Selected Buyer and Seller Issues When Contemplating M&A Transactions in an Uncertain Economy

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Introduction

• It is particularly important to build flexibility into merger and acquisition transactions in times of economic uncertainty
  ➢ Price is only part of the equation
  ➢ Risk is a major issue for the parties

• Risk for Buyer
  ➢ Due Diligence, including representations, warranties and indemnitees
  ➢ Breakup fees, transaction costs
  ➢ Business performance post-closing, integration, customer base, good will, expansion, etc.
Introduction (Cont’d)

• Risk for Seller
  ➢ Buyer’s financial ability to close
  ➢ Excuses for Buyer’s non-performance (material adverse change, etc., governmental and third-party approvals, due diligence, financing)

• The longer any risk is taken, the greater the risk
  ➢ Time to closing
  ➢ Escrow period
  ➢ Installment payment period
  ➢ Earnout period

• Because of the topic, we have not discussed the deductibility of Buyer’s assumption of contingent liabilities of the Seller if a liability accrues post-closing. This topic is beyond the scope of this presentation.
Earnouts and Escrows: Basic Terms

- Contingencies for payment
- Potential amount
- Duration
  - Generally not more than 5 years, usually less
  - Tax-free reorganizations subject to special rules
  - Number and time(s) of payment(s)
- Payment of interest and other earnings
  - For tax-free reorganizations, IRS ruling policy requires paying dividends on escrowed stock to T shareholders (Rev. Proc. 77-37, amplified by Rev. Proc. 84-42)
- Transferability of T shareholders' rights
  - Usually nontransferable, except upon death or by operation of law
Additional Terms for Escrows

- Escrow agent
- Payment of escrow agent’s fees/expenses (who bears cost?)
- Appointment of T shareholders’ representative, if any
- Investment of escrow fund
  - Permitted investments
  - Power to choose investments
- Voting rights, if voting stock is escrowed
  - For tax-free reorganizations, IRS ruling policy requires giving voting rights to T shareholders (Rev. Proc. 77-37, amplified by Rev. Proc. 84-42)
  - Aside from ruling policy, T shareholders should get voting rights if the reorganization is a type that requires T shareholders to receive “voting stock”
Additional Terms for Escrows (Cont’d)

- Tax ownership (who will be taxed on earnings of escrow fund)?
  - Agreement should specify who is to be taxed on earnings
  - For non-reorganization escrows, Prop. Treas. Reg. § 1.468B-8(d)
    would treat P as owner for purpose of determining who is taxed on earnings
Earnouts and Escrows: Principal Issues for Seller/T Shareholders

- Uncertainty of payment
  - Contingencies
  - “Fuzzy math” risk
  - Credit risk

- When will T shareholders be taxable on contingent/escrowed amounts?
Earnouts and Escrows: Principal Issues for Seller/T Shareholders (Cont’d)

• Rules for determining when T shareholders will be taxable on contingent/escrowed amounts.

  ➢ Unless T shareholders qualify for installment sale treatment, present fair market value of contingent/escrowed amounts will be taxable in year of sale.

  ➢ Sales of certain types of property do not qualify for installment sale treatment, e.g., inventory, depreciable property (to the extent of depreciation recapture) and publicly traded stock (IRC § 453(b)(2), (i), (k)(2))

  ➢ Cash escrows present some risk of being treated as payment in the year of sale (Treas. Reg. § 15a. 453-1 (b)(3)), but substantial contingency to right to receive payment (other than passage of time) probably is sufficient to prevent current payment treatment (Rev. Rul. 77-294, predating Treas. Reg. § 15a.453-1(b)(3); Ltr. Rul. 8629038; Ltr. Rul. 8643029)
Principal Issues for Seller/T Shareholders (Cont’d)

- Cash escrows (continued):
  - Documents should not describe escrowed amounts as first paid to T shareholders and then deposited into escrow
  - Documents should provide for recourse, deferred payment obligation of P with escrow treated as owned by P and used to make payments to T shareholders if P does not make payments

- Earnout must be payable by the purchaser, not a third party, to qualify for installment sale treatment (IRC § 453(f)(3))
  - If a subsidiary of P is purchaser and P (instead of the subsidiary) is obligated to make earnout payments, no installment sale

- Installment sale treatment does not apply if contingent amounts constitute equity for federal income tax purposes

- Installment sale treatment does not apply to losses
Principal Issues for Seller/T Shareholders (Cont’d)

• If installment sale treatment applies, how is T shareholder’s basis recovered (how much of each payment is return of capital instead of taxable gain)?
  ➢ Under Treas. Reg. § 15a.453-1(c), basis recovery depends on whether:
    ▪ Contingent amounts are subject to a cap, thus creating a maximum price (basis is recovered in proportion to ration of payment received to maximum price)
    ▪ Contingent amounts are not subject to a cap but are payable over a fixed number of years (basis generally is recovered based on the number of years payments may be received, rather than the amount received)
    ▪ If contingent amounts are not subject to a cap or fixed number of years, basis is recovered over 15 years in equal amounts (but only in years payments are received), if the transaction constitutes a sale for federal income tax purposes
  ➢ If there are multiple contingent payments, possibility exists that T shareholders will have a loss in year of last payment because of mismatching of relative amounts of basis and payments; loss could be nondeductible capital loss
Principal Issues for Seller/T Shareholders (Cont'd)

- Will any part of the contingent payments be treated as interest?
  - Unless the agreement provides for P to pay stated interest at a rate at least equal to the "applicable federal rate" under IRC § 1274, generally a portion of each payment received will be taxable as interest (this assumes the T shareholders are not treated as owning the escrow fund, if any)
  - The interest portion of a payment is determined by discounting the payment by the applicable federal rate (minus any stated interest rate) from the date payment is due to the date of sale. The difference between the amount of the payment and the discounted amount is interest (Treas. Reg. §§ 1.483-4, 1.1275-4(c)(4))

- In a stock escrow, will any gain or loss be recognized on transfer of stock from escrow back to P?
  - Under IRS rulings, return of stock to P generally is a taxable event for T shareholders if number of shares returned is based on then-current value, instead of value on original closing date (Rev. Rul. 78-376; Rev. Rul. 76-334; Rev. Rul. 76-42)
Earnouts and Escrows: Principal Issues for P

- How and when will earnout or escrow amounts affect P’s basis in acquired property?
  - Usually no basis for earnout obligations until payment is made (Treas. Reg. § 1.461-1(a)(1), (2))
  - Same result for escrowed amounts unless Seller/T shareholders own the escrow fund for income tax purposes

- Will any part of earnout or escrow payments be deductible as interest?
  - Determination of amount and timing of imputed interest/original issue discount are same as for Seller/T shareholders

- Will interest or other earnings on escrow fund be taxable to P?

- Will P recognize income or a reduction in basis if contingent amounts do not become payable or if escrow funds are returned to P?
Example 1: Taxable Sale of Stock with Earnout

- **Facts:** T is an S corporation. T has two shareholders; A, who founded S, and B, a key employee. A owns 80% of the T stock and B owns 20%. A’s basis in her T stock is 80x, and B’s basis in his T stock is 200x. P, a C corporation, purchases all the T stock for a total of 1000x in cash (800x paid to A and 200x paid to B), plus an earnout. The earnout provides for P to pay A and B, on a pro rata basis, 30% of T’s average annual revenues in excess of a specified dollar amount for the first three years after closing. The entire earnout amount is to be paid 60 days after the end of the three-year period. P can offset against the earnout any indemnity claims against A and B for breaches of representations and warranties contained in the stock purchase agreement.

- **Issues:**
  - If each uses the installment method, how much basis can A and B recover against cash received at closing? 50%? See Treas. Reg. § 15a.453-1(c)(3).
Taxable Sale of Stock with Earnout (Cont’d)

➤ What if earnout is subject to cap of 500x?
  • Cap permits maximum selling price to be determined (1000x + 500x – imputed interest)
  • Slightly more than 2/3 of basis will be recoverable against cash received at closing (Treas. Reg. § 15a.453-1(c)(2))

➤ What if A’s portion of the earnout, excluding interest, could exceed $5 million?
  • Does the interest charge of IRC § 453A apply to the deferred tax liability attributable to the excess over $5 million? See IRC § 453A(c)(6) (regulations to be prescribed for contingent payment sales); TAM 9853002 (interest charge applied where earnout was subject to cap over $5 million)
Taxable Sale of Stock with Earnout (Cont’d)

➤ What are the tax consequences to A and B, both having used the installment method, if no earnout amount becomes payable?
  - Capital loss for unrecovered basis in year it is determined no amount will be paid (See TAM 9853002)

➤ Would A or B be better off electing out of installment method, thus recovering 100% of basis in year of sale?
  - Must include fair market value of earnout in amount realized in year of sale -- what is fair market value?
Taxable Sale of Stock with Earnout (Cont’d)

➢ Assume earnout is not payable as part of purchase price for stock but instead is payable as contingent consideration under employment contracts between T and A and T and B:

▪ Is earnout really compensation for services?

▪ If not, no installment sale since purchaser of stock is not payor of earnout; like electing out of installment method

▪ If so, full basis recovery in year of sale, and earnout payments will be taxable to A and B as compensation income and deductible by T
Example 2: Taxable Sale of Stock with Escrow

- Facts: The same as in Example 1, except that instead of earnout:

  ➤ 500x of a total purchase price of 1500x is payable three years plus 60 days after closing, contingent upon same revenue formula as in Example 1. P's obligation to pay the $500x is secured by a cash escrow

  ➤ The escrow also secures A's and B's obligations to indemnify P for breaches of their representations and warranties in the stock purchase agreement

  ➤ Escrow fund is invested in short-term Treasury bonds, with earnings to be held in escrow and distributed when (and to same persons as) 500x is distributed
Example 2: Taxable Sale of Stock with Escrow

- Issues (in addition to those in Example 1):
  - Does cash escrow prevent installment sale treatment? Probably not
  - Who is taxed on escrow earnings?
  - Does adding earnings to escrow prevent having a maximum selling price for purposes of basis recovery? Or are earnings, to the extent distributed to A and B, simply variable stated interest?
  - Are answers to issues above different if P is required to pay interest at a stated rate regardless of amount of earnings?
Example 3: Sale of Stock with Escrow: § 338(h)(10) Election

- Facts: The basic facts are the same as in Example 1, except that the earnout is subject to a cap of $500x, having a present value (after discounting by the AFR) of $450x. In addition, A, B and P make an election under IRS § 338(h)(10). The election causes T, A and B to be treated as if T sold its assets and then distributed the net sales proceeds to A and B in complete liquidation. Assume further that:
  - T’s assets not eligible for installment sale treatment have a fair market value (net of all of T’s liabilities) of $1000x and a tax basis (net of all of T’s liabilities) of $800x, resulting in $200x of ordinary income
  - T’s remaining assets consist of undepreciated § 197 intangibles (e.g., customer contracts, going concern value, and goodwill) with zero basis
Example 3: Sale of Stock with Escrow: § 338(h)(10) Election (Cont’d)

• Issues:

➢ Assuming the earnout otherwise is eligible for installment sale treatment, may T, A and B use the installment method? Yes (Treas. Reg. § 1.338(h)(10)-1(d)(8); IRC §§ 453(h), 453B(h))

➢ May T treat the earnout as consideration solely for the § 197 intangibles, thus permitting T not to recognize currently any gain on the sale of § 197 intangibles?

• Probably not, even though New T (the deemed purchaser of T’s assets) must allocate the deemed purchase price first to assets other than § 197 intangibles and will not obtain any basis in the § 197 intangibles until earnout payment is made (See Treas. Reg. § 1.338-6(b)-7(e) Ex. 4)
Example 3: Sale of Stock with Escrow: § 338(h)(10) Election (Cont’d)

Assuming T may not allocate the earnout entirely to § 197 intangibles, how much gain (including ordinary income) does T recognize?

- Total amount realized is 1450x, of which approximately 69% (1000x) is cash and 31% (450x) is maximum amount of earnout (excluding interest)
- 1000x, consisting of 690x cash and 310x potential earnout, is allocated to assets not qualifying for installment sale treatment -- $200 of ordinary income is recognized
- 450x, consisting of 310x cash and 140x earnout, is allocated to § 197 intangibles -- 310x of capital gain is recognized
- T recognizes 510x of gain (200x ordinary income and 310x capital gain)
- A’s basis in her T stock is increased by 80% of 510x, or 408x, from 80x to 488x
- B’s basis in his T stock is increased by 20% of 510x, or 102x, from 200x to 302x
Example 3: Sale of Stock with Escrow
\( \S \ 338(h)(10) \) Election (Cont’d)

In addition to 408x (160x ordinary income and 248x capital gain), how much more gain will A recognize in year of sale if she uses the installment sale method?

- A realizes 1160x (80% of 1450x), consisting of 69% cash (800x) and 31% potential earnout (360x)
- 69% of A’s stock basis of 488x, or 337x, is allocated to the 800x cash, resulting in 463x additional gain
- A’s total recognized gain in year of sale is 871x; A’s remaining unrecovered basis is 151x
- If \( \S \ 338 \) election were not made, A would recognize only 751x gain in year of sale (800x cash minus 69% of 80x basis), all of which would be capital gain
Example 3: Sale of Stock with Escrow
§ 338(h)(10) Election (Cont’d)

How about B (in addition to his 102x share of T’s gain)?

- B realizes 290x (20% of 1450x), consisting of 69% cash (200x) and 31% potential earnout (90x)

- 290x is less than B’s stock basis of 302x, so installment sale method does not apply to deemed redemption of B’s stock
  - Can B’s share of the potential earnout be valued at less than 90x, resulting in greater capital loss on deemed redemption of B’s stock? Presumably so, since fair market value no doubt is less than maximum payable (see Treas. Reg. § 15a. 453(d)(2)(iii))

- If § 338 election were not made, B would recognize 62x gain in year of sale (200x cash minus 69% of 200x basis), all of which would be capital gain
Escrows & Earnouts in Tax-Free Reorganizations

- As with taxable transactions, properly structured escrows and earnouts can be used in tax-free reorganizations to:
  
  - Provide P security with respect to reps and warranties provided by T or T's shareholders;
  
  - Provide P security with respect to contingent liabilities assumed by P or taken subject to in the transaction;
  
  - Provide a mechanism for addressing valuation disputes, either with respect to:
    
    - The value of T (e.g., as shown by T's earnings in the 3-year period following closing); or
    
    - The value of P (e.g., as shown by the market value of P's stock at the end of the 3\textsuperscript{rd} year following closing).
Escrows & Earnouts in Tax-Free Reorganizations

Critical Tax Issues

• What is the impact of escrow or earnout on the various requirements for tax-free treatment, including continuity-of-interest? For example:
  ➢ A significant portion of T’s outstanding stock must be acquired in exchange for P stock; and
  ➢ Precise amount of P stock required to be issued in the transaction varies by type of reorganization.

• Is the intangible property right evidenced by the escrow agreement “stock” for tax purposes? Or, is it other property (e.g., “boot”) for purposes of IRC § 368?

• If stock, when is it valued for purposes of testing the tax-free eligibility of the transaction? When the stock is placed into escrow or when distributed from escrow?
Escrows & Earnouts in Tax-Free Reorganizations
Critical Tax Issues (Cont’d)

• What are the tax consequences if stock issued to T’s shareholders is returned to P (e.g., due to a post-closing breach of T’s reps and warranties)?
• In computing tax basis, how and when do the parties account for the value represented by the P shares held in escrow?
• Is interest imputed with respect to the escrowed P stock?
• Who is taxed on any dividends paid with respect to the escrowed P stock?
• Who bears the economic risk or economic rewards resulting from changes in the value of escrowed P stock?
• How does the tax analysis change if no stock certificates are placed in escrow – but rather, P promises to issue additional stock to T’s shareholders if and when certain contingencies are satisfied (“contingent stock”)?
Escrows & Earnouts in Tax-Free Reorganizations
Example 1

Facts: P acquires T's assets in a transaction intended to qualify under IRC § 368(a)(1)(C). In the transaction:

➢ T deposits a portion of the P stock into escrow to protect P against T's breach of reps and warranties. The escrowed shares are legally issued and outstanding under state law, and appear so on P's balance sheet.

➢ The number of shares to be returned to P will be determined based on the initial negotiated value of the P stock. T has no right to substitute other property (e.g., cash) in satisfaction of any claims P may make under the agreement, and P's recovery is limited to the escrow.

➢ In the transaction, T is legally dissolved, and the rights to the P shares held in escrow are distributed to T's shareholders.

➢ While the P shares are held in escrow, T's shareholders have the right to vote the stock and receive any paid dividends.
Escrows & Earnouts in Tax-Free Reorganizations
Example 1 (Cont’d)

What are the tax implications of the escrow? What if a portion of the escrowed stock is returned to P?

Answers:

• The escrow does not impair the transaction’s qualification as a tax-free reorg.

• The T shareholders realize no gain or loss on the return of any P stock to P. Why? Because the T shareholders receive no benefit and suffer no detriment from any change in the value of the escrowed P stock:
  ➢ The number of shares to be returned is based on initial share value, and
  ➢ The T shareholders have no right to substitute other property.

• Upon return of the shares to P, any tax basis that the T shareholders allocated to the returned P stock is added to the basis of the P stock retained by T’s shareholders (including escrowed shares not returned to P). (Rev. Rul. 76-42)
Escrows & Earnouts in Tax-Free Reorganizations
Example 2

Same as Example 1, except:

- Number of shares of escrowed stock to be recovered by P upon a breach of T’s reps and warranties will be based on the value of the P stock at the time of the claim for damage – not at original deal value.

Questions:

- What are the tax implications of the escrow in general?
- What if the P stock appreciates and a portion of the escrowed stock is returned to P?
Escrows & Earnouts in Tax-Free Reorganizations
Example 2 (Cont'd)

Answer:

- The escrow does not impair the transaction's ability to qualify as a tax-free reorganization.

- However, T shareholders will realize and recognize gain upon the return of stock to P. Why? Because the T shareholders will use appreciated property to satisfy a contingent liability which they assumed when T dissolved. United States v. Davis, 370 U.S. 65 (1962) and Rev. Rul. 78-376.

  ➢ Conclusion reflects deemed ownership of the escrowed stock by T's shareholders.

- The amount of gain is equal to the difference between the fair market value of the returned shares and the T shareholder's adjusted basis of those shares, as determined under IRC § 358(a) and (b).
Escrows & Earnouts in Tax-Free Reorganizations
Tax Characterization

Escrowed and contingent stock arrangements generally do not invalidate otherwise qualified tax-free reorganizations. IRS guidelines set forth in Rev. Proc. 77-37, as amplified by Rev. Proc. 84-42, require that:

- The arrangement generally settles within 5 years;
- There is a valid business purpose for the deferral (e.g., valuation adjustment);
- At least 50% of the maximum number of shares of each class of P stock which may be issued is issued in the initial distribution;
- The event that triggers payment is not within the control of the T shareholders and is not based on a reorganization-related federal income tax liability; and
- There is an objective, readily ascertainable formula for calculating the amount of P stock to be delivered.
Escrows & Earnouts in Tax-Free Reorganizations
Tax Characterization (Cont’d)

Additional IRS requirements for escrowed or contingent stock:

- If P stock is escrowed:
  - The shares must be shown as issued and outstanding on P’s financial statements and must be legally outstanding;
  - T’s shareholders must have current voting and dividend rights with respect to the escrowed P stock; and
  - The escrowed stock must not be subject to restrictions requiring return because of death, failure to continue employment, or similar events.

- If P stock is contingent:
  - The rights to contingent stock must not be readily assignable or marketable; and
  - The arrangement must be satisfied only with additional P shares.
Escrows & Earnouts in Tax-Free Reorganizations
Escrowed Stock -- Summary

- If escrowed P stock satisfies the requirements of Rev. Proc. 77-37, as amplified by Rev. Proc. 84-42, then:

  ➢ T’s shareholders treated as the beneficial owner of escrowed P stock;
  ➢ Tax construction as if T’s shareholders received the P stock at closing and contributed it immediately thereafter to the escrow account;
  ➢ T’s shareholders allocate tax basis in the relinquished T stock to all of the P stock received or deemed received (including shares in escrow);
  ➢ The holding period applicable to the relinquished T stock tacks to all P stock received or deemed received (including shares in escrow); and
  ➢ No interest imputed to T’s shareholders on the escrowed shares. (Rev. Rul. 70-120).
  ➢ If any portion of the escrowed P stock is returned to P, then the T shareholders reallocate that portion of the substituted basis to their remaining P shares.
Escrows & Earnouts in Tax-Free Reorganizations
Contingent Stock -- Summary

- If contingent P stock satisfies the requirements of Rev. Proc. 77-37, as amplified by Rev. Proc. 84-42, then:
  - T’s shareholders treated as receiving the contingent P stock tax-free, but only when the stock actually is issued to them;
  - T’s shareholders (who initially allocate their tax basis in the relinquished T stock only to the P stock actually received at closing) must reallocate basis to any contingent shares received thereafter, excluding shares characterized as interest;
  - The holding period applicable to the relinquished T stock tacks to any contingent P stock received;
  - A portion of the contingent stock received by the T shareholders constitutes imputed interest (Rev. Rul. 67-90 and Rev. Rul. 73-298), taxable to the T shareholders with a fair market value basis when the contingent stock is received (i.e., no OID accrual per Treas. Reg. § 1.483-4(b), Ex. 2); and
- But, is P permitted a deduction for imputed interest? IRC § 163(l) and Rev. Rul. 2002-31.
Escrows & Earnouts in Tax-Free Reorganizations
Impact on Continuity-of-Interest Requirement

- P stock issued in an acquisition which later is redeemed by P “in connection with” the reorganization counts against continuity. Treas. Reg. § 1.368-1(e).

- To eliminate risk, structure transaction to ensure that T’s shareholders will receive sufficient P stock to satisfy the continuity-of-interest requirement – without regard to P stock held in escrow or contingent stock. To achieve:
  
  ➢ Structure escrows to hold (and in the event of a recovery by P, to pay) a proportionate amount of cash and stock determined with reference to the transaction’s tax requirements, and

  ➢ If using contingent arrangements that include cash, defer a portion of the cash and the stock so as to maintain proportionality; the obligation to pay cash should qualify for installment reporting. Prop. Reg. § 1.453-1(f)(2)(iv).

- Remains unclear how deferred stock arrangements are to be tested.
Escrows & Earnouts in Tax-Free Reorganizations

Example 3

Facts:

- P acquires T’s stock in a transaction intended to qualify under IRC § 368(a)(1)(B). A portion of P’s stock is placed into escrow to secure T’s reps and warranties. The escrow conforms to the requirements of Rev. Proc. 84-42. P’s recovery for damages is limited to the escrowed stock.

- Within 6 months after closing, P sustains damage due to a breach of T’s reps and warranties.

- T’s shareholders dispute P’s claim and sue for recovery of the escrowed stock.

- In settlement, the parties agree that (i) P will pay cash to the T shareholders, and (ii) P will recover the P stock held in escrow.
Escrows & Earnouts in Tax-Free Reorganizations
Example 3

Question:

- Is the cash paid by P to T’s shareholders “boot” per IRC § 356? (If so, it would invalidate an otherwise qualified tax-free “B” reorganization.)

Answer:

- No. Because the cash payment was pursuant to a new agreement arising from the post-closing dispute; it was not part of the initial agreement or understanding. Therefore, it is treated as a cash payment by P in redemption of the escrowed P stock, subject to the provisions of IRC § 302. (Rev. Rul. 76-334)

- Caution – ruling assumes away critical issue: was the cash payment part of the original deal?
Escrows & Earnouts in Tax-Free Reorganizations
Example 3

Question:
• Is the cash paid by P to T's shareholders “boot” per IRC § 356? (If so, it would invalidate an otherwise qualified tax-free “B” reorganization.)

Answer:
• No. Because the cash payment was pursuant to a new agreement arising from the post-closing dispute; it was not part of the initial agreement or understanding. Therefore, it is treated as a cash payment by P in redemption of the escrowed P stock, subject to the provisions of IRC § 302. (Rev. Rul. 76-334)
• Caution – ruling assumes away critical issue: was the cash payment part of the original deal?
Other Contingent Payments Arrangements in Tax-Free Reorganizations

- Options and warrants to receive additional P stock:
  
  ➢ For reorganization purposes, options and warrants generally are treated as securities with a zero principal amount which can be received tax-free (provided warrants are to acquire stock other than non-qualified preferred stock). Treas. Reg. § 1.354-1(e)

  ➢ Options and warrants to receive other property (e.g., non-qualified preferred stock) is taxable upon receipt, measured by the difference between the fair market value of the option or warrant and the allocable portion of tax basis in T stock surrendered in the exchange.
Other Contingent Payments Arrangements in Tax-Free Reorganizations (Cont’d)

- Preferred stock convertible into common stock of P, with exchange ratio used to reflect post-closing valuation adjustments.
  - May provide in acquisition agreement that the exchange ratio will be adjusted post-closing to reflect resolution of specified contingencies.

- **Example** – Assume the following:
  - Voting convertible preferred stock issued by P to T shareholders in a reorganization intended to qualify under IRC § 368(a)(1)(B);
  - Original plan provides for a conversion adjustment based on a formula tied to T’s earnings performance during the 5-year period following closing; and
  - Right of T shareholders to receive additional P stock is not assignable.
  - Affirmed as a qualified tax-free reorganization in Rev. Rul. 73-205.'38
Other Contingent Payments Arrangements in Tax-Free Reorganizations

- Contingent Value Rights ("CVRs"):
  - Contractual right issued by P in connection with the issuance of P stock.
  - CVR's issued to T shareholders in connection with a reorganization can be received tax-free if the CVR permits holder to receive only P stock (other than non-qualified preferred stock). Analysis similar to that of warrants and options. Rev. Rul. 66-112 and Rev. Rul. 67-90. See Rev. Proc. 84-42 for additional IRS guidelines.
  - Example: OSI Pharmaceutical’s acquisition of Cell Pathways, where CVRs used to provide T’s shareholders with additional P stock if a pending drug application is approved by the FDA within 5 years.
Other Contingent Payments Arrangements in Tax-Free Reorganizations

• Assignment of T’s Contingent Property Rights:
  
  ➢ Often structured by causing T to (i) transfer the claims to a statutory trust designed to be treated as a grantor trust for federal income tax purposes; and (ii) distribute the trust certificates to T’s shareholders immediately prior to closing.
  
  ➢ Distribution of the certificates or rights will be taxable to T’s shareholders, either as a dividend (assuming adequate E&P) or as boot (taxable to the extent the FMV of the certificates or rights exceeds basis). See Zenz v. Quinlivan, 213 F2d 914 (6th Cir. 1954)
  
  ➢ Receipt of cash upon settlement of the contingency taxable to T shareholders; gain or loss may be (i) ordinary income (based on character of income to T), or (ii) capital gain or loss (measured by the taxable basis in the contingent right).
  
  ➢ See acquisition of Bank United Corp. by Washington Mutual (2001) and proposed merger of Holly Corporation and Frontier Oil.