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NEW TEMPORARY SECTION 355(e) REGULATIONS –  
A VAST IMPROVEMENT

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## **New Temporary Section 355(e) Regulations – A Vast Improvement**

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### **I. BACKGROUND**

In 1997, Congress enacted the Taxpayer Relief Act of 1997,<sup>1</sup> which added section 355(e) to the Internal Revenue Code.<sup>2</sup> Under section 355(e), the so-called anti-Morris Trust provision,<sup>3</sup> a distributing corporation will recognize gain if one or more persons acquire, directly or indirectly, 50 percent or more of the stock (measured by vote or value) of the distributing or any controlled corporation as “part of a plan (or series of related transactions)” (referred to herein as a “plan”) that was in place at the time of the distribution.<sup>4</sup> Section 355(e) also creates a

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<sup>1</sup> Pub. L. No. 105-34 (1997).

<sup>2</sup> Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

<sup>3</sup> In Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966), acq. Rev. Rul. 68-603, 1968-2 C.B. 148, a state bank entered into a merger agreement with a national bank. The state bank had an insurance department, which the national bank did not want to acquire. In order to facilitate the merger, the state bank contributed its insurance department to a newly formed corporation and spun off the corporation to its shareholders. Thus, transactions in which a target company spins off unwanted assets to its shareholders to facilitate an acquisition became known as “Morris Trust” transactions. Such transactions were blessed as tax free under section 355 for more than 30 years until the enactment of section 355(e) in 1997. See, e.g., Rev. Rul. 78-251, 1978-1 C.B. 89; Rev. Rul. 75-406, 1975-2 C.B. 125; Rev. Rul. 72-530, 1972-2 C.B. 212; Rev. Rul. 70-434, 1970-2 C.B. 83. For a discussion of section 355(e), see Mark J. Silverman et al., The New Anti-Morris Trust and Intragroup Spin Provisions, 49 TAX EXEC. 455 (1997).

<sup>4</sup> Code § 355(e)(1), (2)(A). The transaction otherwise qualifies as a section 355 transaction. Accordingly, the recipient shareholders do not recognize gain. All discussions relating to the application of section 355(e) in this article assume that the distribution or distributions of the controlled corporation stock qualify under section 355(a), unless otherwise noted.

rebuttable presumption that any acquisition occurring two years before or after a section 355 distribution is part of such a plan (the “two-year presumption”) “unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.”<sup>5</sup> Section 355(e) further authorizes Treasury and the Internal Revenue Service (the “Service”) to issue regulations “necessary to carry out the purposes” of the legislation.

On August 24, 1999, Treasury and the Service issued proposed regulations under section 355(e)<sup>6</sup> that provided guidance as to what constitutes a plan (the “1999 proposed regulations”). The 1999 proposed regulations created a complicated series of elements that the distributing corporation had to establish to rebut the two-year presumption. The particular rebuttal that applied depended upon when the acquisition occurred relative to the distribution. Not only were the rebuttals the exclusive means of overcoming the two-year presumption but the taxpayer also had to establish that it satisfied the rebuttals by a high burden of proof – clear and convincing evidence. As a result, the 1999 proposed regulations expanded the scope of an already overly broad statute.<sup>7</sup>

On January 2, 2001, Treasury and the Service withdrew the 1999 proposed regulations,<sup>8</sup> and issued new proposed regulations in their place (the “2001 proposed

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<sup>5</sup> Code § 355(e)(2)(B).

<sup>6</sup> Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. 46,155, 46,160 (1999).

<sup>7</sup> For a detailed discussion of the 1999 proposed regulations, see Mark J. Silverman & Lisa M. Zarlenga, The Proposed Section 355(e) Regulations: Broadening the Traditional Notions of What Constitutes a Plan, 52 TAX EXEC. 20 (2000).

<sup>8</sup> 66 Fed. Reg. 76 (2001).

regulations”).<sup>9</sup> The 2001 proposed regulations adopted a facts-and-circumstances approach, which is consistent with the statute.<sup>10</sup> The 2001 proposed regulations contained six safe harbors that, when applicable, obviate the need to perform the facts-and-circumstances analysis.<sup>11</sup> If the safe harbors were not satisfied, the 2001 proposed regulations contained a list of nonexclusive factors to consider in determining whether or not there is a plan.<sup>12</sup> Finally, the 2001 proposed regulations deleted references to a clear and convincing standard of proof.

On August 3, 2001, Treasury and the Service issued temporary regulations under section 355(e).<sup>13</sup> The temporary regulations are identical to the 2001 proposed regulations, except that the temporary regulations reserve section 1.355-7(e)(6) (suspending the running of any time period prescribed in the regulations during which there is a substantial diminution of risk of loss under the principles of section 355(d)(6)(B)) and Example 7 (concluding that multiple acquisitions of target companies using Distributing stock were part of a plan, regardless of whether targets were identified at the time of the spin-off, where purpose for the spin-off was to make such acquisitions). The temporary regulations were issued in response to numerous

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<sup>9</sup> Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. 66 (2001).

<sup>10</sup> See Prop. Treas. Reg. § 1.355-7(b)(1). Section 355(e)(2)(B) provides that acquisitions during the two years before and after a spin-off “shall be treated as pursuant to a plan . . . unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.” Thus, the statute clearly contemplates that taxpayers will be permitted to establish that the distribution and the acquisition were not part of a plan. Neither the statute nor the legislative history limits the manner in which the taxpayer may make this showing. The statute seems to contemplate a facts-and-circumstances approach.

<sup>11</sup> Prop. Treas. Reg. § 1.355-7(f).

<sup>12</sup> Prop. Treas. Reg. § 1.355-7(d)(2), (3).

<sup>13</sup> 66 Fed. Reg. 40,590 (2001).

comments that immediate guidance was needed.<sup>14</sup> Nevertheless, the preamble to the temporary regulations states, “The IRS and Treasury will continue to devote significant resources to analyzing the comments and, in the near future, expect to issue additional guidance regarding the interpretation of the phrase ‘plan (or series of related transactions).’”<sup>15</sup>

The 2001 proposed regulations represented a vast improvement over the 1999 proposed regulations, and the temporary regulations, by deleting an overly broad example and a rule that was unclear in its application, represent further improvement. There are, however, still areas that need clarification. This article will summarize the temporary regulations and point out a few areas that need clarification. An in-depth analysis of the temporary regulations is beyond the scope of this article.

## **II. SUMMARY OF TEMPORARY SECTION 355(e) REGULATIONS**

### **A. Safe Harbors**

The temporary regulations contain six safe harbors.<sup>16</sup> If an acquisition and distribution fall within one of the safe harbors, then they are not treated as part of a plan, and the distributing corporation need not apply the facts-and-circumstances test, which is described below.

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<sup>14</sup> Even before the temporary regulations were issued, however, the Service appeared to apply the principles of the 2001 proposed regulations in issuing private letter rulings. See P.L.R. 200125044 (Mar. 22, 2001); P.L.R. 200115001 (Apr. 28, 2000); P.L.R. 200128038 (Apr. 16, 2001); P.L.R. 200131003 (Apr. 10, 2001).

<sup>15</sup> 66 Fed. Reg. at 40,590.

<sup>16</sup> These safe harbors incorporate to some extent the exclusive rebuttals of the 1999 proposed regulations.

1. Business purpose safe harbors
  - a. Safe Harbor I - Non-acquisition business purpose
    - (i) In general

Safe Harbor I provides that a distribution and an acquisition occurring after the distribution are not part of a plan if: (i) the acquisition occurred more than six months after the distribution (and there was no agreement, understanding, arrangement, or substantial negotiations before a date that is six months after the distribution),<sup>17</sup> and (ii) the distribution was motivated in whole or substantial part by a business purpose other than a business purpose to facilitate an acquisition.<sup>18</sup>

Safe Harbor I refers to a business purpose other than to facilitate “an” acquisition. Thus, the safe harbor appears to be inapplicable in the following situation: D distributes C to facilitate an acquisition of D by X. Negotiations between D and X subsequently break down. One year after the spin-off, Y acquires C. There was a business purpose to facilitate “an” acquisition (i.e., the acquisition of D by X). Thus, Safe Harbor I does not apply.<sup>19</sup> Similarly, an

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<sup>17</sup> The 2001 proposed regulations contained an operating rule, which is further discussed below in connection with the plan factors, which provided that the running of any time period is suspended for any period during which risk of loss is substantially diminished under the principles of section 355(d)(6)(B). Prop. Treas. Reg. § 1.355-7(e)(6). This rule thus applied throughout the 2001 proposed regulations, whenever there is a reference to a time period. The temporary regulations reserved on this operating rule. Temp. Treas. Reg. § 1.355-7T(e)(6).

<sup>18</sup> Temp. Treas. Reg. § 1.355-7T(f)(1). This safe harbor is the same as the general post-spin rebuttal contained in the 1999 proposed regulations. See Prior Prop. Treas. Reg. § 1.355-7(a)(2)(ii).

<sup>19</sup> During a recent meeting of the D.C. Bar Tax Section’s Corporation Tax Committee on January 5, 2001 (the “January 2001 D.C. Bar meeting”), representatives of the Treasury and the Service informally confirmed this conclusion.

intent to facilitate any acquisition, however small, precludes the use of Safe Harbor I. Thus, for example, a spin-off to enable key employees to purchase five percent of the stock of the controlled corporation would not fall within Safe Harbor I.<sup>20</sup>

Safe Harbor I precludes an agreement, understanding, arrangement, or substantial negotiations concerning the acquisition “before a date that is six months after the distribution.”<sup>21</sup> Thus, if substantial negotiations occurred several years before the distribution, Safe Harbor I would be unavailable. As a practical matter, however, this rule is limited by the reference to “the” acquisition – the negotiations must occur with respect to the acquisition that actually occurred.<sup>22</sup>

(ii) Multiple business purposes

Where there are two business purposes for a distribution – one acquisition and one non-acquisition – the distributing corporation must show that the non-acquisition business purpose was “substantial.” The preamble to the 2001 proposed regulations states that analyzing whether a non-acquisition business purpose is substantial is similar to analyzing whether there is a corporate business purpose for a distribution in light of the potential avoidance of federal taxes; the non-acquisition business purpose thus must be “real and substantial even in light of the

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<sup>20</sup> But see discussion of Safe Harbor II, infra.

<sup>21</sup> Temp. Treas. Reg. § 1.355-7T(f)(1)(i)(A).

<sup>22</sup> Note that this language is somewhat broader than what appeared in the 1999 proposed regulations. The 1999 proposed regulations referred to an agreement, understanding, arrangement, or substantial negotiations “at the time of the distribution or within 6 months thereafter.” Prior Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(2).

acquisition business purpose.”<sup>23</sup> In discussing the 1999 proposed regulations, representatives from the Treasury and the Service had informally indicated that this test was intended to be a “but-for” analysis: Would the distributing corporation undertake the spin-off without the acquisition business purpose?<sup>24</sup> Presumably, since the language of the rule has not changed, the but-for analysis continues to apply with respect to the temporary regulations.

The temporary regulations contain certain operating rules that deem or create an acquisition business purpose; i.e., reasonable certainty, internal discussions, and hostile takeovers, which are discussed below. The preamble to the 2001 proposed regulations states that these operating rules apply in determining whether the non-acquisition business purpose is substantial.<sup>25</sup> Thus, for example, if the stated business purpose for a spin-off is cost savings, but an acquisition business purpose is deemed under the operating rules, the distributing corporation must do the but-for analysis. This appears to be true even if the distributing corporation obtained a private letter ruling relying solely on the cost savings business purpose.<sup>26</sup>

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<sup>23</sup> Preamble to Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. at 68. The preamble to the 1999 proposed regulations contained a similar statement. Preamble to Prior Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. at 46,157.

<sup>24</sup> These statements were made during a meeting of the D.C. Bar Tax Section’s Corporation Tax Committee on October 7, 1999 (the “October 1999 D.C. Bar meeting”).

<sup>25</sup> Preamble to Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. at 68.

<sup>26</sup> During the January 2001 D.C. Bar meeting, representatives of the Treasury and the Service informally confirmed this statement, noting that there is no need to distinguish between acquisition and non-acquisition business purposes in order to obtain a private letter ruling.

(a) Operating rule 1 - reasonable certainty

The first business purpose operating rule is that reasonable certainty that an acquisition will occur is evidence of an acquisition business purpose. Thus, in the case of a post-spin acquisition, if it is reasonably certain that within six months after the distribution an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition, then there is evidence of an acquisition business purpose.<sup>27</sup> In the case of a pre-spin acquisition, if it is reasonably certain that within six months after the acquisition a distribution would occur (or an agreement, understanding, arrangement, or substantial negotiations would occur), then there is evidence of an acquisition business purpose. In addition, if the acquisition occurs after the public announcement of the distribution, the public announcement is, itself, evidence of an acquisition business purpose.<sup>28</sup>

Regarding the reasonable certainty rule, the preamble to the 2001 proposed regulations states:

The rule regarding reasonable certainty is necessary to implement section 355(e) because where a taxpayer was reasonably certain that an acquisition would occur, that acquisition was likely to be taken into account in determining whether to effect a distribution. While the IRS and the Department of Treasury believe that reasonable certainty (even where no discussions with potential acquirers have occurred) is relevant in determining whether a plan exists, it should be noted that this concept is significantly modified from the 1999 proposed regulations. This operating rule will apply only in cases where there was a strong possibility that, within 6 months after the distribution, an acquisition would occur . . .<sup>29</sup>

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<sup>27</sup> Temp. Treas. Reg. § 1.355-7T(e)(1)(i). The use of the term “reasonable” implies that the reasonable certainty test is an objective one.

<sup>28</sup> Temp. Treas. Reg. § 1.355-7T(e)(1)(ii).

<sup>29</sup> Preamble to Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. at 68 (emphasis added).

Thankfully, the reasonable certainty test appears much narrower and much less complicated than the reasonable anticipation test of the 1999 proposed regulations.<sup>30</sup> In addition, the reasonable certainty test plays a diminished role in the temporary regulations – it provides evidence of a factor, rather than being an exclusive test. However, it is not clear who bears the burden of proving reasonable certainty. Must the Service first assert that an acquisition that occurred was reasonably certain, or must the taxpayer in all cases produce evidence that the acquisition was not reasonably certain?

The change between the reasonable anticipation test and the reasonable certainty test is illustrated most clearly by comparing the hot market examples of the 1999 proposed regulations and the temporary regulations. Under the 1999 proposed regulations, if a distributing corporation spun off a controlled corporation in a hot market, so that it was reasonable to anticipate that the controlled corporation would be acquired, section 355(e) applied.<sup>31</sup> Under the temporary regulations, however, reasonable certainty that the controlled corporation would be acquired is evidence of an acquisition business purpose. If an actual acquisition does not occur for six months, the distributing corporation may avoid section 355(e) under Safe Harbor I or II. If the acquisition does occur within six months, the distributing corporation may still avoid section 355(e) if it can satisfy the facts-and-circumstances analysis.<sup>32</sup>

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<sup>30</sup> See Prior Prop. Treas. Reg. § 1.355-7(a)(2)(iii). The reasonable anticipation test required that no relevant party would have reasonably anticipated that it was more likely than not that one or more persons, who would not have acquired the interests if the distribution had not occurred, would acquire a 50-percent or greater interest with two years of the distribution.

<sup>31</sup> See Prior Prop. Treas. Reg. § 1.355-7(a)(8), Ex.4.

<sup>32</sup> See Temp. Treas. Reg. § 1.355-7T(m), Ex.5.

Regarding the public announcement rule, presumption of a tainted business purpose apparently follows from the definition of controlling shareholder, which is tested immediately before or immediately after the acquisition.<sup>33</sup> Thus, one who acquires a controlling interest imparts a tainted business purpose on the transaction. The temporary regulations do not, however, limit the rule to persons who become controlling shareholders by reason of the acquisition. Final regulations should clarify this point.

(b) Operating rule 2 - internal discussions

The second business purpose operating rule is that internal discussions regarding an acquisition may be indicative of an acquisition business purpose.<sup>34</sup> The temporary regulations do not, however, provide any guidance as to what is meant by “internal discussions.” Are discussions among non-management level employees sufficient? What if management is considering the possibility of a spin-off, but has not yet approached the board of directors? What if the board has heard a spin-off proposal and has ordered a feasibility study? What if the discussions cease? Representatives of the Treasury and Service had informally indicated that under the 1999 proposed regulations, mere due diligence did not rise to the level of intent for purposes of the general pre-spin rebuttal.<sup>35</sup> However, “internal discussions” appears to encompass a broader spectrum of activities than “intent.”

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<sup>33</sup> Temp. Treas. Reg. § 1.355-7T(k)(3)(iii).

<sup>34</sup> Temp. Treas. Reg. § 1.355-7T(e)(2).

<sup>35</sup> See Prior Prop. Treas. Reg. § 1.355-7(a)(2)(v)(A). The statements made by the Treasury and Service representatives were made during the October 1999 D.C. Bar meeting.

(c) Operating rule 3 - hostile takeovers

The third business purpose operating rule relates to hostile takeovers. The temporary regulations provide that if the distribution is intended, in whole or substantial part, to decrease the likelihood of the acquisition of either the distributing or controlled corporation by separating it from another corporation that is likely to be acquired, then the distributing corporation will be treated as having an acquisition business purpose.<sup>36</sup> Apparently, the concern is that a distribution to separate the wanted company from the unwanted company actually facilitates the acquisition of the wanted company. However, this is not the case where the acquirer wants both the distributing and controlled companies, and the distribution makes the acquirer's goal more difficult to achieve. Although the language of the temporary regulations technically does not apply to the latter situation, it will be difficult, as a practical matter, to distinguish the two situations.

(iii) Similar acquisitions

Unlike the plan and non-plan factors discussed below, Safe Harbor I does not refer to "similar acquisitions." Thus, it appears that Safe Harbor I would apply in the following situation: D has a substantial non-acquisition business purpose for the distribution of C. Within six months, C begins negotiations with potential acquirer X, which negotiations ultimately break down. Eight months after the spin-off, C begins negotiations with potential acquirer Y for a similar acquisition, and ten months after the spin-off, Y acquires C. The acquisition occurs more than six months after the distribution, and no agreement, understanding, arrangement, or

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<sup>36</sup> Temp. Treas. Reg. § 1.355-7T(e)(3).

substantial negotiations concerning “the” acquisition occurred within six months after the distribution.<sup>37</sup>

b. Safe Harbor II - Acquisition business purpose

Safe Harbor II provides that a distribution and acquisition will not be considered part of a plan if (i) the acquisition occurred more than six months after the distribution (and there was no agreement, understanding, arrangement, or substantial negotiations before a date that is six months after the distribution); (ii) the distribution was motivated in whole or substantial part by a business purpose to facilitate an acquisition or acquisitions of no more than 33 percent of the stock of the distributing or controlled corporation; and (iii) no more than 20 percent of the stock of the corporation whose stock was acquired in the acquisition or acquisitions that motivated the distribution was either acquired or subject to an agreement, understanding, arrangement, or substantial negotiations within six months after the distribution.<sup>38</sup> According to informal statements made by representatives of the Treasury and the Service, this safe harbor was intended to address criticisms under the 1999 proposed regulations that if the distributing corporation had an intent to facilitate any acquisition (even a small one), the general post-spin rebuttal was not available for any subsequent, unintended acquisitions.<sup>39</sup> For example, if D distributes C to facilitate a 15-percent public offering by C, and D is subsequently acquired in an unexpected acquisition, section 355(e) would apply under the 1999 proposed regulations. Under

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<sup>37</sup> Note that during the January 2001 D.C. Bar meeting, representatives of the Treasury and the Service noted that even though the safe harbors contain no reference to “similar acquisitions,” they are looking at this issue.

<sup>38</sup> Temp. Treas. Reg. § 1.355-7T(f)(2).

<sup>39</sup> These statements were made during the January 2001 D.C. Bar meeting.

the temporary regulations, Safe Harbor II would apply to D's acquisition (note that the safe harbor does not apply with respect to C's public offering).<sup>40</sup>

2. Safe Harbors III and IV - Acquisitions more than two years out

Safe Harbor III provides that if an acquisition occurs more than two years after a distribution, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within six months thereafter, the acquisition and distribution are not part of a plan.<sup>41</sup> Thus, for example, if D began negotiating with a potential acquirer eight months after the distribution and was acquired 25 months after the distribution, Safe Harbor III should apply.

Safe Harbor IV provides that if an acquisition occurs more than two years before a distribution, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter, the acquisition and distribution are not part of a plan.<sup>42</sup> Thus, for example, if A acquires 50 percent of the stock of D, and eight months later, D begins considering a spin-off, and the spin-off occurs one year after A's acquisition, Safe Harbor IV should apply.

3. Safe Harbor V - Public trading

Safe Harbor V provides a safe harbor for public trading. Safe Harbor V provides that an acquisition of stock of the distributing or controlled corporation that is listed on an

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<sup>40</sup> See Temp. Treas. Reg. § 1.355-7T(m), Ex. 4.

<sup>41</sup> Temp. Treas. Reg. § 1.355-7T(f)(3).

<sup>42</sup> Temp. Treas. Reg. § 1.355-7T(f)(4).

established market is not part of a plan if the acquisition is pursuant to a transfer between shareholders, neither of whom is a five-percent shareholder.<sup>43</sup> This safe harbor expressly does not apply to public offerings or redemptions.<sup>44</sup> Nor does it apply if the transferor or transferee was acting pursuant to an understanding with other persons who, in the aggregate, own five percent or more of the stock of the corporation whose stock is transferred, or if the corporation knows or has reason to know that the transferor or transferee intends to become a five-percent shareholder at any time during the two-year period before and after the distribution.<sup>45</sup>

Safe Harbor V refers to transfers “between shareholders,” which implies that the public trading must occur between existing shareholders. Final regulations should clarify that market sales to new shareholders that own less than five percent of the stock fall within Safe Harbor V.<sup>46</sup>

#### 4. Safe Harbor VI - Compensatory stock arrangements

Safe Harbor VI provides a safe harbor for compensatory stock arrangements. Safe Harbor VI provides that if the stock of the distributing or controlled corporation is acquired by an employee or director of the distributing, controlled, or related corporation in connection with the performance of services in a transaction to which section 83 applies, the acquisition is not part of a plan.<sup>47</sup> Note that this safe harbor does not apply to independent contractors.

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<sup>43</sup> Temp. Treas. Reg. § 1.355-7T(f)(5)(i).

<sup>44</sup> Temp. Treas. Reg. § 1.355-7T(f)(5)(ii)(A).

<sup>45</sup> Temp. Treas. Reg. § 1.355-7T(f)(5)(ii)(B), (C).

<sup>46</sup> According to informal statements made by representatives of the Treasury and the Service during the January 2001 D.C. Bar meeting, such market sales fall within Safe Harbor V.

<sup>47</sup> Temp. Treas. Reg. § 1.355-7T(f)(6).

Safe Harbor VI literally applies to acquisitions of stock in section 83 transactions. The scope of this requirement is unclear. It does not appear to apply to stock acquired pursuant to the exercise of an option to which section 83 does not apply, such as a qualified incentive stock option.<sup>48</sup> The preamble to the 2001 proposed regulations states that Safe Harbor VI excludes from a plan “an acquisition of stock by an employee or director in connection with the performance of services, including an acquisition resulting from the exercise of certain compensatory stock options.”<sup>49</sup> Although it appears from this statement that the safe harbor is intended to reach any transaction in which stock is acquired by an employee or director as compensation, it refers only to “certain” compensatory stock options. Final regulations should clarify the scope of this safe harbor.

While Safe Harbor VI seems to protect the exercise of compensatory stock options, the grant of a compensatory stock option is protected by Temp. Treas. Reg. § 1.355-7T(g)(3)(ii), which is further discussed below.

#### B. Facts-and-Circumstances Test

The temporary regulations provide that whether a distribution and acquisition are part of a plan is determined based on all the facts and circumstances.<sup>50</sup> The ultimate factual determination is the intent of the distributing corporation, the controlled corporation, and their

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<sup>48</sup> During a recent meeting of the American Bar Association Tax Section’s Corporate Tax Committee on January 13, 2001 (the “January 2001 ABA meeting”), representatives of the Treasury and the Service confirmed this interpretation.

<sup>49</sup> Preamble to Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. at 69.

<sup>50</sup> Temp. Treas. Reg. § 1.355-7T(b)(1).

respective controlling shareholders (collectively the “relevant parties”).<sup>51</sup> With respect to a pre-spin acquisition, the focus is on the intent of the relevant parties that a distribution occur in connection with the acquisition; with respect to a post-spin acquisition, the focus is on the intent of the relevant parties that the acquisition or a similar acquisition occur in connection with the distribution.<sup>52</sup> The temporary regulations make it clear that the reference to “similar” does not mean identical – “the actual acquisition and the intended acquisition may be similar even though the identity of the person acquiring stock of Distributing or Controlled (acquirer), the timing of the acquisition or the terms of the actual acquisition are different from the intended acquisition.”<sup>53</sup> Nonetheless, the scope of “similar acquisition” is not entirely clear. For example, is an acquisition at a different price similar? What if the price difference is substantial? What

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<sup>51</sup> With respect to non-public companies, a controlling shareholder is defined as any person who possesses voting power representing a meaningful voice in the governance of the corporation. Temp. Treas. Reg. § 1.355-7T(k)(3)(i). With respect to public companies, a controlling shareholder is defined as a five-percent shareholder who actively participates in the management or operation of the corporation. Id. § 1.355-7T(k)(3)(ii).

This rule represents a significant change from the 1999 proposed regulations. The 1999 proposed regulations stated that the intent of the distributing corporation, the controlled corporation, and their controlling shareholders to facilitate an acquisition was relevant. Prior Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(B). Irrespective of this statement, however, the 1999 proposed regulations appeared to consider the intent of third parties. See, e.g., Preamble of Prior Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. 46,155, 46,157 (1999) (noting that the intent of the acquirer at the time of the distribution is not “necessarily relevant” in determining whether there is a plan); id. at 46,158 (stating that it is “appropriate . . . to require the distributing corporation to take into account the reasonably anticipated, likely actions of others to demonstrate that a distribution and acquisition are not part of a plan”); Prior Prop. Treas. Reg. § 1.355-7(a)(8), Exs.2, 4.

<sup>52</sup> See Temp. Treas. Reg. § 1.355-7T(b)(1).

<sup>53</sup> Temp. Treas. Reg. § 1.355-7T(b)(2).

about a change in the type of consideration? What about a change in the target corporation (i.e., an acquisition of the controlled corporation rather than the distributing corporation)?<sup>54</sup>

The 2001 proposed regulations seemingly adopted a broad interpretation of the scope of “similar acquisition.” Example 7 of the 2001 proposed regulations involved a distribution by D for the purpose of using stock of D to expand its business through the acquisition of target corporations. At the time of the distribution, D had no specific goals regarding how much of its stock would ultimately be used. D had identified X and Y as potential targets before the public announcement of the distribution and had begun negotiations with X after the announcement but before the distribution. D acquires X one month after the distribution, and acquires Y one year after the distribution (negotiations with Y began seven months after the distribution). D identifies Z as a potential target after the distribution and acquires Z 18 months after the distribution. The 2001 proposed regulations concluded that the acquisition of X was part of a plan within the meaning of section 355(e) and that, because the acquisitions of Y and Z were “similar” to that of X, they too were part of a plan.<sup>55</sup>

In light of the purpose of section 355(e) to prevent disguised sales, the Y and Z acquisitions should not be considered part of the same plan as the distribution. Y had only been identified at the time of the disposition. There was no contact with Y at the time of the

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<sup>54</sup> According to informal statements made by representatives of the Treasury and the Service during the January 2001 D.C. Bar meeting and the January 2001 ABA meeting, a change in the target corporation should not be regarded as similar. Moreover, an acquisition by the same acquirer is likely to be subject to greater scrutiny in determining whether it is similar.

<sup>55</sup> See Prop. Treas. Reg. § 1.355-7(m), Ex. 7. Interestingly, D likely would not have been able to obtain a ruling that the distribution in Example 7 was tax free under section 355(a), because of a lack of a specific and imminent acquisition. See Rev. Proc. 96-30, 1996-1 C.B. 696.

distribution; indeed, negotiations did not even begin until seven months after the distribution. Moreover, Z had not even been identified as a potential target at the time of the distribution. By including the Y and Z acquisitions as part of the same plan, Example 7 illustrated that corporations, as a practical matter, can no longer consummate tax-free spin-offs for the corporate business purpose of acquiring target corporations. Fortunately, Treasury and the Service have recognized that Example 7 needs further consideration and have removed the example from the temporary regulations.<sup>56</sup>

The temporary regulations provide a list of nonexclusive factors to consider in demonstrating the existence of a plan, which are discussed below. The weight given to each factor depends on the particular case, and the existence of a plan is not determined merely by comparing the number of plan and non-plan factors.<sup>57</sup> Thus, Treasury and the Service appear to have adopted the approach of the regulations relating to the device test of section 355.<sup>58</sup>

1. Plan factors

The temporary regulations list nine factors that tend to show the existence of a plan:<sup>59</sup>

*Post-Distribution Acquisitions:*

1. In the case of a post-distribution acquisition, a relevant party and the acquirer discussed the acquisition or a similar acquisition before the distribution.

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<sup>56</sup> See Temp. Treas. Reg. § 1.355-7T(m), Ex. 7.

<sup>57</sup> Temp. Treas. Reg. § 1.355-7T(d)(1).

<sup>58</sup> See Treas. Reg. § 1.355-2(d)(1).

<sup>59</sup> Temp. Treas. Reg. § 1.355-7T(d)(2)(i)-(ix).

2. In the case of a post-distribution acquisition, a relevant party and a potential acquirer discussed the acquisition before the distribution, and a similar acquisition by a different person occurred after the distribution.
3. In the case of a post-distribution acquisition involving a public offering or auction, a relevant party discussed the acquisition with an investment banker or other outside adviser before the distribution.

*Pre-Distribution Acquisitions:*

4. In the case of a pre-distribution acquisition, a relevant party and the acquirer discussed a distribution before the acquisition.
5. In the case of a pre-distribution acquisition, a relevant party and a potential acquirer discussed a distribution before the acquisition, and a similar acquisition by a different person occurred before the distribution.
6. In the case of a pre-distribution acquisition involving a public offering or auction, a relevant party discussed a distribution with an investment banker or other outside adviser before the acquisition.

*Either Pre- or Post-Distribution Acquisition:*

7. In the case of either a pre- or post-distribution acquisition, the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition of the distributing or controlled corporation.
8. In the case of either a pre- or post-distribution acquisition, the acquisition and the distribution occurred within six months of each other, or there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction within six months after the first transaction.
9. In the case of either a pre- or post-distribution acquisition, the debt allocation between the distributing and controlled corporations made an acquisition likely in order to service the debt.

a. Discussions with acquirer or potential acquirer

The first three factors focus on discussions in the context of a post-spin acquisition. The inquiry is whether a relevant party discussed the acquisition, and the acquisition or a similar acquisition by the same or different person occurred after the distribution.<sup>60</sup> Note

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<sup>60</sup> Temp. Treas. Reg. § 1.355-7T(d)(2)(i), (ii).

that the temporary regulations specify that the discussions must occur with the acquirer (or potential acquirer or a controlling shareholder thereof). In the case of a post-spin public offering or auction, the inquiry is whether a relevant party discussed the acquisition with an investment banker or other outside advisor before the distribution.<sup>61</sup>

The next three factors focus on discussions in the context of a pre-spin acquisition. The inquiry is whether a relevant party discussed a distribution before the acquisition, and the acquisition or a similar acquisition by a different person occurred before the distribution.<sup>62</sup> Similar to the factors relating to post-spin acquisitions, the temporary regulations specify that the discussions must occur with the acquirer (or potential acquirer or controlling shareholder thereof). In the case of a pre-spin public offering or auction, the inquiry is whether a relevant party discussed a distribution with an investment banker or other outside advisor before the acquisition.<sup>63</sup>

b. Business purpose

The seventh plan factor focuses on the existence of a business purpose to facilitate the acquisition or a similar acquisition of the distributing or controlled corporation.<sup>64</sup> This factor incorporates language similar to that contained in the 1999 proposed regulations in the general

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<sup>61</sup> Temp. Treas. Reg. § 1.355-7T(d)(2)(iii).

<sup>62</sup> Temp. Treas. Reg. § 1.355-7T(d)(2)(iv), (v).

<sup>63</sup> Temp. Treas. Reg. § 1.355-7T(d)(2)(vi).

<sup>64</sup> Temp. Treas. Reg. § 1.355-7T(d)(2)(vii).

and alternative post-spin rebuttals,<sup>65</sup> except that it has been broadened to encompass similar acquisitions.

c. Timing of distribution

The eighth plan factor is that the acquisition and distribution occur within six months of each other (or there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction within six months after the first transaction).<sup>66</sup> The 2001 proposed regulations provided as an operating rule that the running of any time period is suspended for any period during which risk of loss is substantially diminished under the principles of section 355(d)(6)(B).<sup>67</sup> The scope of this rule was unclear, but it would appear that if the distributing corporation has tracking stock outstanding, which tolls the holding period under section 355(d)(6)(B), it would not be able to satisfy this factor or any of the first four safe harbors discussed above (which all incorporate time limitations). The reason for this rule in the context of tracking stock is not clear, because the use of tracking stock does not appear to be contrary to any of the purposes behind section 355(e). The temporary regulations remove this confusion by reserving on the rule.<sup>68</sup>

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<sup>65</sup> See Prior Prop. Treas. Reg. § 1.355-7(a)(2)(ii), (iii).

<sup>66</sup> Temp. Treas. Reg. § 1.355-7T(d)(2)(viii). This factor, too, incorporates language similar to that contained in the 1999 proposed regulations in the general post-spin rebuttal. See Prior Prop. Treas. Reg. § 1.355-7(a)(2)(ii).

<sup>67</sup> Prop. Treas. Reg. § 1.355-7(e)(6).

<sup>68</sup> Temp. Treas. Reg. § 1.355-7T(e)(6).

d. Debt allocation

The ninth plan factor is that the debt allocation between the distributing and controlled corporation make an acquisition of either corporation likely in order to service the debt.<sup>69</sup>

2. Non-plan factors

The temporary regulations list seven factors that tend to refute the existence of a plan:<sup>70</sup>

*Post-Distribution Acquisitions:*

1. In the case of a post-distribution acquisition, no relevant party discussed the acquisition or a similar acquisition with the acquirer or potential acquirer before the distribution.
2. In the case of a post-distribution acquisition involving a public offering or auction, no relevant party discussed the acquisition with an investment banker or other outside adviser before the distribution.
3. In the case of a post-distribution acquisition, there was an identifiable, unexpected change in market or business conditions occurring after the distribution that resulted in the acquisition that was otherwise unexpected at the time of the distribution.

*Pre-Distribution Acquisitions:*

4. In the case of a pre-distribution acquisition, no relevant party discussed the distribution before the acquisition. This factor does not apply if the acquisition occurs after the date of the public announcement of the planned distribution.
5. In the case of a pre-distribution acquisition, there was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.

*Either Pre- or Post-Distribution Acquisition:*

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<sup>69</sup> Temp. Treas. Reg. § 1.355-7T(d)(2)(ix).

<sup>70</sup> Temp. Treas. Reg. § 1.355-7T(d)(3)(i)-(vii).

6. In the case of either a pre- or post-distribution acquisition, the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition.
7. In the case of either a pre- or post-distribution acquisition, the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition (including a previously proposed acquisition that did not occur).

- a. Discussions with acquirer or potential acquirer

Three of the non-plan factors focus on the participation of the relevant parties in discussions regarding the second transaction of the pair being tested. In the case of a post-spin acquisition, no relevant party discussed the acquisition or a similar acquisition with the acquirer or any potential acquirer before the distribution.<sup>71</sup> In the case of a pre-spin acquisition, no relevant party discussed a distribution with the acquirer before the acquisition.<sup>72</sup> Note that, like the plan factors above, the temporary regulations specify that the discussions must occur with the acquirer (or potential acquirer). In the case of a public offering or auction after a distribution, no relevant party discussed the acquisition with an investment banker or other outside advisor.<sup>73</sup>

- b. Unexpected changes

Two other non-plan factors focus on unexpected changes in market or business conditions. In the case of a post-spin acquisition, there was an identifiable, unexpected change in market or business conditions occurring after the distribution that resulted in the acquisition that

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<sup>71</sup> Temp. Treas. Reg. § 1.355-7T(d)(3)(i).

<sup>72</sup> Temp. Treas. Reg. § 1.355-7T(d)(3)(iv).

<sup>73</sup> Temp. Treas. Reg. § 1.355-7T(d)(3)(ii). Note that there is no similar factor with regard to public offerings or auctions before a distribution. The reason for this omission is not clear.

was otherwise unexpected at the time of the distribution.<sup>74</sup> In the case of a pre-spin acquisition, there was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.<sup>75</sup>

c. Business purpose

The sixth non-plan factor is that the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition of the distributing or controlled corporation. However, the presence of an acquisition business purpose is relevant in determining the extent to which the distribution was motivated by a non-acquisition business purpose.<sup>76</sup> This is essentially the flip-side of the seventh plan factor discussed above.

Note, however, that the presence of any acquisition business purpose, whether substantial or not, constitutes a plan factor, but a non-acquisition business purpose must be substantial to constitute a non-plan factor. In addition, as discussed above, the temporary regulations provide certain operating rules, which can create an acquisition business purpose (i.e., reasonable certainty, internal discussions, and hostile takeovers). The preamble to the 2001 proposed regulations states that these operating rules apply in determining whether the non-acquisition business purpose is substantial.<sup>77</sup>

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<sup>74</sup> Temp. Treas. Reg. § 1.355-7T(d)(3)(iii).

<sup>75</sup> Temp. Treas. Reg. § 1.355-7T(d)(3)(v).

<sup>76</sup> Temp. Treas. Reg. § 1.355-7T(d)(3)(vi).

<sup>77</sup> Preamble to Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. at 68.

d. Same time and form

The seventh non-plan factor is that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition (including a previously proposed similar acquisition that did not occur).<sup>78</sup> This factor incorporates language similar to that contained in the 1999 proposed regulations in the alternative pre-spin rebuttal,<sup>79</sup> except that it has been broadened to encompass similar acquisitions. The parenthetical seems to require that all contemplated acquisitions be tested against the distribution to determine whether the distribution would have occurred at the same time and in the same form if any of the proposed acquisitions had occurred.

C. Agreement, Understanding, Arrangement, or Substantial Negotiations

The temporary regulations retain the phrase “agreement, understanding, arrangement or substantial negotiations” contained in the 1999 proposed regulations. Like the 1999 proposed regulations, the temporary regulations do not define the phrase, except to state that the parties do not necessarily have to enter into a binding contract or reach an agreement on all terms in order for an “agreement, understanding, arrangement, or substantial negotiations” to exist.<sup>80</sup> The temporary regulations also provide that in the case of a public offering or auction, an agreement, understanding, arrangement, or substantial negotiations can exist even if an acquirer has not been specifically identified, and that the determination will be based on

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<sup>78</sup> Temp. Treas. Reg. § 1.355-7T(d)(3)(vii).

<sup>79</sup> See Prior Prop. Treas. Reg. § 1.355-7(a)(2)(v)(B).

<sup>80</sup> Temp. Treas. Reg. § 1.355-7T(k)(1). See Prior Prop. Treas. Reg. § 1.355-7(a)(5).

discussions with an investment banker or other outside adviser.<sup>81</sup> The 1999 proposed regulations contained a similar statement in the preamble; however, the lack of an identified acquirer was not limited to public offerings and auctions.<sup>82</sup>

Like the 1999 proposed regulations, the temporary regulations treat certain options as agreements. If stock is acquired pursuant to an option, the option is treated as an agreement to acquire stock on the date the option is granted, unless the distributing corporation establishes that, on the later of the date of the distribution or the date of the grant, the option was not more likely than not to be exercised.<sup>83</sup> For purposes of this rule, the term “option” is defined broadly to include call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements (including rights to cause the redemption of stock), any other instrument that provides for the right or possibility to issue, redeem, or transfer stock (including an option on an option), or any other similar interests.<sup>84</sup>

Certain instruments, however, are excluded from the definition of an option, unless such instruments are granted with a principal purpose of avoiding the application of section 355(e). Excluded instruments include options provided to employees or directors of the distributing, controlled, or a related corporation in connection with the performance of services that (i) is not excessive by reference to the services performed, (ii) is nontransferable within the

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<sup>81</sup> Temp. Treas. Reg. § 1.355-7T(k)(1).

<sup>82</sup> Preamble to Prior Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. at 46,159.

<sup>83</sup> Temp. Treas. Reg. § 1.355-7T(g)(1)(i).

<sup>84</sup> Temp. Treas. Reg. § 1.355-7T(g)(2). Note that the temporary regulations remove the references to restricted stock and cash settlement options. Cf. Prior Prop. Treas. Reg. § 1.355-7(a)(7)(ii).

meaning of § 1.83-3(d), and (iii) does not have a readily ascertainable fair market value as defined in § 1.83-7(b).<sup>85</sup> Excluded instruments also include options that are part of a security arrangement in a typical lending transaction, options that are exercisable only upon death, disability, mental incompetency, or separation from service, bona fide rights of first refusal, and any other instrument designated by the Service in revenue procedures, notices, or other published guidance.<sup>86</sup>

### **III. CONCLUSION**

In short, the 2001 proposed regulations represented a vast improvement over the 1999 proposed regulations, and the temporary regulations further improve on the 2001 proposed regulations by reserving on controversial Example 7 and on the uncertain rule regarding suspension of time periods where risk of loss is diminished. The application of a facts-and-circumstances analysis, while it may not always result in a great deal of certainty, was clearly contemplated by the statute. The safe harbors provide exceptions to deal with more straightforward situations. Nevertheless, certain issues that are not addressed in the temporary should be addressed in the final regulations, such as the definition of “substantial” as it relates to non-acquisition business purposes, the definition of “substantial negotiations,” the effect of breaking off negotiations, the scope of “similar acquisitions,” and the effect of internal discussions.

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<sup>85</sup> Temp. Treas. Reg. § 1.355-7T(g)(3)(ii).

<sup>86</sup> Temp. Treas. Reg. § 1.355-7T(g)(3)(i), (iii), (iv), and (v).