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Client Alert

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IRS Provides Safe Harbor Valuation Methods for Tax-Free Reorganizations

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On January 23, the Internal Revenue Service (the "IRS") released Revenue Procedure 2018-12 (the "Revenue Procedure") detailing a safe harbor that will permit taxpayers to utilize average-price methods for purposes of determining stock consideration values in corporate reorganizations. The Revenue Procedure is helpful to corporations that engage in acquisitions intended to qualify as tax-free reorganizations where the consideration is a mix of stock and cash (or other property). In particular, the Revenue Procedure should give transacting parties the ability to determine with certainty whether a given transaction satisfies the continuity of interest ("COI") doctrine when the acquisition agreement uses average-price methods to set the value of stock consideration.

Background

In order for a corporate transaction to qualify as a tax-free reorganization under the Internal Revenue Code (the "Code") it must, among other things, satisfy the COI doctrine. The purpose of the COI doctrine is to prevent a transaction from qualifying for non-recognition treatment if the transaction more closely resembles a sale rather than a reorganization. In general, the doctrine requires shareholders of the target corporation to preserve a substantial part of their proprietary interest in the target corporation by receiving stock in the acquiring corporation. Treasury Regulations and prevailing opinion practice both reflect the view that an acquisition will generally satisfy the COI doctrine if at least 40 percent of the total consideration, by value, received by a target corporation's shareholders consists of stock of the acquiring corporation.

Prior to 2005, an acquiring corporation's stock had to be valued as of the transaction's closing date for purposes of determining whether the 40 percent threshold was met. This "Closing Date Rule" can cause problems if an acquiring corporation's stock falls in value between the date the parties agree to undertake a transaction (the signing date) and the date the transaction becomes effective (the closing date). Under these circumstances, a consideration mix that satisfied the COI requirement at signing could fail to satisfy the requirement at closing due to the decline in value of the stock component. To alleviate this concern, the Treasury Department issued final regulations (the "Final Regulations") that implemented the "Signing Date Rule." Under that rule, if transacting

parties have entered into a binding contract that provides for “fixed consideration,” the transaction’s consideration is valued, for purposes of measuring COI, at the end of the last business day prior to the signing date. Consequently, the COI calculation will not be affected by fluctuations in the value of the acquiring corporation’s stock after signing. In cases where the Signing Date Rule does not apply due to the absence of fixed consideration, COI continues to be evaluated at the time of closing. Thus, the existence or absence of “fixed consideration” is a key factor under the Final Regulations. Generally speaking, fixed consideration exists if the contract specifies a number of acquirer shares, an amount of cash, and a description of any other property for which each share of target corporation stock will be exchanged. The Final Regulations provide several helpful rules that treat consideration as fixed despite common contingencies relating to escrows, dissenting shareholders, and shareholder-election features that allow holders to choose between cash and stock consideration.

Consideration is not fixed, however, where the parties adopt economic terms that insulate target shareholders from post-signing fluctuations in the value of the acquirer’s stock. For example, if a merger agreement provides that each share of target stock will be converted into $50 of cash and $50 of acquirer stock, measured using the trading price on the day before closing, consideration is not fixed because the number of shares delivered will be adjusted to offset changes in value between signing and closing. Fixed consideration is also absent if the acquisition agreement includes provisions that increase or decrease the amount of cash consideration to offset changes in the value of acquirer stock.

New Safe Harbor for Average-Price Methods

In the Revenue Procedure, the IRS acknowledged that transacting parties commonly use average trading price methods to value stock consideration and that such methods often are a more reliable standard for determining stock value than utilizing a single day’s trading price. The IRS concluded that taxpayers should be able to rely on these methods to evaluate COI compliance.

Under the Revenue Procedure, if taxpayers use one of three safe harbor valuation methods (a “Safe Harbor Valuation”) to determine the value of acquirer stock for purposes of setting “the number of shares of each class of [acquirer] stock, the amount of money, and any other property” to be included in the consideration mix, then the Safe Harbor Valuation can also be used to value the stock for COI purposes in lieu of the value that would normally apply under the Signing Date Rule or the Closing Date Rule. The three permitted Safe Harbor Valuation methods are: (1) the average of the daily volume weighted average prices of a stock, (2) the average of the daily average high-low trading prices for a stock, or (3) the average of the daily closing prices of a stock. Each of these three methods must be applied over a “Measuring Period” of between five and 35 consecutive trading days. If the Signing Date Rule applies, the Measuring Period must end no earlier than three trading days before the day prior to signing and no later than the day prior to signing (or, if earlier, the last pre-signing trading day).[i] Similarly, if the Closing Date Rule applies, the Measuring Period must end no earlier than three trading days before closing and no later than the closing date (or the last pre-closing trading day).

In order to use one of the Safe Harbor Valuation methods, taxpayers must otherwise satisfy the requirements for reorganizations in Code sections 368 and 354. The safe harbor can, however, be used to ensure a failure to satisfy the COI requirement, in which case an otherwise-qualifying transaction would not be treated as a reorganization. In addition, the stock at issue must be traded on a national securities exchange, and the transacting parties must treat the transaction consistently (either as a reorganization or not). Finally, the acquisition agreement must include provisions identifying the chosen Safe Harbor Valuation method, the applicable Measuring Period and the applicable national securities exchange, and the transaction must close in a manner consistent with these provisions of the agreement.

The Revenue Procedure is effective with respect to transactions that have an effective date on or after January 23, 2018. The IRS will consider requests for rulings and determination letters with respect to issues to which the safe harbor does not apply, as well as issues involving the applicability of the safe harbor.

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[i] Section 3.01 of the Revenue Procedure provides that the safe harbor is only available to transactions falling under the Signing Date Rule if the transaction is governed by "a contract that is binding on the parties no later than the beginning of the first trading day of the Measuring Period." Since the Measuring Period must end *before* signing, this provision appears to be a drafting error. The clear intent of the Revenue Procedure is to permit Safe Harbor Valuations based on pre-signing averages to be used under the Signing Date Rule. We understand that the IRS is aware of and intends to fix this drafting error.