the assets of the issuing corporation, or the

value of any surrogate for either the value of the stock of the issuing corporation or the assets of the issuing corporation increase or decrease after the last business day before the first date there is a binding contract, or if the terms of the contingent adjustment provide that any increase or decrease in the number of shares of the issuing corporation will be computed using any value of the issuing corporation shares after the last business day before the first date the contract is a binding contract.

F. Anti-Dilution Provisions

These temporary regulations also clarify that if the issuing corporation's capital structure is altered and the number of shares of the issuing corporation to be issued to the target corporation shareholders is altered pursuant to a customary anti-dilution clause, the signing date value of the issuing corporation's shares must be adjusted to take this alteration into account.

G. Other Issues

The IRS and Treasury Department continue to study other issues related to the determination of whether the COI requirement is satisfied.

Effective Date

These temporary regulations are effective March 20, 2007 and apply to transactions occurring pursuant to a binding contract entered into after September 16, 2005. These temporary regulations provide transitional relief for certain transactions occurring pursuant to a binding contract entered into after September 16, 2005, and on or before March 20, 2007. Parties to transactions within the scope of the transitional relief may elect to apply the 2005 final regulations instead of these temporary regulations. Certain parties must adopt consistent treatment to obtain this relief.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that 5 U.S.C. 553(b) and (d) do not apply to these regulations. For applicability of the Regulatory Flexibility Act, please refer to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations were submitted to the Chief Counsel for Advocacy of the Small Business

Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Lisa S. Dobson of the Office of the Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

■ **Par. 2.** Section 1.368-1 is amended by:

- 1. Revising paragraph (e)(2).
- 2. Redesignating the text of paragraph (e)(8) as paragraph (e)(8)(i) and revising it.
- 3. Adding paragraph (e)(8)(ii).

The revisions and addition read as follows:

§ 1.368-1 Purpose and scope of exception of reorganization exchanges.

* * * * *

(e) * * *

(2) [Reserved]. For further guidance, see § 1.368-1T(e)(2).

* * * * *

(8) *Effective dates*—(i) *In general.* Paragraphs (e)(1) and (e)(3) through (e)(7) of this section apply to transactions occurring after January 28, 1998, except that they do not apply to any transaction occurring pursuant to a written agreement which is binding on January 28, 1998, and at all times thereafter. Paragraph (e)(1)(ii) of this section, however, applies to transactions occurring after August 30, 2000, unless the transaction occurs pursuant to a written agreement that is (subject to customary conditions) binding on that date and at all times thereafter. Taxpayers who entered into a binding agreement on or after January 28, 1998, and before August 30, 2000, may request a private letter ruling permitting them to apply the final regulations to their transaction. A private letter ruling will not be issued unless the taxpayer establishes to the satisfaction of the IRS that there is not a significant risk of different parties to the transaction taking inconsistent positions, for Federal tax purposes, with respect to the

applicability of the final regulations to the transaction.

(ii) *Signing date rule.* [Reserved]. For further guidance, see § 1.368-1T(e)(8)(ii).

■ **Par. 3.** Section 1.368-1T is added to read as follows:

§ 1.368-1T Purpose and scope of exception of reorganization exchanges (temporary).

(a) through (e)(1) [Reserved]. For further guidance, see § 1.368-1(a) through (e)(1).

(e)(2) *Measuring continuity of interest*—(i) *In general.* In determining whether a proprietary interest in the target corporation is preserved, the consideration to be exchanged for the proprietary interests in the target corporation pursuant to a contract to effect the potential reorganization shall be valued on the last business day before the first date such contract is a binding contract, if such contract provides for fixed consideration. If a portion of the consideration provided for in such a contract consists of other property identified by value, then this specified value of such other property is used for purposes of determining the extent to which a proprietary interest in the target corporation is preserved. If the contract does not provide for fixed consideration, this paragraph (e)(2)(i) is not applicable.

(ii) *Binding contract*—(A) *In general.* A binding contract is an instrument enforceable under applicable law against the parties to the instrument. The presence of a condition outside the control of the parties (including, for example, regulatory agency approval) shall not prevent an instrument from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, shall not prevent an instrument from being a binding contract.

(B) *Modifications*—(1) *In general.* If a term of a binding contract that relates to the amount or type of the consideration the target shareholders will receive in a potential reorganization is modified before the closing date of the potential reorganization, and the contract as modified is a binding contract, the date of the modification shall be treated as the first date there is a binding contract.

(2) *Modification of a transaction that preserves continuity of interest.* Notwithstanding paragraph (e)(2)(ii)(B)(1) of this section, a modification of a term that relates to the amount or type of consideration the target shareholders will receive in a transaction that would have resulted in

the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification will not be treated as a modification if—

(i) The modification has the sole effect of providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders;

(ii) The modification has the sole effect of decreasing the amount of money or other property to be delivered to the target corporation shareholders;

or

(iii) The modification has the effect of decreasing the amount of money or other property to be delivered to the target corporation shareholders and providing for the issuance of additional shares of issuing corporation stock to the target corporation shareholders.

(3) *Modification of a transaction that does not preserve continuity of interest.* Notwithstanding paragraph (e)(2)(ii)(B)(1) of this section, a modification of a term that relates to the amount or type of consideration the target shareholders will receive in a transaction that would not have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification will not be treated as a modification if—

(i) The modification has the sole effect of providing for the issuance of fewer shares of issuing corporation stock to the target corporation shareholders;

(ii) The modification has the sole effect of increasing the amount of money or other property to be delivered to the target corporation shareholders;

or

(iii) The modification has the effect of increasing the amount of money or other property to be delivered to the target corporation shareholders and providing for the issuance of fewer shares of issuing corporation stock to the target corporation shareholders.

(C) *Tender offers.* For purposes of this paragraph (e)(2), a tender offer that is subject to section 14(d) of the Securities and Exchange Act of 1934 [15 U.S.C. 78n(d)(1)] and Regulation 14D (17 CFR 240.14d-1 through 240.14d-101) and is not pursuant to a binding contract, is treated as a binding contract made on the date of its announcement, notwithstanding that it may be modified by the offeror or that it is not enforceable against the offerees. If a modification (not pursuant to a binding contract) of such a tender offer is subject to the provisions of Regulation 14d-6(c) (17 CFR 240.14d-6(c)) and relates to the

amount or type of the consideration received in the tender offer, then the date of the modification shall be treated as the first date there is a binding contract.

(iii) *Fixed Consideration*—(A) *In general*. A contract provides for fixed consideration if it 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 by specific 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. A contract that provides a target corporation shareholder with an election to receive a number of shares of stock of the issuing corporation and/or money and/or other property in exchange for all of the shareholder's proprietary interests in the target corporation, or each of the shareholder's proprietary interests in the target corporation, provides for fixed consideration if the determination of the number of shares of issuing corporation stock to be provided to the target corporation shareholder is determined using the value of the issuing corporation stock on the last business day before the first date there is a binding contract.

(B) *Contingent adjustments to the consideration*—(1) *In general*. Except as provided in paragraph (e)(2)(iii)(B)(2) of this section, a contract that provides for contingent adjustments to the consideration will be treated as providing for fixed consideration if it would satisfy the requirements of paragraph (e)(2)(iii)(A) of this section without the contingent adjustment provision.

(2) *Exceptions*. A contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration that 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 last business day before the first date the contract is a binding contract. For example, a contract will not be treated as providing for fixed consideration if the contract provides for contingent adjustments to the consideration in the event that the value of the stock of the issuing corporation, the value of the assets of the issuing corporation, or the value of any surrogate for either the value of the stock of the issuing corporation or the assets of the issuing corporation increase or decrease after the last business day before the first date there

is a binding contract; or in the event the contract provides for contingent adjustments to the number of shares of the issuing corporation stock to be provided to the target corporation shareholders computed using any value of the issuing corporation shares after the last business day before the first date there is a binding contract.

(C) *Escrows*. Placing part of the consideration to be exchanged for proprietary interests in the target corporation in escrow to secure target's performance of customary pre-closing covenants or customary target representations and warranties will not prevent a contract from being treated as providing for fixed consideration.

(D) *Anti-dilution clauses*. The presence of a customary anti-dilution clause will not prevent a contract from being treated as providing for fixed consideration. However, the absence of such a clause will prevent a contract from being treated as providing for fixed consideration if the issuing corporation alters its capital structure between the first date there is an otherwise binding contract to effect the transaction and the effective date of the transaction in a manner that materially alters the economic arrangement of the parties to the binding contract. If the number of shares of the issuing corporation to be issued to the target corporation shareholders is altered pursuant to a customary anti-dilution clause, the value of the shares determined under paragraph (e)(2)(i) of this section must be adjusted accordingly.

(E) *Dissenters' rights*. The possibility that some shareholders may exercise dissenters' rights and receive consideration other than that provided for in the binding contract will not prevent the contract from being treated as providing for fixed consideration.

(F) *Fractional shares*. The fact that money may be paid in lieu of issuing fractional shares will not prevent a contract from being treated as providing for fixed consideration.

(iv) *Valuation of new issuances*. For purposes of applying paragraph (e)(2)(i) of this section, any class of stock, securities, or indebtedness that the issuing corporation issues to the target corporation shareholders pursuant to the potential reorganization and that does not exist before the first date there is a binding contract to effect the potential reorganization is deemed to have been issued on the last business day before the first date there is a binding contract to effect the potential reorganization.

(v) *Examples*. For purposes of the examples in this paragraph (e)(2)(v), P is the issuing corporation, T is the target

corporation, S is a wholly owned subsidiary of P, all corporations have only one class of stock outstanding, A is an individual, no transactions other than those described occur, and the transactions are not otherwise subject to recharacterization. The following examples illustrate the application of this paragraph (e)(2):

Example 1. Application of signing date rule. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and \$60 of cash in exchange for all of the outstanding stock of T. Twenty of the P shares, however, will be placed in escrow to secure customary target representations and warranties. The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is \$1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is \$.25 per share. None of the stock placed in escrow is returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$40 of P stock and \$60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 2. Treatment of forfeited escrowed stock. (i) *Escrowed stock*. The facts are the same as in Example 1 except that T's breach of a representation results in the escrowed consideration being returned to P. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Pursuant to paragraph (e)(1)(i) of § 1.368-1, for continuity of interest purposes, the T stock is exchanged for \$20 of P stock and \$60 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

(ii) *Escrowed stock and cash*. The facts are the same as in paragraph (i) of this Example 2 except that the consideration placed in escrow consists solely of eight of the P shares and \$12 of the cash. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the

transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Pursuant to paragraph (e)(1)(i) of § 1.368-1, for continuity of interest purposes, the T stock is exchanged for \$32 of P stock and \$48 of cash, and the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the transaction satisfies the continuity of interest requirement.

Example 3. Redemption of stock received pursuant to binding contract. The facts are the same as in *Example 1* except that A owns 50 percent of the outstanding stock of T immediately prior to the merger and receives 10 P shares and \$30 in the merger and an additional 10 P shares upon the release of the stock placed in escrow. In connection with the merger, A and S agree that, immediately after the merger, S will purchase any P shares that A acquires in the merger for \$1 per share. Shortly after the merger, S purchases A's P shares for \$20. Because the contract provides for the number of shares of P and the amount of money to be exchanged for all of the proprietary interests in T, under this paragraph (e)(2), there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. In addition, S is a person related to P under paragraph (e)(4)(i)(A) of § 1.368-1. Accordingly, A is treated as exchanging his T shares for \$50 of cash. Because, for continuity of interest purposes, the T stock is exchanged for \$20 of P stock and \$80 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 4. Modification of binding contract—continuity not preserved. The facts are the same as in *Example 1* except that on April 1 of Year 1, the parties modify their contract. Pursuant to the modified contract, which is a binding contract, the T shareholders will receive 50 P shares (an additional 10 shares) and \$75 of cash (an additional \$15 of cash) in exchange for all of the outstanding T stock. On March 31 of Year 1, the value of the P stock is \$.50 per share. Under this paragraph (e)(2), although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. The execution of the transaction without modification would have resulted in the preservation of a substantial part of the value of the target corporation shareholders' proprietary interests in the target corporation if there had been no modification. However, because the modified contract provides for additional P stock and cash to be exchanged for all the proprietary interests in T, the exception in paragraph (e)(2)(ii)(B)(2) of this section does not apply to preserve the original signing date. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on March 31 of Year 1.

Because, for continuity of interest purposes, the T stock is exchanged for \$25 of P stock and \$75 of cash, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 5. Modification of binding contract disregarded—continuity preserved. The facts are the same as in *Example 4* except that, pursuant to the modified contract, which is a binding contract, the T shareholders will receive 60 P shares (an additional 20 shares as compared to the original contract) and \$60 of cash in exchange for all of the outstanding T stock. In addition, on March 31 of Year 1, the value of the P stock is \$.40 per share. Under this paragraph (e)(2), although there was a binding contract providing for fixed consideration as of January 3 of Year 1, terms of that contract relating to the consideration to be provided to the target shareholders were modified on April 1 of Year 1. Nonetheless, the modification has the sole effect of providing for the issuance of additional P shares to the T shareholders. In addition, the execution of the terms of the contract without regard to the modification would have resulted in the preservation of a substantial part of the value of the T shareholders' proprietary interest in T because, for continuity of interest purposes, the T stock would have been exchanged for \$40 of P stock and \$60 of cash. Pursuant to paragraph (e)(2)(ii)(B)(2) of this section, the modification is not treated as a modification for purposes of paragraph (e)(2)(ii)(B)(1) of this section. Accordingly, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$60 of P stock and \$60 of cash, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore the transaction satisfies the continuity of interest requirement.

Example 6. New issuance. The facts are the same as in *Example 1*, except that, instead of cash, the T shareholders will receive a new class of P securities that will be publicly traded. In the aggregate, the securities will have a stated principal amount of \$60 and bear interest at the average LIBOR (London Interbank Offered Rates) during the 10 days prior to the potential reorganization. If the T shareholders had been issued the P securities on January 2 of Year 1, the P securities would have had a value of \$60 (determined by reference to the value of comparable publicly traded securities). Whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock and the P securities to be issued to the T shareholders on January 2 of Year 1. Under paragraph (e)(2)(iv) of this section, for purposes of valuing the new P securities, they will be treated as having been issued on January 2 of Year 1. Because, for continuity of interest purposes, the T stock is exchanged for \$40 of P stock and \$60 of other property, the transaction preserves a substantial part of the value of the proprietary interest in T. Therefore, the

transaction satisfies the continuity of interest requirement.

Example 7. Fixed consideration—continuity not preserved. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, 60 shares of the T stock will be exchanged for \$80 of cash and 40 shares of the T stock will be exchanged for 20 shares of P stock. On January 2 of Year 1, the value of the P stock is \$1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. This contract provides for fixed consideration and therefore whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. However, applying the signing date rule, the P stock represents only 20 percent of the value of the total consideration to be received by the T shareholders. Accordingly, based on the economic realities of the exchange, the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 8. Anti-dilution clause. (i) Absence of anti-dilution clause. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. Pursuant to the contract, the T shareholders will receive 40 P shares and \$60 of cash in exchange for all of the outstanding stock of T. The contract does not contain a customary anti-dilution provision. The P stock is listed on an established market. On January 2 of Year 1, the value of the P stock is \$1 per share. On April 10 of Year 1, P issues its stock to effect a stock split; each shareholder of P receives an additional share of P for each P share that it holds. On April 11 of Year 1, the value of the P stock is \$.50 per share. Because P altered its capital structure between January 3 and June 1 of Year 1 in a manner that materially alters the economic arrangement of the parties, under paragraph (e)(2)(iii)(D) of this section, the contract is not treated as a binding contract that provides for fixed consideration. Accordingly, whether the transaction satisfies the continuity of interest requirement cannot be determined by reference to the value of the P stock on January 2 of Year 1.

(ii) **Adjustment for anti-dilution clause.** The facts are the same as in paragraph (i) of this *Example 8* except that the contract contains a customary anti-dilution provision, and the T shareholders receive 80 P shares and \$60 of cash in exchange for all of the outstanding stock of T. Under paragraph (e)(2)(iii)(D) of this section, the contract is treated as a binding contract that provides for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is generally determined by reference to the value of the P stock on January 2 of Year 1. However, under paragraph (e)(2)(iii)(D) of this section, the value of the P stock on January 2 of Year 1 must be adjusted to take the stock split into account. For continuity of interest purposes, the T stock is exchanged for \$40 of P stock $((\$1 \div 2) \times 80)$ and \$60 of

cash. Therefore, the transaction satisfies the continuity of interest requirement.

Example 9. Shareholder election. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. On January 2 of Year 1, the value of the P stock and the T stock is \$1 per share. Pursuant to the contract, at the shareholders' election, each share of T will be exchanged for cash of \$1, or alternatively, P stock. The contract provides that the determination of the number of shares of P stock to be exchanged for a share of T stock is made using the value of the P stock on the last business day before the first date there is a binding contract (i.e., \$1 per share). Accordingly, the contract provides for fixed consideration, and the determination of whether the transaction satisfies the continuity of interest requirement is based on the number of shares of P stock the T shareholders receive in the exchange and by reference to the value of the P stock on January 2 of Year 1.

Example 10. Contingent adjustment based on the value of the issuing corporation stock—continuity not preserved. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. On January 2 of Year 1, the value of the P stock is \$1 per share. Pursuant to the contract, if the value of the P stock does not decrease after January 2 of Year 1, the T shareholders will receive 40 P shares and \$60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive \$.16 of additional P shares and \$.24 for every \$.01 decrease in the value of one share of P stock after January 2 of Year 1. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the P stock is \$.40 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive 24 more P shares ($(60 \times \$.16)/\$.40$) and \$14.40 more cash ($60 \times \$.24$) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 64 P shares and \$74.40 of cash. Because the contract provides that additional P shares and cash will be delivered to the T shareholders if the value of the stock of P decreases after January 2 of Year 1, under paragraph (e)(2)(iii)(B)(2) of this section, the contract is not treated as providing for fixed consideration, and therefore whether the transaction satisfies the continuity of interest requirement cannot be determined by reference to the value of the P stock on January 2 of Year 1. For continuity of interest purposes, the T stock is exchanged for \$25.60 of P stock ($64 \times \$.40$) and \$74.40 of cash and the transaction does not preserve a substantial part of the value of the proprietary interest in T. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 11. Contingent adjustment to boot based on the value of the target corporation stock—continuity not preserved. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. On January 2 of Year 1, T has 100 shares outstanding, and each T share is worth \$1. On January 2 of

Year 1, each P share is worth \$1. Pursuant to the contract, if the value of the T stock does not increase after January 3 of Year 1, the T shareholders will receive 40 P shares and \$60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive \$1 of additional cash for every \$.01 increase in the value of one share of T stock after January 3 of Year 1. On June 1 of Year 1, the value of the T stock is \$1.40 per share and the value of the P stock is \$.75 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive \$40 more cash ($40 \times \1) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 40 P shares and \$100 of cash. Because the contract provides the number of shares of P stock and the amount of money to be exchanged for all the proprietary interests in T, and the contingent adjustment to the cash consideration is not based on changes in the value of the P stock, P assets, or any surrogate thereof, after January 2 of Year 1, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. For continuity of interest purposes, the T stock is exchanged for \$40 of P stock ($40 \times \1) and \$100 of cash. Therefore, the transaction does not satisfy the continuity of interest requirement.

Example 12. Contingent adjustment to stock based on the value of the target corporation stock—continuity preserved. On January 3 of Year 1, P and T sign a binding contract pursuant to which T will be merged with and into P on June 1 of Year 1. On that date T has 100 shares outstanding, and each T share is worth \$1. On January 2 of Year 1, each P share is worth \$1. Pursuant to the contract, if the value of the T stock does not decrease after January 3 of Year 1, the T shareholders will receive 40 P shares and \$60 of cash in exchange for all of the outstanding stock of T. Furthermore, the contract provides that the T shareholders will receive \$.40 less P stock and \$.60 less cash for every \$.01 decrease in the value of one share of T stock after January 3 of Year 1. The contract also provides that the number of P shares by which the consideration will be reduced as a result of this adjustment will be determined based on the value of the P stock on January 2 of Year 1. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract. On that date, the value of the T stock is \$.70 per share and the value of the P stock is \$.75 per share. Pursuant to the terms of the contract, the consideration is adjusted so that the T shareholders receive 12 fewer P shares ($(30 \times \$.40)/\1) and \$18 less cash ($30 \times \$.60$) than they would absent an adjustment. Accordingly, at closing the T shareholders receive 28 P shares and \$42 of cash. Because the contract provides for the number of shares of P stock and the amount of money to be exchanged for all of the proprietary interests in T, the contract does not provide for contingent adjustments to the consideration based on a change in value of the P stock, P assets, or any surrogate thereof, after January 2 of Year 1, and the adjustment

to the number of P shares the T shareholders receive is determined based on the value of the P shares on January 2 of Year 1, there is a binding contract providing for fixed consideration as of January 3 of Year 1. Therefore, whether the transaction satisfies the continuity of interest requirement is determined by reference to the value of the P stock on January 2 of Year 1. For continuity of interest purposes, the T stock is exchanged for \$28 of P stock ($28 \times \1) and \$42 of cash. Therefore, the transaction satisfies the continuity of interest requirement.

(e)(3) through (7) [Reserved]. For further guidance, see § 1.368-1(e)(3) through (7).

(8) *Effective dates.* (i) [Reserved]. For further guidance, see § 1.368-1(e)(8)(i).

(ii) *Signing date rule.* Paragraph (e)(2) of this section applies to transactions occurring pursuant to binding contracts entered into after September 16, 2005. For transactions occurring pursuant to binding contracts entered into after September 16, 2005, and on or before March 20, 2007, the parties to the transaction may elect to apply the provisions of § 1.368-1(e)(2) as contained in 26 CFR part 1, revised April 1, 2006, instead of the provisions of this paragraph (e)(2). However, the target corporation, the issuing corporation, the controlling corporation of the acquiring corporation if stock thereof is provided as consideration in the transaction, and any direct or indirect transferee of transferred basis property from any of the foregoing, may not elect to apply the provisions of § 1.368-1(e)(2) as contained in 26 CFR part 1, revised April 1, 2006, unless all such taxpayers elect to apply the provisions of such regulations. This election requirement will be satisfied if none of the specified parties adopts inconsistent treatment. The applicability of this section expires on or before March 19, 2010.

Kevin M. Brown,

Deputy Commissioner for Services and Enforcement.

Approved: March 14, 2007.

Eric Solomon,

Assistant Secretary of the Treasury (Tax Policy).

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