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Taxation of CVRs in Public M&A Transactions

I. General Background

A. The issuance of CVRs (contingent value/payment rights) to holders of publicly-traded Target stock upon the acquisition of Target are designed to provide such holders with valuation protection or additional consideration based on post-closing events.

B. Valuation or price protection CVRs were used in a number of transactions dating back to the late 1980's (e.g., Dow Chemical/Marion Laboratories, Rhone Poulenc/Rorer Group, Viacom/Paramount Communications, Viacom/Blockbuster, General Mills/Pillsbury) to guarantee the value of the consideration to the Target stockholders over a defined post-closing period.

1. The value of a price protection CVR is generally inversely related to the price of the underlying security, since it will provide for a payout equal to the amount by which a specified target price exceeds the actual price of the referenced security at maturity of the CVR.

2. CVRs can be payable in cash and/or securities.

3. A valuation or price protection CVR is generally treated by the IRS as a cash settlement put option, the tax consequences of which are addressed in Rev. Rul. 88-31, 1988-1 C.B. 302; Announcement 88-86, 1988-20 I.R.B. 50.

C. Event-driven CVRs, which are addressed in the sections of this outline that follow, are typically used by Acquirors and Targets to bridge valuation gaps in relation to contingencies.

1. CVRs are particularly common in health care and biotech M&A deals (e.g., Sanofi-Aventis/Genzyme, Celgene/Abraxis Bioscience, Ligand/MetaBasis Therapeutics, Ligand/Neurogen, Ligand/Pharmacopeia, Endo/Indevus), Fresenius/APP, OSI Pharmaceuticals/Cell—see attached tax disclosure excerpts).

2. Payouts under the CVRs can be dependent on achieving milestones such as FDA approval, receipt of royalty payments, proceeds from litigation claims, asset sales or tax refunds, achieving sales targets or financial performance metrics.

3. CVRs can take the form of non-assignable contract rights, assignable certificates, or publicly-traded securities.

II. Tax Consequences: Timing Issues to Target Shareholders upon Receipt of CVRs

A. Installment Method

1. The installment method is not available for the sale of publicly-traded stock.

2. Rationale: a holder of publicly-traded shares does not have the liquidity problem that the installment method was designed to alleviate since the holder could sell the shares in the market and realize the expected value of the installment payments.

B. Open Transaction Method

1. If applicable, holder of Target stock is not taxed until the CVR payments are received.

a. A portion of each payment is treated as imputed interest.

b. The balance ("principal") is treated as additional consideration for the Target shares sold.

(i) Stock basis is recovered first.

(ii) Gain is recognized only to extent principal exceeds stock basis.

2. Leading case sanctioning the open transaction method is Supreme Court decision in Burnet v. Logan, 283 U.S. 404 (1931), where the Court determined that it was impossible to determine with fair certainty the market value of the buyer's agreement to pay royalties based on the amount of ore mined by a Target subsidiary after closing to the taxpayer who sold stock in the Target corporation.

3. "Only in rare and extraordinary cases will the fair market value of the contingent payments be treated as not reasonably ascertainable." Treas. Reg. Section 1.1001-1(g)(2)(ii); Treas. Reg. Section 15A.453-1(d)(2)(iii); Rev. Rul. 58-402, 1958-2 C.B. 15; and S. Rep. No. 96-1000, at 24 (1980).

4. If the CVRs are publicly traded, there is no ability to report the transaction on the open transaction method, and indeed, if the Target company stock that is sold was publicly traded, it should be relatively easy to impute a market value for the CVRs.

5. Some practitioners may take the position that the cash equivalency doctrine would permit cash method taxpayers to avoid recognizing income upon receipt of a deferred payment right, but the IRS, the Ninth Circuit, and the Court of Claims will surely disagree. See Treas. Reg. Section 15A.453-1(d)(2)(i); Rev. Rul. 79-292, 1979-2 C.B. 287; FSA 002200 (Oct. 16, 1997); Warren Jones Co. v. Comm'r, 524 F.2d 788 (9th Cir. 1975); Campbell v. U.S., 661 F.2d 209 (Ct. Cl. 1981).

C. Closed Transaction Method

1. If the open transaction method is unavailable, the fair market value of the CVRs must be taken into account upon receipt as additional consideration for the Target stock.

2. The CVR will then take such fair market value as its tax basis.

III. Tax Consequences of CVR Collections

A. When payments are subsequently made on the CVR, a portion of each payment will be characterized as imputed interest. Treas. Reg. Sections 1.483-4(a), 1.1275-4(c)(4)(ii)(A).

B. The remaining "principal" payment will be applied against and reduce basis and be taxable to the extent the principal exceeds the CVR's basis.

C. If the shareholder fails to recover the full basis in the CVR, a loss is allowed in the year the CVR expires.

D. The $1 billion question: What is the character of principal payments in excess of basis: capital gain or ordinary income?

1. If contract right collection – ordinary income

a. Collections on the CVR will constitute ordinary income. Capital gain is only possible if there has been a "sale or exchange" of a capital asset. Section 1222.

b. While the CVR itself is a capital asset, it has not been sold or exchanged as payments from the issuer are received, but rather the holder is in receipt of "collection income." Cf. Fairbanks v. U.S., 306 U.S. 436 (1939); Ogilvie v. Comm'r, 216 F.2d 748 (6th Cir. 1954).

c. Section 1234A, which provides that "[g]ain . . . attributable to the cancellation, lapse, expiration, or other termination of a right or obligation . . . with respect to property which is (or on acquisition would be) a capital asset in the hands of the taxpayer . . . shall be treated as gain . . . from the sale of a capital asset," does not appear to alter this result. Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, Situation 1; TAM 9730007; FSA 1634 (July 6, 1995).

d. An actual sale of the CVR, as opposed to collection of CVR payments, should produce capital gain because the CVR itself is a capital asset. Cf. Rev. Rul. 2009-13, Situation 2.

2. If debt instrument – ordinary income

a. It is unlikely that a CVR would be considered indebtedness under general principles of federal income tax law since it is contingent as to payment and is not an unqualified obligation to pay a sum certain at a fixed maturity date.

b. Although Section 1271(a) provides that amounts received on "retirement" of a debt instrument are treated as received in exchange for the debt instrument, if the Target stock is publicly traded, even if the CVR were a debt instrument, it would be a contingent payment debt instrument ("CPDI") subject to Treas. Reg. Section 1.1275-4(b).

(i) Ordinary interest income (and deduction to issuer) to the extent actual payments on the CVR/CPDI exceed the projected payment schedule.

(ii) Any gain on the sale of the CVR/CPDI would be taxable to the holder as ordinary income.

3. If deferred payment contract sale – capital gain

a. Treas. Reg. Section 1.483-4(a) provides: "If this section applies to a contract, interest under the contract is generally computed and accounted for using rules similar to that which would apply if the contract were a debt instrument subject to Section 1.1275-4(c). . . . Each contingent payment on the overall contract is characterized as principal and interest under rules similar to those contained in Section 1.1275-4(c)(4)."

b. Treas. Reg. Section 1.1275-4(c) provides for capital treatment on the portion of the earnout payment that is treated as "principal" when the total payment is discounted to reflect the time value of money. See TAM 199909002, 199909003, and 9840001.

(i) Each TAM involved the sale of customer receivables to a finance company for a fixed payment plus contingent payments based on collections which the IRS analyzed as a deferred payment contract subject to Section 483.

(ii) The fair market value of the contingent payments was treated as amount realized in the year of sale under the closed transaction method.

(iii) The deferred payment contracts were determined to be subject to all of the rules of Treas. Reg. Section 1.1275-4(c). "[T]he holder's basis in the contingent payments under a contract is reduced by any principal payments (as characterized by Section 1.1275-4(c)(4)(ii)) received by the holder. If the holder's basis in the contingent payments is reduced to zero, any additional payments . . . are treated as gain from the sale or exchange of the contract."

4. If Arrowsmith or the "origin of the claim" doctrine applies – capital gain

a. One might attempt to argue that in substance the CVR earnout is additional purchase price for the Target stock, resulting in capital gains on collection of the CVR. In Arrowsmith v. Comm'r, 344

U.S. 6 (1952), the taxpayer's settlement of a lawsuit arising from his receipt of property as a shareholder in a liquidated corporation related back to the original liquidation exchange.

b. The CVR, however, represents a separate property right/asset received in the original sale transaction, and therefore it is more difficult to support a relation back of payments on the CVR to the original sale or exchange of the publicly-traded Target shares. Cf. Alvarez v. U.S., 431 F.2d 1261 (5th Cir. 1970).

c. Arguably, the taxpayer may attempt to apply the origin of the claim doctrine to justify capital gains treatment: the origin of the claim (sale of stock) remains the same despite an intervening sale or exchange. See Nahey v. Comm'r, 196 F.3d 866 (7th Cir. 1999), where the taxpayer acquired a legal claim for lost profits as part of a purchase of a business and argued that the proceeds were capital gains when the claim was settled because he had acquired the claim in a capital transaction. While the Tax Court relied on lack of a "sale or exchange" to produce ordinary income, the Seventh Circuit justified ordinary income treatment because the claim originated in an ordinary income transaction.

IV. How to achieve greater certainty?

A. IRS ruling? Good luck.

B. Ritt's Rights!