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# M&A Alert: Tax-Free Deals Made Easier

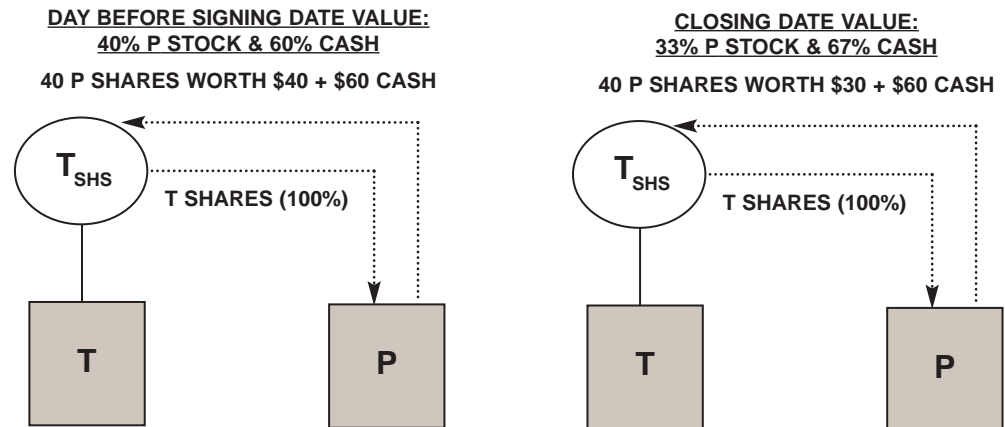
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## IRS MAKES SOME TAX-FREE DEALS EASIER TO ACCOMPLISH

On September 16, 2005, the IRS published new regulations that make some tax-free reorganization transactions easier to accomplish. These new regulations operate by requiring certain consideration packages to be valued as of the last business day before the date on which a deal is signed. Prior to the issuance of the new regulations, taxpayers generally were required to value a consideration package as of the date on which a deal actually closed.

Consider the following example:

- On January 3 of Year 1, an acquiring corporation (“P”) and a target corporation (“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 cash for all the outstanding stock of T.
- On January 2 of Year 1, P stock is worth \$1 per share. On June 1 of Year 1, T merges with and into P pursuant to the terms of the contract, and as of that date P stock has declined in value and is worth only \$0.75 per share.



Under prior law, the transaction probably would not have the ability to qualify as a tax-free reorganization because, as of the closing date, the value of the P stock to be delivered to the T shareholders represents only about 33% of the total consideration package.

By comparison, under the new regulations, the transaction will have the ability to qualify as a tax-free reorganization because, as of the last business day before the signing date, the value of the P stock to be delivered to the T shareholders represents 40% of the total consideration package.

The new regulations specifically address what is referred to as the “continuity of shareholder interest” requirement, which applies to most forms of tax-free reorganization and which generally requires that at least 40% of the consideration package *by value* must be in the form of acquiror stock.

However, it should be noted that the new regulations apply only for purposes of the continuity of shareholder of interest requirement, and they do not apply for purposes of other potentially applicable requirements (such as the “acquisition of control” requirement that applies to tax-free reverse triangular merger transactions).

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In addition, taxpayers should take care to note that the new regulations are not elective and will apply in all cases where “fixed consideration” is deemed to be provided for under the terms of a “binding contract.”

Taxpayers should also be aware that the new regulations contain special rules that are designed to address cases where:

- a contract is subsequently modified by the parties after the original signing date;
- an acquisition is conducted in the form of a tender offer;
- the target shareholders can elect to receive a mix of acquiror stock or other consideration, or both;
- the contractual terms call for a portion of the consideration to be placed in escrow or where contingent shares of acquiror stock may be issued;
- the acquiring corporation alters its capital structure between signing and closing;
- the acquiring corporation will issue a new class of stock or indebtedness as part of the consideration package; or
- the contractual terms call for the use of cash in lieu of issuing fractional shares of acquiror stock or where target shareholders have dissenters’ rights.

Taxpayers should also be aware that unresolved and difficult questions may continue to arise in a variety of common transactional situations that do not appear to be addressed by the new regulations, such as certain cases where:

- the contractual terms call for a closing or post-closing “working capital” adjustment;
- the target shareholders are afforded price protection through a “collar” or other similar mechanism; or
- an “earn-out” or other similar arrangement is used and the contingent consideration will consist of cash or property other than shares of the acquiring corporation.

Over the course of the last year, members of HRO’s Federal Income Tax Group participated in submitting extensive comments to the IRS in connection with this regulatory project. In the end, many of these comments were incorporated into the final version of the new regulations. As a result, HRO is well ahead of the curve in this area. Please feel free to contact one of our tax partners listed on page one for further information on the new regulations.

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