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THE PROPOSED SECTION 355(e) REGULATIONS: BROADENING THE TRADITIONAL NOTIONS OF WHAT CONSTITUTES A PLAN

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The Proposed Section 355(e) Regulations: Broadening the Traditional Notions of What Constitutes a Plan

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I. INTRODUCTION

In 1997, Congress enacted the Taxpayer Relief Act of 1997,[1] which added section 355(e) to the Internal Revenue Code.[2] Under section 355(e), the so-called anti-Morris Trust provision,[3] 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.[4] Section 355(e) also creates a

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[1] Pub. L. No. 105-34 (1997).

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

[3] 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).

[4] 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."[5] 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.[6]

On August 19, 1999, Treasury and the Service issued proposed regulations under section 355(e) that provide guidance as to what constitutes a plan.[7] The proposed regulations generally treat the test of whether a plan exists as a subjective one that depends ultimately on the intent and expectations of the relevant parties.[8] The proposed regulations rely on a variety of factors to determine whether a plan exists, including the timing of the transactions, the business purpose for the distribution, the likelihood of an acquisition, the intent of the parties, the existence of agreements, understandings, arrangements, or substantial negotiations, and the causal connection between the distribution and the acquisition.[9] Although the proposed

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[5] Code § 355(e)(2)(B).

[6] Code § 355(e)(5). This language gives Treasury and the Service the authority to interpret the statute and to establish the standards required to demonstrate that a distribution and acquisition are not pursuant to a plan. The legislative history provides guidance as to the purpose of the statute, but it does not prevent the Treasury and the Service from reaching an independent judgment as to the meaning of the statute. Indeed, Treasury and the Service have exercised similar authority in the past. See, e.g., Prop. Treas. Reg. § 1.355-6 (considerably narrowing section 355(d)); Treas. Reg. § 1.338-4 (narrowing the section 338 consistency rules).

[7] The proposed regulations are proposed to apply to distributions that occur after the regulations are published in final form. Preamble to Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. 46,155, 46,160 (1999) (hereinafter "Preamble").

[8] Preamble, 64 Fed. Reg. at 46,157.

[9] Id.

regulations provide guidance on the issue of what constitutes a plan, they create significant concerns regarding the scope of section 355(e). Indeed, the proposed regulations may be viewed as going beyond the traditional notions of what constitutes a plan, thus inappropriately expanding the statute.[10]

This article will analyze the proposed section 355(e) regulations and provide recommendations for revising the proposed regulations.[11] Part II describes the proposed regulations in general, Part III analyzes the proposed regulations in the context of several examples, and Part IV sets forth several recommendations to the Service for amending the proposed regulations.

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[10] Section 355(e) is a poorly drafted statute based on flawed principles. So-called Morris Trust transactions had been authorized by the Service for more than 30 years, and there is no reason to impose a tax on basic Morris Trust transactions. Section 355(e) was aimed at certain abusive transactions that looked more like a sale than a tax-free spin-off. As further discussed in Part III.A., infra, one feature of such "disguised sale" transactions is that the corporation to be acquired borrows money (or assumes a large amount of debt) and distributes (or contributes) the proceeds of such debt to its parent prior to a spin-off. The acquiror often will contribute cash to the acquired entity, which is used to repay the debt. Basic Morris Trust transactions do not contain such features and do not resemble disguised sales.

The Clinton Administration first described the perceived abuse in its 1997 budget proposal and proposed an amendment to section 355(d) to address it. Congress, however, further expanded the proposal. Thus, the statute, along with the proposed regulations, has prevented companies from doing legitimate tax-free spin-offs.

[11] For other detailed analyses of the proposed regulations, see Michael L. Schler, What is a "Plan (or Series of Related Transactions)" Under Section 355(e)?, Tax Forum No. No. 535 (Oct. 4, 1999); Gordon E. Warnke, The Proposed Section 355(e) Regulations, The New York City Tax Club (Sept. 13, 1999).

II. THE PROPOSED SECTION 355(e) REGULATIONS: IN GENERAL

A. In General

The preamble to the proposed section 355(e) regulations states that the proposed regulations "provide guidance concerning the interpretation" of a plan. While the proposed regulations provide ways to rebut the two-year presumption, they only implicitly define what constitutes a plan.

Through a series of examples, the proposed regulations seem to interpret the concept of a plan broadly. The preamble to the proposed regulations notes that Congress intended that a plan be interpreted broadly.[12] The Service points to two specific indications of this intent. First, in contrast to section 355(d), which utilizes the concept of "a person" and applies certain aggregation rules to treat related persons and persons acting in concert as one person, section 355(e) adopted a more expansive approach by referring simply to "one or more persons." Second, the Conference Report provides that public offerings of a sufficient size could trigger section 355(e). This suggests that there does not need to be an identified acquiror on the date of the distribution and that the intent of the acquiror is not necessarily relevant in determining whether there is a plan.[13] For example, the proposed regulations treat a distribution for the purpose of facilitating a public offering by the distributing or controlled corporation of more than 50 percent of its stock as part of a plan for purposes of section 355(e).[14]

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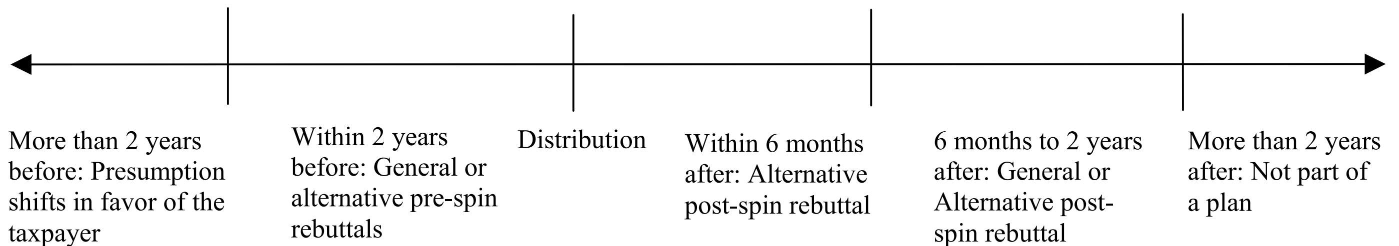
[12] Preamble, 64 Fed. Reg. at 46,157.

[13] Id.

[14] See Prop. Treas. Reg. § 1.355-7(a)(8), Exs. 1, 9.

In addition to defining a plan broadly, the proposed regulations impose a high burden of proof on the taxpayer to rebut the two-year presumption. The taxpayer must establish that it satisfies the tests set forth in the proposed regulations by "clear and convincing evidence." It is not clear, as a practical matter, what the taxpayer will have to establish to satisfy the clear and convincing standard.[15] Moreover, the rebuttals provided by the proposed regulations purport to be the exclusive means for rebutting the two-year presumption.

As mentioned above, the proposed regulations rely on a variety of factors to determine the existence of a plan. However, one factor -- temporal proximity -- was specified by the statute.[16] The proposed regulations reflect the significance of this factor, creating, in effect, a timeline of standards to rebut the existence of a plan:[17]



[15] Clear and convincing evidence has been described as evidence that need not be beyond a reasonable doubt, but must be stronger than a mere preponderance of the evidence. See Gladden v. Self, 55-1 U.S.T.C. ¶ 9,227 (E.D. Ark. 1954). A preponderance of the evidence has been described as the greater weight of evidence, which is sufficient to incline the mind of a fair and impartial juror to one side of the issue rather than the other. See, e.g., White v. United States, 59-2 U.S.T.C. ¶ 9,584 (M.D. Ga. 1958); Wissler v. United States, 58-1 U.S.T.C. ¶ 9,414 (S.D. Iowa 1958).

[16] See Code § 355(e)(2)(B); Preamble, 64 Fed. Reg. at 46,157.

[17] Note that the standard with respect to acquisitions that occur more than two years before differs slightly from the standard with respect to acquisitions that occur more than two years after a spin-off. No reason is stated in the preamble to the proposed regulations for the differing standards.

B. Post-Spin Rebuttals

1. Introduction

With respect to acquisitions that occur after a section 355 distribution, the distributing corporation may overcome the two-year presumption using one of two alternative tests. These tests are summarized below and are discussed in further detail in Part III.

2. Acquisitions between six months and two years after the distribution

If the acquisition occurred more than six months after the distribution (and there was no agreement, understanding, arrangement, or substantial negotiations at the time of the distribution or within six months thereafter), the distributing corporation may overcome the two-year presumption by establishing that the distribution was motivated in whole or in substantial part by a corporate business purpose other than an intent to facilitate an acquisition (or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired) (the "General Post-Spin Rebuttal").[18] Thus, the primary focus of the General Post-Spin Rebuttal is the business purpose for the distribution. Because the distribution need only be motivated "in substantial part" by a non-acquisition business purpose, the existence of an acquisition-related business purpose does not automatically preclude the use of the General Post-Spin Rebuttal.[19]

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[18] Prop. Treas. Reg. § 1.355-7(a)(2)(ii). The parenthetical is intended to reach distributions that are intended to ward off a hostile takeover. See infra Part III.D.1.d. for a discussion of the application of the General Post-Spin Rebuttal in the context of hostile takeovers.

[19] See Prop. Treas. Reg. § 1.355-7(a)(8), Exs. 3, 5. See infra Part III.D.1.c. for a discussion of the application of the General Post-Spin Rebuttal where both acquisition and non-acquisition business purposes exist for the spin-off.

In determining whether the distribution was motivated in whole or substantial part by a non-acquisition business purpose, the intent of the distributing corporation, the controlled corporation, or the controlling shareholders of either the distributing or controlled corporation is relevant.[20]

3. Acquisitions within six months after the distribution

If the distribution was motivated by an acquisition business purpose, or the acquisition occurred within six months after the distribution, the distributing corporation may overcome the two-year presumption by satisfying a more stringent three-prong test (the "Alternative Post-Spin Rebuttal"). All three prongs must be satisfied.

(i) First prong

(A) Neither the distributing or controlled corporation nor a controlling shareholder of either corporation intended that one or more person would acquire a 50-percent or greater interest in the distributing or controlled corporation (the "First Prong Intent Test"), or

(B) The distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in the distributing or controlled corporation (the "First Prong Facilitation Test");

(ii) Second prong - Neither the distributing or controlled corporation nor their controlling shareholders reasonably would have 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

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[20] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(B). The phrase "controlling shareholder" is defined in Prop. Treas. Reg. § 1.355-7(a)(4) and applies for purposes of both the pre-spin and post-spin rebuttals. See Part III.E.2.a., b., infra, for a discussion of this definition.

occurred, would acquire a 50-percent or greater interest in the distributing or controlled corporation within two years after the distribution (the "Reasonable Anticipation Prong"); and

(iii) Third prong - The distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired (the "Hostile Takeover Prong").[21]

The First Prong Intent Test focuses on whether the intended change in ownership totals 50 percent or more. Thus, it is satisfied even if one or more of the relevant parties intended that a distribution facilitate an acquisition, as long as the parties did not intend that there be a 50-percent or greater change in ownership.

The preamble to the proposed regulations provides that the First Prong Facilitation Test, on the other hand, may be satisfied where the parties intend a 50-percent change in ownership, as long as the parties did not intend that the distribution would facilitate any part of the acquisition.[22] In other words, the distribution must not be motivated by an intent to facilitate an acquisition, which is very similar to the General Post-Spin Rebuttal. Thus, the First Prong Facilitation Test may be satisfied as long as the distribution is not motivated by an acquisition-related business purpose, even though the relevant parties may intend a 50-percent

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[21]Prop. Treas. Reg. § 1.355-7(a)(2)(iii). Note that the General Post-Spin Rebuttal contains language that is similar to both the First Prong Facilitation Test and the Hostile Takeover Prong. See infra Part III.D.2.c. (comparing the General Post-Spin Rebuttal with the First Prong Facilitation Test); Part III.D.2.g. (comparing the General Post-Spin Rebuttal with the Hostile Takeover Prong).

[22] See Preamble, 64 Fed. Reg. at 46,158.

change in ownership. As a practical matter, however, it seems difficult to establish a lack of an intent to facilitate an acquisition where a 50-percent acquisition is intended by the parties.

The Reasonable Anticipation Prong, like the First Prong Intent Test requires that a relevant party reasonably anticipate an acquisition of the full 50 percent.[23] The Hostile Takeover Prong is similar to the General Post-Spin Rebuttal.[24]

For purposes of applying the Alternative Post-Spin Rebuttal, the tax consequences of section 355(e) are disregarded in determining the intentions and reasonable anticipations of the relevant parties.[25] Absent such an exception, the distributing corporation could argue that it should satisfy the Alternative Post-Spin Rebuttal, because it would not be reasonable for a party to act in a manner that would result in section 355(e) liability. Conversely, the Service could argue that the presence of an indemnity agreement between the distributing and controlled corporations indicates that the parties anticipated section 355(e) liability.[26]

4. Acquisitions more than two years after a distribution

With respect to acquisitions occurring more than two years after the distribution, such an acquisition is presumed to be part of a plan only if there was an agreement, understanding, or arrangement concerning the acquisition during the two-year period after the distribution. The distributing corporation may rebut the presumption using the General Post-

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[23] Id.

[24] See infra Part III.D.2.g. for a discussion of the Hostile Takeover Prong.

[25] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(4)(D).

[26] Preamble, 64 Fed. Reg. at 46,158-59.

Spin or Alternative Post-Spin Rebuttals discussed above.[27] However, it is not a negative presumption.

C. Pre-Spin Rebuttals

1. Introduction

With respect to acquisitions that occur within two years before the distribution, the preamble to the proposed regulations states that the most reliable indicator that a plan exists are an intent to make the distribution at the time of the acquisition and a causal connection between the acquisition and the distribution.[28] The preamble notes that if a person becomes a controlling shareholder by acquisition, that person's intention becomes the single best indicator of whether a later distribution was part of a plan.[29] With respect to acquisitions that occur before a section 355 distribution, the distributing corporation may overcome the two-year presumption using one of two alternative tests. These tests are summarized below and are discussed in further detail in Part III.

2. Acquisitions within two years before the distribution

a. General Rebuttal

The distributing corporation may rebut the two-year presumption with respect to acquisitions within two years before a distribution if it establishes that, at the time of the acquisition, the distributing corporation and its controlling shareholders did not intend to

[27] Prop. Treas. Reg. § 1.355-7(a)(3)(i).

[28] Preamble, 64 Fed. Reg. at 46,159.

[29] Id.

effectuate a distribution (the "General Pre-Spin Rebuttal").[30] For this purpose, whether a shareholder is "controlling" is determined immediately after the acquisition.[31]

b. Alternative Rebuttal

Second, provided that no person acquiring an interest becomes a controlling shareholder by reason of the acquisition (or becomes a controlling shareholder thereafter during the two-year period beginning on the date of the distribution), the distributing corporation can overcome the two-year presumption by establishing that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of the acquisition (the "Alternative Pre-Spin Rebuttal").[32] For purposes of these tests, a controlling shareholder is defined as a person who, directly or indirectly, or together with related persons, possesses voting power in the distributing or controlled corporation representing a meaningful voice in the governance of the corporation.[33] In the case of a publicly traded corporation, a controlling shareholder is any person who owns five percent of more of any class of stock of the distributing or controlled corporation and actively participates in the management or operation of the corporation.[34]

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[30] Prop. Treas. Reg. § 1.355-7(a)(2)(v)(A).

[31] Id.

[32] Prop. Treas. Reg. § 1.355-7(a)(2)(v)(B).

[33] Prop. Treas. Reg. § 1.355-7(a)(4).

[34] Id. This definition applies for purposes of both the pre-spin and post-spin rebuttals. See Part III.E.2.a., b., infra, for a discussion of this definition.

3. Acquisitions more than two years before the distribution

With respect to acquisitions that occur more than two years before a distribution, the presumption shifts in favor of the distributing corporation. Thus, the proposed regulations provide that the acquisition and distribution are presumed not to be part of a plan, unless the Service can establish by clear and convincing evidence that, at the time of the acquisition, (i) the distributing corporation or its controlling shareholders intended to effectuate the distribution, and (ii) the acquisition resulted in a change in the timing or the terms of the distribution or a person acquiring an interest in that acquisition became a controlling shareholder.[35] In other words, the proposed regulations appear to require the Service to establish that the taxpayer fails to satisfy both the General Pre-Spin and Alternative Pre-Spin Rebuttals in order to treat an acquisition that occurred more than two years before a distribution as part of the same plan.

D. Agreement, Understanding, Arrangement, or Substantial Negotiations

The proposed regulations refer to an "agreement, understanding, arrangement, or substantial negotiations" several times. First, to satisfy the General Post-Spin Rebuttal, the acquisition must have occurred more than six months after the distribution, and there must not have been an agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within six months thereafter.[36] Second, to satisfy the First Prong Intent Test and the Reasonable Anticipation Prong of the Alternative Post-Spin Rebuttal, there can be no intent or reasonable anticipation of a 50-percent acquisition during the two-year period after the distribution (or later pursuant to an agreement, understanding, or

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[35] Prop. Treas. Reg. § 1.355-7(a)(3)(ii).

[36] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(2).

arrangement existing at the time of the distribution or within six months thereafter).[37] Third, acquisitions occurring more than two years after a distribution will be considered part of a plan only if there was an agreement, understanding, or arrangement concerning the acquisition at the time of the distribution or within two years thereafter.[38] Fourth, to satisfy the Alternative Pre-Spin Rebuttal, no person acquiring an interest in the pre-spin acquisition may become a controlling shareholder by reason of that acquisition or at any point thereafter and before the end of the 2-year period beginning on the date of the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or within six months thereafter).

The proposed regulations do not, however, define the terms "agreement," "understanding," "arrangement," or "substantial negotiations," except to state that the parties do not necessarily have to have entered into a binding contract or have reached an agreement on all terms to have an "agreement, understanding, or arrangement."[39] The preamble notes that an agreement, understanding, arrangement, or substantial negotiations can take place even if the acquiror has not been specifically identified (e.g., a public offering, an auction by an investment banker).[40] Thus, the distributing corporation's unilateral intent may be sufficient to give rise to

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[37] Prop. Treas. Reg. § 1.355-7(a)(2)(iii)(A)(1), (B).

[38] Prop. Treas. Reg. § 1.355-7(a)(3)(i).

[39] Prop. Treas. Reg. § 1.355-7(a)(5).

[40] Preamble, 64 Fed. Reg. at 46,159. The preamble states that Treasury and the Service are particularly interested in receiving comments regarding transactions that involve an investment banker and when contacts with such investment banker should be considered an agreement, understanding, or substantial negotiations. Id.

an agreement, understanding, arrangement, or substantial negotiations. This may be contrasted with the standard for establishing a business purpose for a spin-off, where the taxpayer generally must reveal a specific acquiror or target.[41]

The proposed regulations treat certain options as agreements. If stock is acquired pursuant to an option, the option is treated as an agreement on the date of issuance, unless the distributing corporation establishes by clear and convincing evidence that, on the later of the date of the distribution or the date of issuance, the option was not more likely than not to be exercised.[42] The determination of whether an option is more likely than not to be exercised is based on all of the facts and circumstances.[43] 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), restricted stock, any other instruments that provide for the right or possibility to issue, redeem, or transfer stock, cash settlement options, or any other similar

[41] See Rev. Proc. 96-30, 1966-1 C.B. 969, Appendix A, § 2. To utilize acquisition-related business purposes for advance ruling purposes, the taxpayer generally must reveal a specific acquiror or target. For example, where the distribution is to facilitate an acquisition, the taxpayer must identify the acquiring corporation and demonstrate that the acquiring corporation is not related to the taxpayer and will not complete the acquisition unless the distributing and controlled corporations are separated. Id. at Appendix A, § 2.07. The taxpayer must demonstrate the same with respect to a target corporation where the distribution is to facilitate the acquisition of a target corporation by the distributing or controlled corporation. Id. at Appendix A, § 2.08.

[42] Prop. Treas. Reg. § 1.355-7(a)(7)(i)(A).

[43] Id. In applying the facts-and-circumstances test, the fair market value of the stock underlying an option is determined by taking into account control premiums and minority and blockage discounts. Id.

interests.[44] The proposed regulations do, however, exempt certain instruments from the definition of option, unless they are issued, transferred, or listed with a principal purpose of avoiding the application of section 355(e) or the proposed regulations. Exempt instruments include certain compensatory options,[45] options that are part of a security arrangement in a typical lending transaction, options that are exercisable only upon death, disability, or mental incompetency, and bona fide rights of first refusal.[46]

E. Aggregation of Acquisitions

The proposed regulations provide that each acquisition of stock of a corporation pursuant to a plan involving a distribution will be aggregated with all other acquisitions of stock pursuant to a plan involving that distribution to determine whether the 50-percent threshold is met.[47] Thus, the appropriate rebuttal is applied separately to each pre-spin acquisition and each post-spin acquisition, and those acquisitions that fail either the pre-spin or post-spin rebuttal tests are aggregated. For example, assume that D plans to distribute its C stock solely to facilitate acquisitions by D. Prior to the distribution, D acquires X (the "X acquisition"). X's shareholders receive 24 percent of D's stock. Six months after the distribution, D acquires Y (the "Y acquisition"). Y's shareholders receive 25 percent of D's stock. Eighteen months after

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[44] Prop. Treas. Reg. § 1.355-7(a)(7)(ii).

[45] Compensatory options are excluded from the definition of option only if they are nontransferable within the meaning of Treas. Reg. § 1.83-3(d) and do not have a readily ascertainable fair market value as defined in Treas. Reg. § 1.83-7(b). Prop. Treas. Reg. § 1.355-7(a)(7)(iii)(B).

[46] Prop. Treas. Reg. § 1.355-7(a)(7)(iii).

[47] Prop. Treas. Reg. § 1.355-7(a)(6).

the distribution, D acquires Z (the "Z acquisition"). Z's shareholders receive 26 percent of D's stock.[48] Assume that D is able to rebut the two-year presumption using one of the pre-spin rebuttals with respect to the X acquisition, but is not able to rebut the two-year presumption with respect to the post-spin Y and Z acquisitions. The Y and Z acquisitions would be aggregated to determine whether the 50-percent threshold was met. Thus, in this example, 51 percent of D's stock would be treated as acquired pursuant to a plan, and section 355(e) would apply. Assume instead that D is able to rebut the two-year presumption with respect to the Z acquisition, but not with respect to the X and Y acquisitions. In that example, the X and Y acquisitions would be aggregated, and 49 percent of D's stock would be treated as acquired pursuant to a plan. Thus, section 355(e) would not apply.

F. Multiple Controlled Corporations

The proposed regulations also provide much-needed guidance as to the measure of gain where more than one controlled corporation is distributed, but only one of the corporations is acquired. The proposed regulations clarify that the distributing corporation recognizes gain only with respect to the stock of the distributed controlled corporation(s) that was subject to the 50-percent or greater acquisition.[49] If the distributing corporation is the acquired corporation, however, it must recognize gain on all of the distributed corporations.[50]

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[48] The facts of this example are similar to those in Prop. Treas. Reg. § 1.355-7(a)(8), Ex. 5. Although the example mentions the rule that aggregates the acquisitions, it does not fully analyze the rule in the context of the facts of the example.

[49] Prop. Treas. Reg. § 1.355-7(b).

[50] Preamble, 64 Fed. Reg. at 46,160.

III. ANALYSIS OF PROPOSED REGULATIONS

A. Purpose of Section 355(e)

The legislative history of section 355(e) points to the "abuse" at which section 355(e) was aimed:

> The Committee believes that section 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired.[51]

A few highly publicized transactions, such as Viacom's spin-off of its cable company to TCI; General Motors' sale of Hughes Electronics to Raytheon; and Walt Disney's sale of its newspaper properties to Knight-Ridder, contained features that Congress felt caused the transaction to more closely resemble a sale. For example, one feature of such "disguised sale" transactions is that the corporation to be acquired borrows money or assumes a large amount of debt and distributes the proceeds of such debt to its parent prior to a spin-off. Upon the subsequent acquisition, the acquiring group inherits the debt of the acquired corporation, while the proceeds of such debt are retained by the "selling" group.[52] Another feature that has appeared in such transactions is a recapitalization of the interests of the old shareholders of the

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[51] H.R. Rep. No. 105-148, at 462 (1997) (hereinafter "House Report") (emphasis added); S. Rep. No. 105-33, at 139-40 (1997) (hereinafter "Senate Report") (emphasis added).

[52] See Joint Committee on Taxation, Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposal, at 51-52 (Mar. 11, 1997) (hereinafter JCT Description of Budget Proposal); Introductory Statement by Chairman Archer, 143 Cong. Rec. E702 (daily ed. Apr. 17, 1997). Note that, unlike the abusive transactions targeted by Congress, the basic Morris Trust transaction does not involve any cashing out of the shareholders' investments and thus does not resemble a sale of the business.

acquired corporation, converting their stock from common stock to nonvoting preferred stock or stock with voting rights that are disproportionate to the value of such stock, and the simultaneous issuance of voting common stock to the acquiring corporation.[53]

Congress' concern over disguised sale transactions is reminiscent of its reasons for enacting section 355(d) in 1990. Congress enacted section 355(d) in order to prevent so-called "mirror substitute transactions."[54] The legislative history of section 355(d) states that Congress intended to prevent the avoidance of the General Utilities repeal and the tax-free disposition of subsidiaries in transactions that resemble sales:

> The provisions for tax-free divisive transactions under section 355 were a limited exception to the repeal of the General Utilities doctrine, intended to permit historic shareholders to continue to carry on their historic corporate businesses in separate corporations. It is believed that the benefit of tax-free treatment should not apply where the divisive transaction, combined with a stock purchase resulting in a change of ownership, in effect results in the disposition of a significant part of the historic shareholders' interests in one or more of the divided corporations.[55]

Thus, the enactment of section 355(e) can be seen as an attempt to complete what Congress had started when it enacted section 355(d). In fact, in the Administration's budget proposals for

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[53] JCT Description of Budget Proposal, supra note 52, at 51-52. This appears to reflect a feature contained in Viacom's spin-off of its cable company to TCI. The Service correctly ruled that the transaction qualified as a tax-free spin-off. See P.L.R. 9637043 (June 17, 1996). The only way this transaction may be viewed as a disguised sale is if the preferred stock is viewed as debt and the conversion of common stock to preferred stock is thus treated as a taxable exchange. See, e.g., Code §§ 351(g); 354(a)(2)(C).

[54] See also Code § 337(c). For a more detailed discussion of the purpose of section 355(d), see Mark J. Silverman et al., The Proposed Section 355(d) Regulations: Narrowing the Scope of an Overly Broad Statute, 26 J. CORP. TAX'N. 271 (2000).

[55] H.R. Rep. No. 101-881, at 341 (1990) (emphasis added).

fiscal year 1997 and 1998, the anti-Morris Trust provision, was proposed as an amendment to section 355(d).[56] By referring to “new shareholders” acquiring interests in connection with a spin-off, the legislative history of section 355(e) makes it clear that Congress was concerned with new shareholders coming in – not with ownership shifts among historic shareholders.

Section 355(e)(5) states that “[t]he Secretary shall prescribe regulations as may be necessary to carry out the purposes of this subsection.” Thus, the regulations should strive to tax only those distributions that look more like sales of one of the businesses.[57]

B. Exclusivity of the Rebuttals

Section 355(e) 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.”[58] 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.[59]

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[56] See Department of the Treasury, General Explanation of the Administration’s Proposals (March 1996); Department of the Treasury, General Explanations of the Administration’s Revenue Proposals, at 62 (Feb. 1997).

[57] The recently proposed regulations under section 355(d) provide an excellent example of regulations that implement the purpose behind the statute and narrow an overly broad statute. See Prop. Treas. Reg. § 1.355-6; see also Silverman et al., supra note 54.

[58] Code § 355(e)(2)(B).

[59] A senior staff member of the Joint Committee on Taxation stated during a meeting of the D.C. Bar Tax Section’s Corporation Tax Committee held shortly after enactment of section 355(e) that the legislative history intentionally omitted an explanation of what constitutes a plan, because whether a plan exists will “always be a matter of facts and circumstances.” See also

(Continued …)

Under the proposed regulations, however, the rebuttals discussed above appear to be the exclusive means of overcoming the two-year presumption.[60] Thus, if a distributing corporation does not fall within one of the rebuttals, section 355(e) applies, regardless of the existence of other facts and circumstances negating a plan.

This result is contrary to the language of the statute. Moreover, by imposing an exclusive rule, the proposed regulations expand the scope of an overly broad statute. As further discussed below in Part III.D., the proposed regulations, in their current form, would often be useless to taxpayers. Although the Service may defend the exclusive rebuttals on the basis that they are more administrable than a facts-and-circumstances approach, the regulations as proposed are not necessarily more administrable. The rebuttals require inquiries not only into a relevant party's intent but also what other parties could reasonably anticipate. Moreover, the proposed regulations require that the taxpayer prove a negative. No taxpayer can reasonably satisfy these stringent requirements. Rather than constituting an absolute rule, the rebuttals should simply be safe harbors to satisfy the taxpayer's burden of proof.

C. Clear and Convincing Standard of Proof

Section 355(e) and the legislative history are silent as to the burden of proof imposed on the taxpayer in overcoming the two-year presumption. The proposed regulations require that the taxpayer establish each element of the rebuttals by clear and convincing evidence -- a high standard. The Service presumably believed that a two-year presumption

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New Corporate Laws Beg For Interpretive Regs, 97 TNT 196-2 (Oct. 9, 1997).

[60] This conclusion as to the exclusivity of the rebuttals in the proposed regulations was confirmed by informal statements made by representatives of Treasury and the Service during a meeting of the D.C. Bar Tax Section's Corporation Tax Committee on Oct. 7, 1999.

warranted a burden of proof that is greater than the usual burden of proof in civil cases (i.e., preponderance of the evidence). Although it is not necessary to impose a higher burden of proof in cases of statutory presumptions,[61] a number of statutory and regulatory provisions have provided that clear and convincing evidence is necessary to overcome a presumption.[62]

The problem with a clear and convincing standard lies not in the fact that it is a high standard, but rather with the fact that the rebuttals in the proposed regulations may require the distributing corporation to know or anticipate the intent or actions of unrelated third parties, which is impossible to establish by clear and convincing evidence. Presumably, a whole new type of investment banker opinion will be required to satisfy this burden of proof.[63]

[61] Indeed, some courts have applied a lower standard -- preponderance of the evidence -- in cases of statutory presumptions. See Essick v. Westover, 52-2 U.S.T.C. ¶ 10,872 (S.D. Cal. 1952) (requiring a preponderance of the evidence to overcome the presumption in section 2035); Estate of Walton v. Commissioner, 42 B.T.A. 300 (1940) (same); see also section 672(c) (requiring a preponderance of the evidence to overcome the statutory presumption that a related or subordinate party is subservient for purposes of the grantor trust rules).

[62] For example, certain Code sections have both created a presumption and imposed a clear and convincing standard to overcome the presumption. See section 280G(b)(2)(C) (golden parachute payments); section 47(d)(3)(D) (measure of progress expenditures for the rehabilitation credit); section 613A(b)(3) (definition of "regulated natural gas" for purposes of percentage depletion rules). In addition, several regulatory provisions have created a presumption and imposed a clear and convincing standard to overcome the presumption. See, e.g., Treas. Reg. § 1.897-6T(c)(2) (tax avoidance on U.S. real property interests); Treas. Reg. § 1.881-3(c)(2) (participation by intermediate entity in conduit financing arrangement); Treas. Reg. § 1.675-1(b)(4) (trustee's powers being exercised in a fiduciary capacity); Treas. Reg. § 1.166-6(b)(2) (fair market value of mortgaged property sold); Treas. Reg. § 1.1275-4(b)(4)(i)(B) (comparable yield for contingent payment debt instruments).

[63] It is unclear how the clear and convincing standard will be applied by the Service in cases where a private ruling has been obtained. For example, assume that a distributing corporation obtained a ruling that a spin-off effectuated for the purpose of cost savings qualified as tax free under section 355. Further assume that 50 percent of the distributing corporation's stock was acquired eight months later. In order to satisfy the General Post-Spin Rebuttal, the distributing corporation must establish that it had a substantial non-acquisition business purpose by clear and convincing evidence. Could the distributing corporation satisfy its burden of proof

(Continued …)

D. Post-Spin Acquisitions

1. General Post-Spin Rebuttal

With respect to acquisitions more than six months after a spin-off, the proposed regulations provide a more relaxed presumption than the statute (i.e., six months v. two years). This six-month rule provides greater flexibility for corporate spin-offs. Treasury and the Service should be commended for this proposal.[64] As discussed above, the General Post-Spin Rebuttal requires that (i) the distribution was motivated in whole or substantial part by a corporate business purpose (other than an intent to facilitate an acquisition or decrease the likelihood of an acquisition), and (ii) the acquisition occurred more than six months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations at the time of the distribution or within six months thereafter.[65]

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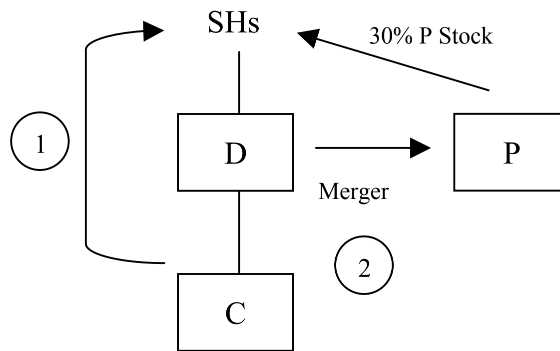
by pointing to the business purpose accepted in the earlier ruling? Or, is the standard of proof for establishing a corporate business purpose under Revenue Procedure 96-30 something less than clear and convincing, so that the Service may, in essence, reverse its earlier ruling?

[64] As noted in Part III.D.1.a., infra, however, the six-month rule is of limited benefit, because the proposed regulations interpret acquisition-related business purposes so broadly.

[65] Prop. Treas. Reg. § 1.355-7(a)(2).

a. Facilitating an Acquisition

Example 1 - Basic Morris Trust Transaction



Facts: P wants to acquire D but does not want C. In order to facilitate the acquisition of D by P, D distributes C to its shareholders in a transaction otherwise meeting the requirements of section 355. D then merges into P, with the D shareholders receiving 30 percent of the P stock.

This is the classic Morris Trust transaction. D would not be able to satisfy the General Post-Spin Rebuttal, both because the acquisition by P occurred within six months of the distribution and because the purpose of the distribution was to facilitate the acquisition of D by P.

The proposed regulations provide a few additional examples of business purposes to facilitate an acquisition. For example, assume that the business purpose for the distribution is to facilitate a stock offering by D of 50 percent of its stock, and D completes its public offering one year after the distribution. Such a business purpose is a tainted business purpose that precludes application of the General Post-Spin Rebuttal.[66] Other tainted business purposes set forth in the proposed regulations include (i) making D or C a more attractive acquisition

[66] See Prop. Treas. Reg. § 1.355-7(a)(8), Ex.1.

candidate,[67] (ii) facilitating acquisitions of target companies by D or C,[68] and (iii) facilitating a public offering of 20 percent of the stock of D or C.[69]

The proposed regulations do not limit in any way the phrase "intent to facilitate an acquisition." As a result, a business purpose to facilitate any acquisition, regardless of how small, precludes the use of this rebuttal. Thus, for example, the General Post-Spin Rebuttal cannot be satisfied if the business purpose for the distribution is to issue a five-percent stock interest to a key employee or ESOP. These acquisition-related business purposes have long been accepted by the Service for advance ruling purposes.[70] However, as a practical matter, such business purposes will no longer be desirable, and taxpayers will attempt to bring their spin-offs within one of the non-acquisition business purposes in order to use the General Post-Spin Rebuttal. Such a broad interpretation of tainted business purposes is not necessary to achieve the purposes of section 355(e). Facilitating the issuance of stock to a key employee or ESOP simply does not present the disguised sale abuse at which section 355(e) was aimed. Indeed, any business purpose (including an acquisition-related business purpose) that does not involve an intent to facilitate a 50-percent acquisition should be deemed to satisfy the requirement of the General Post-Spin Rebuttal. At a minimum, the General Post-Spin Rebuttal should be modified

[67] Prop. Treas. Reg. § 1.355-7(a)(8), Ex.5. Informal statements made by representatives of Treasury and the Service during a recent meeting of the D.C. Bar Tax Section's Corporation Tax Committee on Oct. 7, 1999 implied that where the business purpose for the distribution is "fit and focus," one needs to consider the underlying fit to determine whether, in reality, the purpose is to make D or C a more attractive acquisition candidate.

[68] Prop. Treas. Reg. § 1.355-7(a)(8), Ex.7.

[69] See Prop. Treas. Reg. § 1.355-7(a)(8), Ex.9.

[70] Rev. Proc. 96-30, 1996 C.B. 696, Appendix A, § 2.

to require that the business purpose be to facilitate an acquisition of a threshold percentage interest (e.g., greater than 33 percent). Such a rule would permit stock issuances and public offerings that are not structured to result in a 50-percent ownership shift.

Moreover, if there is not a substantial non-acquisition business purpose for a distribution, the General Post-Spin Rebuttal is not available for <u>any</u> post-spin acquisition, regardless of whether the acquisition is related to the original acquisition-related business purpose for the distribution. For example, assume that D plans to spin off C for the sole purpose of issuing five percent of its stock to key employees. Immediately after the spin-off, D issues five percent of its stock to its key employees. Eight months after the spin-off, an unrelated party acquires 45 percent of D's stock. D cannot satisfy the General Post-Spin Rebuttal with respect to either acquisition, because it did not have a substantial non-acquisition business purpose for the spin-off.[71] This is true even though the second acquisition was completely unrelated to the acquisition-related business purpose. Because, as discussed below, the alternative three-prong rebuttal is extremely onerous, this result could have a chilling effect on many basic spin-offs.

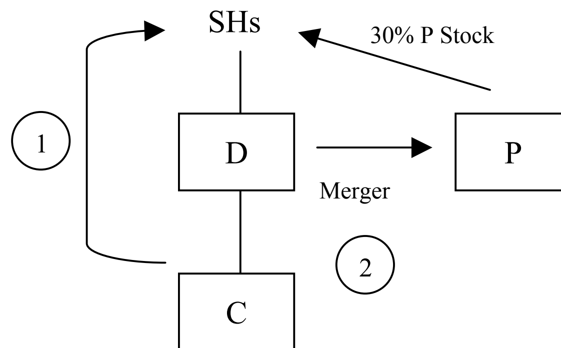
An acquisition-related business purpose should not preclude application of the General Post-Spin Rebuttal to acquisitions that are unrelated to that business purpose. Thus, if the business purpose for the distribution was to facilitate a public offering of 40 percent of C's stock, and an unrelated individual subsequently acquires an additional 10 percent of C's stock, only the 40 percent acquired in the public offering should be outside the General Post-Spin Rebuttal. On the other hand, if the business purpose for the distribution were to facilitate a

[71] <u>See</u> Prop. Treas. Reg. § 1.355-7(a)(8), Exs. 7, 9.

public offering of 40 percent of C's stock, but C ends up issuing 50 percent of its stock in the public offering, the entire 50 percent should be outside the General Post-Spin Rebuttal.

Finally, a business purpose to facilitate an acquisition of D stock precludes use of the General Post-Spin Rebuttal for a subsequent acquisition of C stock. Representatives from Treasury have informally indicated that this would be corrected in the final regulations.[72]

b. Example 2 - Application of General Post-Spin Rebuttal



Facts: D plans to distribute C pro rata to its shareholders. The distribution is motivated solely by a non-acquisition business purpose. Eighteen months after the spin-off, D merges into P, with the D shareholders receiving 30 percent of the P stock.

D will be able to rebut the two-year presumption using the General Post-Spin Rebuttal, because the distribution was motivated in whole by a non-acquisition business purpose, and the acquisition occurred more than six months after the distribution.[73]

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[72] These statements were made during a meeting of the D.C. Bar Tax Section's Corporation Tax Committee on Oct. 7, 1999; see also Sheppard, More Whinging About the Proposed Anti-Morris Trust Rules, 1999 TNT 205-3 (Oct. 22, 1999) (hereinafter "More Whinging").

[73] See Prop. Treas. Reg. § 1.355-7(a)(2)(ii).

c. Multiple business purposes

The proposed regulations provide that the General Post-Spin Rebuttal is satisfied if the distribution was motivated in whole or in substantial part by a non-acquisition corporate business purpose.[74] An intent to facilitate an acquisition or decrease the likelihood of an acquisition is a factor "tending to disprove" that the distribution was motivated in substantial part by a non-acquisition business purpose, but the taxpayer can nonetheless prevail under the General Post-Spin Rebuttal if it establishes by clear and convincing evidence that the distribution was motivated in substantial part by the non-acquisition business purpose.[75] The preamble to the proposed regulations provides that the analysis of whether the 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. Thus, the other business purpose must be "real and substantial even in light of the acquisition business purpose."[76] Representatives from Treasury and the Service have indicated informally that this test is not intended to be a weighing of the business purposes; rather, they are looking for a causal connection -- would the distributing corporation have done the spin-off without the acquisition-related business purpose?[77]

Assume, for example, that D distributes the stock of its controlled subsidiary, C, to achieve significant cost savings and, in substantial part, to make D a more attractive

[74] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(1).

[75] Prop. Treas. Reg. § 1.355-7(a)(8), Exs. 3, 5.

[76] Preamble, 64 Fed. Reg. at 46,157.

[77] These statements were made during a recent meeting of the D.C. Bar Tax Section's Corporation Tax Committee on Oct. 7, 1999; see also More Whinging, supra note 72.

acquisition candidate. By providing that the existence of the acquisition-related business purpose tends to disprove that the distribution was motivated in substantial part by the cost savings business purpose, the proposed regulations appear to impose a "heightened" clear and convincing burden of proof on the taxpayer -- not only must the taxpayer rebut the statutory two-year presumption but it must also rebut a presumption that the acquisition business purpose is controlling. If D in this example can establish by clear and convincing evidence that it would have done the distribution even without the acquisition-related business purpose, D can prevail under the General Post-Spin Rebuttal.

This "but-for" approach seems to require that the non-acquisition business purpose be the primary purpose for the spin-off. This is inconsistent with the language of the proposed regulations and preamble, which simply require that the non-acquisition business purpose be "substantial."[78] The but-for approach may also lead to incorrect results in some cases. Assume, for example, that D has a substantial non-acquisition business purpose for the distribution of its C stock. However, in order to operate following the spin-off, D must pay down debt. D anticipates engaging in an equity offering of approximately 20 percent of its stock after the spin-off in order to raise the necessary cash. D engages in the equity offering shortly after the spin-off. One year later, an unrelated party acquires 30 percent of D's stock. Under the language of the proposed regulations, the General Post-Spin Rebuttal should be available with respect to the second acquisition, because D had a substantial non-acquisition business purpose for the spin-off. D may not, however, satisfy the but-for analysis, because D could not have done the spin-off without the equity offering.

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[78] See Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(1).

Moreover, the but-for test will likely cause changes in the current advance ruling practices. Taxpayers often have more than one business purpose for a spin-off. Revenue Procedure 96-30 requires that the taxpayer "[d]escribe in detail each purpose . . . for the distribution."[79] The Service then evaluates separately each of the business purposes relied upon by the taxpayer. In the past, it has not mattered which business purpose was accepted by the Service. However, the but-for test in the General Post-Spin Rebuttal will encourage taxpayers to focus on the non-acquisition business purpose (even though they will still be required to disclose all business purposes) for the distribution. If the Service issues section 355(e) rulings, it will presumably be ruling that the non-acquisition business purpose is the primary purpose.

d. Decreasing the likelihood of an acquisition -- hostile takeovers

As mentioned above, not only does an intent to facilitate an acquisition preclude use of the General Post-Spin Rebuttal, but an intent to decrease the likelihood of an acquisition of one or more businesses by separating those businesses from others that are likely to be acquired will also preclude use of the General Post-Spin Rebuttal, if there is no other substantial non-acquisition business purpose.[80] A hostile takeover presents a peculiar problem in interpreting the meaning of the term "plan."[81] If a distributing corporation distributes a

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[79] Rev. Proc. 96-30, 1996-1 C.B. 696, § 4.04(1), (6).

[80] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(1).

[81] For a dialog relating to the problem of hostile takeovers, see Bernard Wolfman, Special Report Put Odd Spin on Section 355(e), 98 TNT 16-107 (Jan. 26, 1998); Mark J. Silverman et al., Spin-Offs: The Rest of the Story, 98 TNT 26-51 (Feb. 9, 1998); Bernard Wolfman, Setting the Record Straight on ITT/Hilton Case, 98 TNT 31-63 (Feb. 17, 1998); Mark J. Silverman et al., 'Friendly Counterpunching' on Spin-Offs Should Bring IRS Action, 98 TNT 35-94 (Feb. 23, 1998).

controlled corporation specifically to avoid a hostile takeover (a valid business purpose under Rev. Proc. 96-30[82]), but the distribution does not prevent such a takeover, one could argue that the distributing corporation distributed the controlled corporation with no plan that another party acquire 50 percent or more of the stock of the distributing or controlled corporation. In fact, its plan was the exact opposite -- to avoid such an acquisition.

The proposed regulations have specifically adopted a rule that a hostile takeover results in the application of section 355(e).[83] The preamble notes that distributions to decrease the likelihood of an acquisition are often difficult to differentiate from those intended to facilitate an acquisition and should receive the same treatment, because both relate to a perceived possibility of an acquisition.[84] Representatives from Treasury and the Service have, in support of the rule in the proposed regulations, informally noted that while the Administration's original proposal contained language treating hostile takeovers as unrelated to the distribution,[85] the legislative history of section 355(e) was silent on the matter.

Congress' silence, however, cannot be presumed to imply the opposite -- that a distribution to deter a hostile takeover is per se part of a plan. Indeed, in discussing this issue, a senior staff member of the Joint Committee on Taxation stated shortly after enactment of section

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[82] 1996-1 C.B. 696.

[83] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(1); see also Preamble, 64 Fed. Reg. at 46,157; Prop. Treas. Reg. § 1.355-7(a)(8), Exs. 2, 3. A very similar test applies with respect to the Alternative Pre-Spin Rebuttal, which is discussed below. See Prop. Treas. Reg. § 1.355-7(a)(2)(iii)(C).

[84] Preamble, 64 Fed. Reg. at 46,157.

[85] See Department of the Treasury, General Explanations of the Administration's Revenue Proposals, at 62 (Feb. 1997).

355(e) that the legislative history does not include a statement exempting hostile takeovers, because it is difficult to determine when a hostile takeover becomes non-hostile -- not because Congress believed that hostile takeovers should be considered part of a plan.[86] The appropriate response to this concern is to provide rules permitting the taxpayer to establish the hostility of the takeover -- not to treat all hostile takeovers as part of a plan.

Moreover, the preamble's statement that distributions to facilitate acquisitions or decrease the likelihood of an acquisition are difficult to differentiate is misplaced. Indeed, there are some significant differences. A distribution to facilitate an acquisition is part of a plan of the distributing corporation. To utilize acquisition-related business purposes for advance ruling purposes, the taxpayer generally must reveal a specific acquiror or target.[87] Thus, the plan is generally mutual. A hostile takeover, on the other hand, involves a unilateral plan on the part of the hostile acquiror. It not only does not involve the distributing or controlled corporation but it is also unwanted on the part of the distributing or controlled corporation.[88]

The reference to decreasing the likelihood of an acquisition should be deleted from both the General Post-Spin and Alternative Post-Spin Rebuttals. To address the concern that a purportedly hostile takeover is actually a friendly one, the regulations could require that

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[86] See A.E. Staley Mfg. Co. v. Commissioner, 97-2 U.S.T.C. (CCH) ¶ 50,521 (7th Cir. 1997), rev'g 105 T.C. 166 (1995), where the Tax Court and Seventh Circuit disagreed over whether a transaction was hostile or non-hostile in the context of the deductibility of acquisition costs.

[87] See supra note 41.

[88] Note that treating a hostile takeover as per se part of a plan cuts both ways. The distributing corporation can spin-off a business with a large built-in gain as a sort of poison pill, hoping that the tax bite will prove to be too much for the hostile acquiror.

the taxpayer demonstrate that certain factors are present, such as imminence of the takeover attempt and detriment resulting from a successful takeover. These are the factors that the Service has historically required the taxpayer to establish in connection with obtaining a section 355 ruling where the stated business purpose is to thwart a hostile takeover.[89]

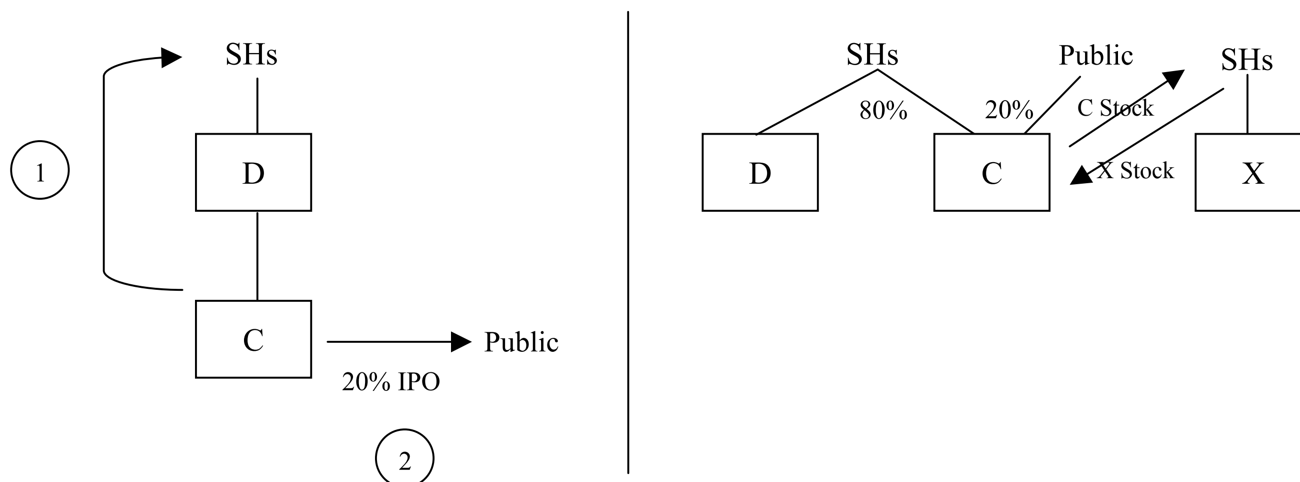
2. Alternative Post-Spin Rebuttal

As discussed above, the Alternative Post-Spin Rebuttal requires that the distributing corporation satisfy a three-prong test: (i) (A) neither the distributing or controlled corporation nor a controlling shareholder of either corporation intended that one or more person would acquire a 50-percent or greater interest in the distributing or controlled corporation (First Prong Intent Test), or (B) the distribution was not motivated in whole or substantial part by an intention to facilitate an acquisition of an interest in the distributing or controlled corporation (First Prong Facilitation Test); (ii) neither the distributing or controlled corporation nor their controlling shareholders reasonably would have 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 in the distributing or controlled corporation within two years after the distribution (Reasonable Anticipation Prong); and (iii) the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from

[89] See P.L.R. 8930055 (May 3, 1989), revoked P.L.R. 9005070 (Nov. 9, 1989) (because the transaction had not been consummated); P.L.R. 8819075 (Feb. 17, 1988); P.L.R. 8421062 (Feb. 21, 1984).

others that are likely to be acquired (Hostile Takeover Prong).[90] The examples below illustrate the application of the three prongs of the Alternative Post-Spin Rebuttal.

a. Example 3 - Surprise Acquisition



Facts: D plans to distribute the stock of C for the purpose of facilitating a public offering by C. C issues 20 percent of its stock in a public offering one month after the distribution. Neither D, C, nor their controlling shareholders intended any further transactions involving D or C stock, nor would they reasonably anticipate that it was more likely than not that one or more persons would acquire a 50-percent interest in D or C within two years who would not have acquired such interest absent the distribution. Two months after the distribution, C is approached unexpectedly regarding an opportunity to acquire X. Five months after the distribution, C acquires X in exchange for 40 percent of the C stock.

Because C's acquisition of X occurred within six months of the distribution, D will not be able to use the General Post-Spin Rebuttal.[91] The proposed regulations do, however,

[90] Prop. Treas. Reg. § 1.355-7(a)(2)(iii).

[91] Note that even if C's acquisition of X occurred more than six months after the distribution, C would still be precluded from using the General Post-Spin Rebuttal, because the distribution was motivated solely by an intent to facilitate an acquisition of C's stock in a public offering. See Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(1).

provide that in the case of a surprise acquisition, the Alternative Post-Spin Rebuttal is satisfied.[92] First, neither D, C, nor their controlling shareholders intended that one or more persons would acquire a 50-percent or greater interest in D or C during the two-year period.[93] Second, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in C. Third, the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired.[94]

This example appears to represent a relatively simple case of a surprise acquisition, which is properly treated as not part of a plan involving the distribution. However, such situations will not be so simple in practice. How must the distributing corporation demonstrate that the acquisition was a surprise? Such a demonstration entails proving a negative -- that C had no prior contact or knowledge of the opportunity to acquire X. Further, as illustrated by the examples below, the Alternative Post-Spin Rebuttal becomes even more difficult to apply in other situations.

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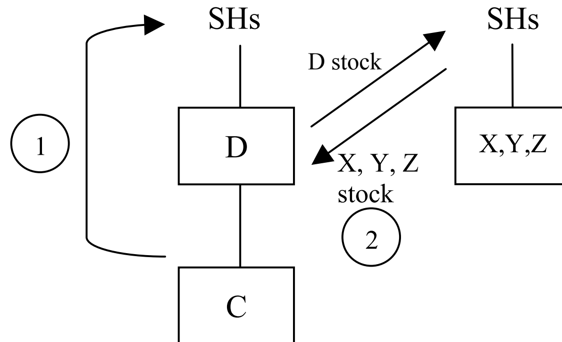
[92] The facts in this example are based on the facts in Prop. Treas. Reg. § 1.355-7(a)(8), Ex.9(iii).

[93] Note that the First Prong Intent Test must be relied upon, because the First Prong Facilitation Test is not satisfied where the business purpose for the distribution is to facilitate a public offering.

[94] For these same reasons, the acquisition of 20 percent of C's stock in the public offering should satisfy the Alternative Post-Spin Rebuttal.

b. Example 4 - Facilitating Acquisitions of Multiple Targets by D



Facts: On the advice of an investment banker, D plans to distribute its C stock to its shareholders solely to facilitate acquisitions by D. D has no specific goals regarding how much D stock will be issued in these acquisitions. D and its investment banker have identified X and Y as potential acquisition targets. Within six months after the distribution, D negotiates with and acquires X. X's shareholders receive 30 percent of D's stock. One year after the distribution, D acquires Y. Y's shareholders receive 19 percent of D's stock. After the distribution, D and its investment banker identify Z as another desirable target. Eighteen months after the distribution, D acquires Z. Z's shareholders receive 17 percent of D's stock.

D will not be able to satisfy the General Post-Spin Rebuttal with respect to the acquisition of X, because the acquisition occurred within six months of the distribution.[95] In addition, D will not be able to satisfy the General Post-Spin Rebuttal with respect to the acquisitions of Y and Z, because the sole purpose for the distribution was to facilitate an acquisition of D stock.[96]

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[95] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(2).

[96] Prop. Treas. Reg. 1.355-7(a)(8), Ex.7(iii); see also Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(1).

To rebut the two-year presumption using the Alternative Post-Spin Rebuttal, D must satisfy the three-prong test. First, D must establish that, at the time of the distribution, D, C, and their controlling shareholders did not intend that one or more persons would acquire a 50-percent or greater interest. Under the facts of this example, D had no specific goals regarding the amount of D stock to be issued in the acquisitions. However, D and its investment banker had identified X and Y as potential targets, and D subsequently issued 49 percent of its stock in acquiring X and Y. The proposed regulations do not specifically address whether the First Prong Intent Test is satisfied under these facts.[97] Although the proposed regulations provide that a pre-spin acquisition that is part of a plan involving the distribution is counted as an amount intended to be acquired,[98] they do not provide any specific guidance as to how to calculate the amount intended with respect to post-spin acquisitions. Presumably, the Service would consider at least 49 percent as the amount intended, and it would be extremely difficult for D to establish a lack of the requisite intent by clear and convincing evidence under these circumstances -- even though D had no specific goals regarding the amount of stock it would issue.

Second, D must establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest in D or C within two years. Similar to the First Prong Intent Test, the proposed regulations do not specifically address

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[97] The facts in this example are based on the facts in Prop. Treas. Reg. § 1.355-7(a)(8), Ex.7(v). Note that the First Prong Intent Test must be relied upon in this example, because the First Prong Facilitation Test is not satisfied where the business purpose for the distribution is to facilitate acquisitions by D.

[98] Prop. Treas. Reg. § 1.355-7(a)(2)(iv)(A).

whether the Reasonable Anticipation Prong is satisfied under these facts.[99] Presumably, the Service would analyze the Reasonable Anticipation Prong in a manner similar to the First Prong Intent Test.

Third, the proposed regulations provide that, in this example, D will be able to establish that the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of an acquisition.[100]

In sum, the proposed regulations do not specifically address whether the Alternative Post-Spin Rebuttal is satisfied where the business purpose for a distribution is to facilitate acquisitions using the distributing corporation's stock, but the distributing corporation has no specific intent or goals to issue 50 percent of its stock in such acquisitions. As a practical matter, however, the distributing corporation is unlikely to be able to satisfy its burden of proof.

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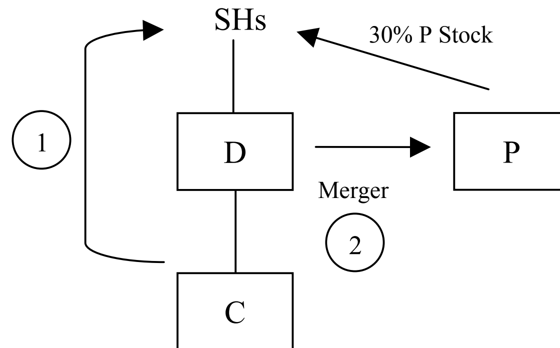
[99] See Prop. Treas. Reg. § 1.355-7(a)(8), Ex.7(v). The proposed regulations do provide that a pre-spin acquisition that is part of a plan involving the distribution is counted as an amount reasonably anticipated to be acquired, but they do not address how to calculate the amount reasonably anticipated to be acquired with respect to post-spin acquisitions. Prop. Treas. Reg. § 1.355-7(a)(2)(iv)(C).

[100] Prop. Treas. Reg. § 1.355-7(a)(8), Ex.7(v).

c. Example 5 - Investment Banker Advice Received Before Spin-Off is Announced



Facts: D consulted with an investment banker regarding an acquisition of D. The investment banker advised D that it would be a more attractive acquisition candidate if it spun-off C. D distributes C to its shareholders to achieve significant nontax cost savings and, in substantial part, to maximize the possibility of D's acquisition. At the time of the distribution, D has not, directly or indirectly, solicited or received any indication of interest from potential acquirors. Seven months after the distribution, D engages the investment banker to conduct an auction of D. One of the bidders, P, acquires D one year after the distribution.

D will be able to rebut the two-year presumption using the General Post-Spin Rebuttal, if it can establish that the distribution was motivated in substantial part by the need to achieve nontax cost savings.[101] On the other hand, the proposed regulations provide that D will not be able to rebut the two-year presumption using the Alternative Post-Spin Rebuttal, because it will not satisfy either the First Prong Intent Test or the First Prong Facilitation Test.[102] D will not be able to establish that it did not intend that one or more persons would acquire a 50-percent

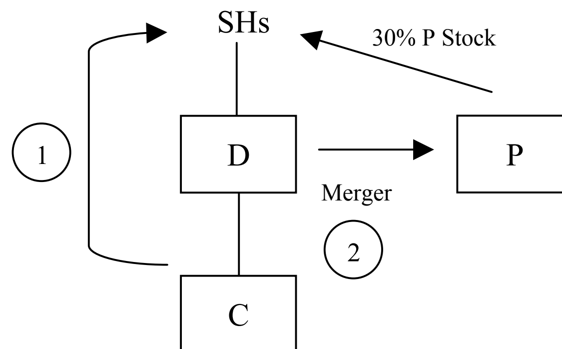
[101] Prop. Treas. Reg. § 1.355-7(a)(8), Ex.5(i).

[102] Prop. Treas. Reg. § 1.355-7(a)(8), Ex.5(ii).

or greater interest in D or that the distribution was not motivated in whole or substantial part by an acquisition-related business purpose.

This example illustrates how the rebuttals apply when D has two substantial business purposes for the distribution -- one acquisition-related purpose and one non-acquisition purpose. If, as recommended above in Part III.D.1.c., the General Post-Spin Rebuttal is applied without using a but-for analysis, then it is satisfied as long as the non-acquisition business purpose is substantial. Thus, the General Post-Spin Rebuttal would still apply where there are two substantial business purposes. The First Prong Facilitation Test, on the other hand, cannot apply where the distribution was motivated in substantial part by an acquisition-related business purpose. Thus, the First Prong Facilitation Test automatically does not apply where there are two substantial business purposes. Thus, in the example above, section 355(e) applies if the acquisition occurs within six months after the distribution, but not if the acquisition occurs more than six months after the distribution. There is no reason for this disparate treatment.

d. Example 6 - Investment Banker Advice Received After Spin-Off is Announced



Facts: D, a public company, plans to distribute C pro rata to its shareholders. The distribution is motivated by a non-acquisition business purpose. After the announcement date, D's investment banker informs D's management that there is a lot of interest in new investment in D now that it will no longer own C. The

> investment banker further informed D's management that P, a potential acquiror, had expressed an interest in acquiring D after the distribution. Five months after the distribution, D is acquired by P.

D will not be able to rebut the two-year presumption using the General Post-Spin Rebuttal, because the acquisition occurred within six months of the distribution.[103] Moreover, the proposed regulations provide that D will not be able to rebut the two-year presumption using the Alternative Post-Spin Rebuttal, because it will not satisfy the Reasonable Anticipation Prong.[104] D will not be able to establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest.

This result is inappropriate and will prevent valid spin-offs. D decided to distribute the stock of C for business purposes completely unrelated to the acquisition, and announced its intention to do so. After a spin-off is announced to the public, a distributing corporation is unlikely to back out of it. However, because a potential acquiror happened to indicate an interest in D prior to the actual distribution, D is forced to choose between incurring a corporate-level tax or backing out of the distribution. What if P waited until immediately after the distribution to express their interest to D. Arguably, D would not have reasonably anticipated the acquisition, and the Alternative Post-Spin Rebuttal could be used.[105] This

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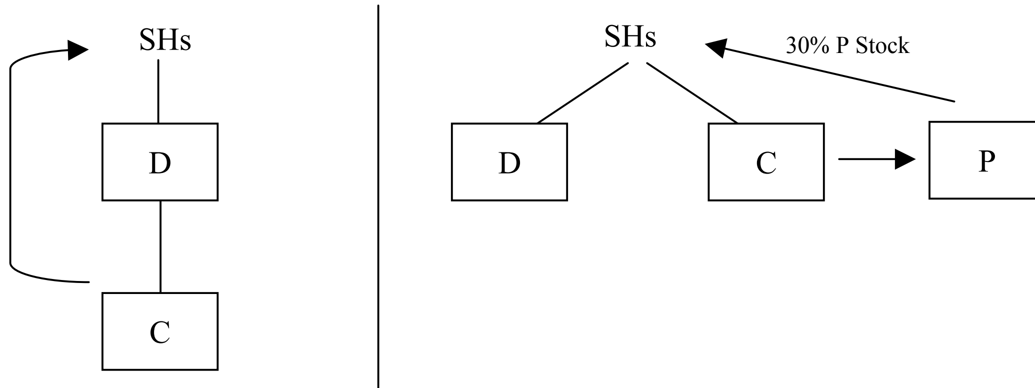
[103] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(2).

[104] The facts of this example are based on the facts of Prop. Treas. Reg. § 1.355-7(a)(8), Ex.8.

[105] It will still be difficult for D to satisfy the Alternative Post-Spin Rebuttal in the case where P waits until immediately after the distribution, because D must prove a negative -- that it did not reasonably anticipate the acquisition.

disparate treatment makes no sense. With respect to public companies, whether a plan exists, and thus whether the rebuttals are satisfied, should be determined at the time of the announcement of the distribution.

e. Example 7 - Inadequate Offers to Acquire D



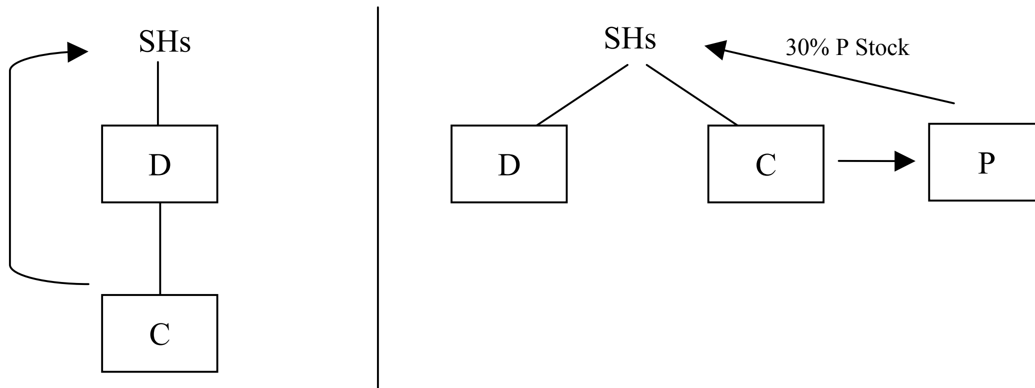
Facts: D consulted with its investment banker regarding its long-term strategic options, including a sale of C or, alternatively, a separation of C's business through a tax-free spin-off. The offers received for the acquisition of C were inadequate and rejected by D. Thus, upon the advice of D's investment banker, and for a non-acquisition business purpose, D distributes C to its shareholders. Within six months after the distribution, P acquires C.

D will not be able to rebut the two-year presumption using the General Post-Spin Rebuttal, because the acquisition occurred within six months of the distribution.[106] Because D engaged in the spin-off as an alternative to an acquisition and for a non-acquisition business purpose, D should be able to satisfy either the First Prong Intent Test or the First Prong Facilitation Test. Further, D will be able to satisfy the Hostile Takeover Prong. However, D will not be able to establish that, at the time of the distribution, neither D, C, nor their controlling

[106] Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(2).

shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest who would not have acquired such interests if the distribution had not occurred. D had received offers to acquire only C before D distributed the stock of C. Under the proposed regulations, only persons who more likely than not would have acquired an interest in D if the distribution had not occurred are treated as persons who more likely than not would have acquired a proportionate interest in C if the distribution had not occurred.[107] Because P had no intent to acquire D, D will not be able to satisfy the Reasonable Anticipation Prong. However, if the offers had been to acquire D, then D may be able to satisfy the Reasonable Anticipation Prong, because it may be able to establish that P would have acquired D if the distribution had not occurred.

f. <u>Example 8 - Hot Market</u>



<u>Facts</u>: D distributes C pro rata to its shareholders. The distribution is motivated solely by a non-acquisition business purpose. At the time of the distribution, although D has not been approached by any potential acquirors of C, D would reasonably anticipate that, under current market conditions, if C is separated from D, an acquisition of a 50-percent or greater interest is more likely than

[107] Prop. Treas. Reg. § 1.355-7(a)(2)(iv)(B).

not to occur within two years. C is acquired by P within six months after the distribution.

Because the acquisition occurred within six months after the distribution, D cannot use the General Post-Spin Rebuttal to rebut the two-year presumption. Moreover, the proposed regulations provide that D will not be able to rebut the two-year presumption using the Alternative Post-Spin Rebuttal, because it will not satisfy the Reasonable Anticipation Prong.[108] D will not be able to establish that, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest.

This example illustrates how overly broad the Reasonable Anticipation Prong is. What if the business purpose for the distribution in this example were to satisfy the terms of a court order? The application of section 355(e) seems overly harsh and unfair under such circumstances. Applied in this manner, the Reasonable Anticipation Prong not only goes well beyond the Congressional purpose of section 355(e) but, as discussed below, it also ignores traditional notions of what constitutes a plan or series of related transactions. The Reasonable Anticipation Prong effectively precludes companies in industries that are actively consolidating from doing tax-free spin-offs.

Application of familiar step-transaction principles,[109] instead of a sweeping reasonable anticipation test, is sufficient to address the concerns of Congress, Treasury, and the

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[108] See Prop. Treas. Reg. § 1.355-7(a)(8), Ex.4.

[109] Courts have developed a number of approaches for dealing with these step-transaction issues. Most prevalent are the binding commitment test, the mutual interdependence test, and the end result test. See McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F.2d 520 (7th Cir. 1982). Under the binding commitment test, a series of transactions will be stepped together only if at the time that the first step is commenced, there is a binding legal commitment to

(Continued …)

Service without overreaching the language and purpose of the statute. The step-transaction doctrine is typically applied in determining whether transactions are related to one another. In fact, step-transaction principles have been applied to interpret phrases similar to "plan or series of related transactions" that appear elsewhere in the Code. For example, section 302(b)(2)(D) provides that section 302(b) does not apply to a redemption made pursuant to a "plan the effect of which is a series of redemptions" resulting in a distribution that is not substantially disproportionate. This phrase has been interpreted to incorporate common law step-transaction principles.[110]

The preamble to the proposed regulations provides that the Reasonable Anticipation Prong is intended to reflect (i) the idea that a causal connection between the

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undertake the subsequent step(s). See, e.g., Commissioner v. Gordon, 391 U.S. 83 (1968). Under the mutual interdependence test, a series of transactions will be stepped together if the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series. See, e.g., King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969). Under the end result test, a series of transactions will be stepped together whenever the evidence shows that the parties' intent at the outset was to achieve the particular result, and that the separate steps were all entered into as means of achieving that result. See, e.g., Kuper v. Commissioner, 533 F.2d 152 (5th Cir. 1976).

[110] See Roebling v. Commissioner, 77 T.C. 30 (1981) (holding that the redemption must be "an integrated step in a firm and fixed plan"); Johnston v. Commissioner, 77 T.C. 679 (1981) (same); see also Rev. Rul. 85-14, 1985-1 C.B. 92 (ruling that a plan does not require the existence of an agreement between two shareholders, but rather a shareholder's "design . . . to arrange a redemption as part of a sequence of events that ultimately restores" control to such shareholder is sufficient).

Further, the Service has interpreted the phrase "same plan or arrangement" to incorporate the step-transaction doctrine. See Preamble to the final regulations under sections 704(c)(1)(B) and 737. The regulations address the treatment of a distribution by a partnership of property contributed by a partner. Although the regulations themselves do not incorporate the step-transaction doctrine as the standard for determining whether a distribution was part of the same plan or arrangement, the preamble to these regulations indicates that the Service considers the step-transaction doctrine to apply.

distribution and the acquisition indicates the presence of a plan and (ii) the idea that the presence of negotiations is not necessary for a plan to exist.[111] First, with respect to the causation factor, the Reasonable Anticipation Prong incorporates a "but-for" analysis -- if the acquisition would not have occurred but for the distribution, then the two are part of the same plan.[112] Even if a but-for analysis is appropriate, the proposed regulations improperly focus on the acquisition rather than the distribution. As a result, the distributing corporation must prove a lack of intent on the part of the acquiror. The statutory language of section 355(e), on the other hand, provides that the distribution must be part of a plan (or series of related transactions) pursuant to which one or more persons acquire the requisite 50-percent interest.[113] The statute clearly contemplates that the distribution be the focus of the analysis. Thus, the but-for analysis more properly should consider whether the distribution would have occurred but for the acquisition.[114] Such an analysis properly focuses on the intent of the distributing corporation, controlled corporation, or controlling shareholders. Under such an analysis, the distribution in Example 8 would have occurred regardless of the acquisition; thus, it should not be considered part of the same plan. This statement of the but-for analysis appears similar to the mutual interdependence test of the

[111] Preamble, 64 Fed. Reg. at 46,158.

[112] Id.

[113] Code § 355(e)(2)(A).

[114] See Candace A. Ridgway, Through a Glass, Darkly: Section 355(e) Proposed Regulations in Need of the Guiding Light, 40 Tax Mgmt. Memorandum 359, 363-64 (1999) for a discussion of the proposed regulations' but-for analysis.

step-transaction doctrine, which asks whether the legal relations created by one transaction would have been fruitless without a completion of the series.[115]

Second, with respect to the necessity of negotiations, the preamble to the proposed regulations reflects a concern that a distributing corporation could attempt to avoid section 355(e), under circumstances that virtually assure an acquisition, by arguing that despite the imminence of an acquisition, effectuating the acquisition was not a motive for the distribution. Treasury and the Service rejected any requirement for mutual agreement or negotiations, "because Congress intended the statute to apply in situations beyond those in which a distribution is made prior to and as part of an acquisition by a specifically identified acquiror."[116] In support of this conclusion, the preamble notes that the legislative history specifically referred to public offerings as possibly triggering section 355(e), even though presumably no public buyer would have been identified at the time of the distribution.[117]

These concerns simply do not justify a rule as sweeping as the Reasonable Anticipation Prong. Indeed, as suggested by Example 8, section 355(e) may apply not only in the absence of a specifically identified acquiror but also in the absence of <u>any</u> involvement on the part of the distributing or controlled corporation. As such, the proposed regulations lose focus of whose plan is relevant for purposes of section 355(e). The Reasonable Anticipation Prong goes well beyond the statutory language and the purpose of section 355(e) to prevent disguised sales.

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[115] <u>See, e.g.</u>, <u>King Enterprises, Inc. v. United States</u>, 418 F.2d 511 (Ct. Cl. 1969).

[116] Preamble, 64 Fed. Reg. at 46,158.

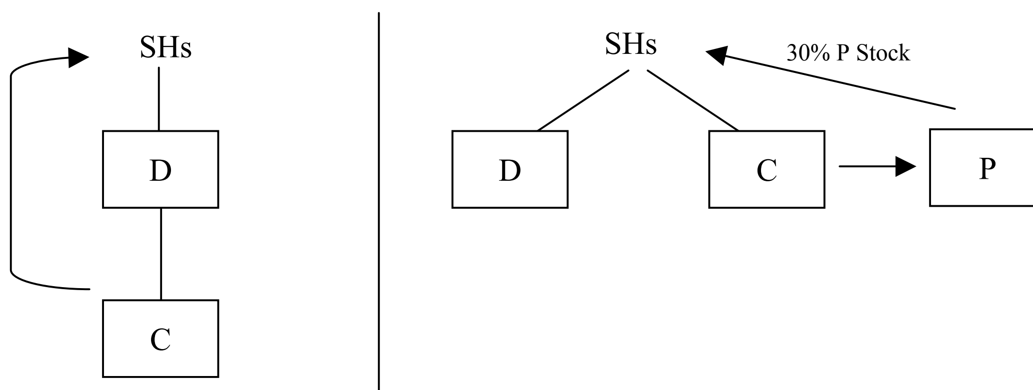
[117] <u>Id.</u>

The statutory language of section 355(e) provides that the distribution must be part of a plan (or series of related transactions) pursuant to which one or more persons acquire the requisite 50-percent interest.[118] Because the statute contemplates a single plan involving the distribution and acquisition, and the distributing corporation, the controlled corporation, and/or their controlling shareholders must necessarily be involved in the plan of distribution, one of these relevant parties must, by definition, be involved in the plan of acquisition. Indeed, the preamble to the proposed regulations recognize as much -- they state that "to determine whether a plan of acquisition exists, one must look at all parties to the transaction, including the distributing and controlled corporations and their shareholders, not just the potential acquirors."[119] Focusing on the relevant parties is not inconsistent with the reference to public offerings in the legislative history, because the distributing or controlled corporation will be taking positive action to facilitate the acquisition of its stock by the public. Likewise, other similar transactions, such as private placements or auctions by an investment banker, will continue to fall within this concept of a plan.

[118] Code § 355(e)(2)(A).

[119] Preamble, 64 Fed. Reg. at 46,156.

g. Example 9 - Hostile Takeover



Facts: P announces an intention to acquire D, principally to acquire C's business. Due to market conditions, P's available capital, and P's success in acquiring other corporations, D would reasonably anticipate that an acquisition of a 50-percent or greater interest in D is more likely than not to occur within two years. To lower its borrowing costs and in an effort to prevent the acquisition of D (by separating it from the more attractive C), D distributes the C stock pro rata to its shareholders. P acquires C within six months after the distribution.

Because the acquisition occurred within six months after the distribution, D cannot use the General Post-Spin Rebuttal to rebut the two-year presumption.[120] Moreover, the proposed regulations provide that D will not be able to rebut the two-year presumption using the Alternative Post-Spin Rebuttal, because it will not satisfy the Hostile Takeover Prong.[121] D will satisfy the First Prong Facilitation Test, because the distribution was not motivated by an

[120] Note that if the General Post-Spin Rebuttal did not apply a but-for analysis, as recommended in Part III.D.1.c., supra, then D would have satisfied the first part of the General Post-Spin Rebuttal, because there was a substantial non-acquisition business purpose for the distribution. Prop. Treas. Reg. § 1.355-7(a)(2)(ii)(A)(1).

[121] See Prop. Treas. Reg. § 1.355-7(a)(8), Ex.2(iii).

intention to facilitate an acquisition. Likewise, D will satisfy the Reasonable Anticipation Prong, because, at the time of the distribution, neither D, C, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a 50-percent or greater interest who would not have acquired such interest if the distribution had not occurred. However, D will not satisfy the Hostile Takeover Prong, because D will not be able to establish that the distribution was not motivated in whole or substantial part by an intention to decrease the likelihood of an acquisition of D by separating it from C, which was likely to be acquired.

Like Example 5, above, this example illustrates how the rebuttals apply when D has two substantial business purposes for the distribution -- one non-acquisition purpose and one hostile takeover purpose. If, as recommended above in Part III.D.1.c., the General Post-Spin Rebuttal is applied without using a but-for analysis, then it is satisfied as long as the non-acquisition business purpose is substantial. Thus, the General Post-Spin Rebuttal would still apply where there are two substantial business purposes, provided the acquisition occurs more than six months after the distribution. The Hostile Takeover Prong (contained in the Alternative Post-Spin Rebuttal), on the other hand, cannot be satisfied where the distribution was motivated in substantial part by an intention to decrease the likelihood of an acquisition of D by separating it from C. Thus, the Hostile Takeover Prong automatically would not be satisfied where there are two substantial business purposes. Thus, in the example above, section 355(e) applies if the acquisition occurs within six months after the distribution, but not if the acquisition occurs more than six months after the distribution. There is no reason for this disparate treatment. A hostile takeover does not become less hostile by reason of the passage of time. This result is extremely harsh and is not necessary to comport with the legislative intent behind section 355(e).

h. Simplification of the Alternative Post-Spin Rebuttal

As drafted, the Alternative Post-Spin Rebuttal is extremely complicated and should be simplified. The First Prong Intent Test requires that the intended change in ownership equal 50 percent or more. This 50-percent threshold is appropriate and is consistent with our recommendation above in Part III.D.1.a. with respect to the General Post-Spin Rebuttal to require a business purpose to facilitate a 50-percent acquisition. The First Prong Facilitation Test is unnecessary and should be removed from the Alternative Post-Spin Rebuttal. Further, as noted above in Part III.D.2.f., we recommend modifying the Reasonable Anticipation Prong to incorporate general step-transaction principles. Finally, as recommended above in Part III.D.1.d., the Hostile Takeover Test should be removed from the regulations, which results in further simplification.

If all of these changes are made, the Alternative Post-Spin Rebuttal would contain two prongs: (i) neither the distributing or controlled corporation nor a controlling shareholder of either corporation intended that one or more persons would acquire a 50-percent or greater interest in the distributing or controlled corporation, and (ii) applying general step-transaction principles, the distribution and acquisition should not be stepped together. This test is not only much simpler, but it is also consistent with the intent of the proposed regulations to impose a higher burden on the distributing corporation with respect to acquisitions occurring within six months of the distribution.

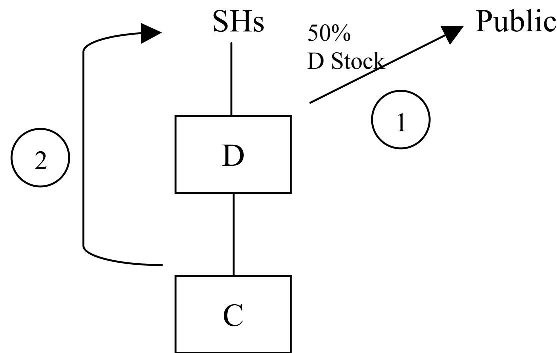
E. Pre-Spin Acquisitions

1. General Pre-Spin Rebuttal

As discussed above, the General Pre-Spin Rebuttal requires that the distributing corporation establish that, at the time of the acquisition, the distributing corporation and its

controlling shareholders did not intend to effectuate a distribution.[122] Thus, the General Pre-Spin Rebuttal focuses on the intent of the distributing corporation and its controlling shareholders to effectuate the distribution at the time of the acquisition,.

a. Example 10 - Public Offering Before Distribution



Facts: D does an initial public offering of 50 percent if its stock. At the time of the initial public offering, D does not intend to distribute the stock of C. One year later, D distributes the stock of C pro rata to its shareholders.

The General Pre-Spin Rebuttal is satisfied in this example, because D did not intend to effectuate a distribution of C at the time of the public offering. This result is the correct one, because there is no relationship between the public offering and the distribution.

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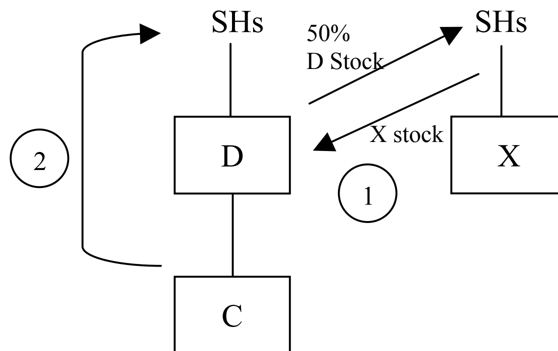
[122] Prop. Treas. Reg. § 1.355-7(a)(2)(v)(A).

b. Example 11 - Formation of Intent



Facts: D acquires the stock of X, a widely held corporation, in exchange for 50 percent of D's stock. None of the X shareholders receiving D stock becomes a controlling shareholder of D. Several months later, D distributes the stock of C.

Assume that D's acquisition of X occurs after the announcement of the distribution of C. In this case, D clearly intended to effectuate the distribution at the time of the acquisition, and the General Pre-Spin Rebuttal is not available. The proposed regulations address this straightforward case.[123] The proposed regulations, however, are silent with respect to the point at which D's intent to effectuate a distribution is formed. For example, what if X were acquired while D's management was considering the possibility of a spin-off, but the board of directors had not yet considered it? What if the board had considered the spin-off and was studying its feasibility? What if the board had approved the spin-off? Representatives of Treasury and the Service have informally indicated that mere due diligence with respect to the

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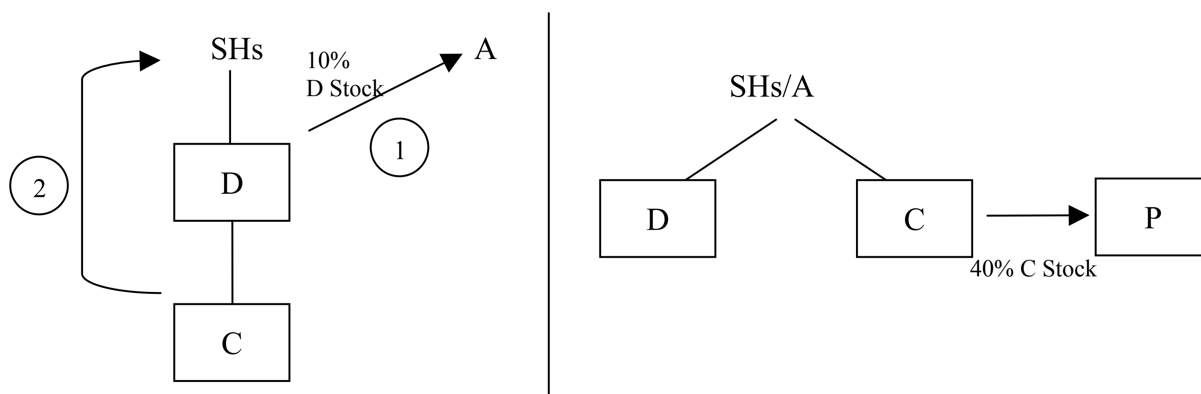
[123] See Prop. Treas. Reg. § 1.355-7(a)(8), Exs. 6, 7(iii). However, if D can establish that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of the acquisition, then D may rebut the two-year presumption using the Alternative Pre-Spin Rebuttal. See Prop. Treas. Reg. § 1.355-7(a)(2)(v)(B).

distribution should not rise to the level of intent.[124] Thus, it would seem that board approval indicates intent, but that mere consideration by management or the board and conducting feasibility studies and the like should not rise to the level of intent. Establishing these differences by clear and convincing evidence may prove difficult.

c. Example 12 - Acquisition Before Announcement of Distribution



Facts: A acquires a 10-percent interest in D. Prior to the acquisition, and unbeknownst to A, D's board had approved, but had not yet announced, a plan to distribute the stock of C pro rata to its shareholders. Shortly thereafter, D announces that it will distribute the stock of C, and eight months later, D distributes the stock of C. After the distribution, a third party acquires 40 percent of the stock of C[125] in a transaction related to the distribution.

Because D intended to distribute the stock of C at the time A acquired the D stock, D will not be able to use the General Pre-Spin Rebuttal.[126] Given the proposed

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[124] These statements were made during a meeting of the D.C. Bar Tax Section's Corporation Tax Committee on Oct. 7, 1999.

[125] Note that the remaining 10 percent of C's stock is acquired by A in the spin-off of C. Although section 355(e)(3)(A)(ii) does not take into account acquisitions of C stock by reason of holding D stock, the exception does not apply to such an acquisition of C stock if the D stock held before the acquisition was acquired pursuant to a plan. Code § 355(e)(3) (flush language).

[126] However, if D can establish that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of the

(Continued …)

regulations' focus on the intent of controlling shareholders, this result makes little sense. The preamble to the proposed regulations states that "if a person becomes a controlling shareholder by acquisition, that person's intention becomes the single best indicator of whether a later distribution was part of a plan."[127] Thus, if A, with full knowledge of the planned distribution, acquired a controlling interest in D, one could say that the acquisition and the distribution are part of A's plan.[128] In this example, however, the proposed distribution had not been announced at the time A became a controlling shareholder. If A did not even know about the distribution and had no influence on D's decision to effectuate the distribution, how could one say the distribution is part of the same plan as the acquisition? In this case, it seems that the distribution is part of D's plan, and the acquisition is part of A's separate plan. Because section 355(e) requires that the distribution and acquisition be part of a single plan,[129] this result is inappropriate. The rule should provide that the acquiring shareholder has knowledge of, and involvement with, the distributing corporation's intent to distribute the controlled corporation.

Note that a pre-spin acquisition of the distributing corporation can taint a subsequent acquisition of the controlled corporation. In this example, 40 percent of C was acquired after the distribution as part of a plan. Assume that D is unable to satisfy either the

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acquisition, then D may rebut the two-year presumption using the Alternative Pre-Spin Rebuttal. See Prop. Treas. Reg. § 1.355-7(a)(2)(v)(B).

[127] Preamble, 64 Fed. Reg. at 46,159.

[128] Although the examples in the proposed regulations illustrate only the situation where the acquiring shareholder acquires stock directly from the distributing corporation, presumably the same analysis applies where stock in the distributing corporation is acquired from the current shareholders.

[129] Code § 355(e)(2)(A).

General Pre-Spin or Alternative Pre-Spin Rebuttals with respect to A's acquisition. Because neither acquisition could satisfy the rebuttals, they are aggregated for purposes of determining whether the 50-percent threshold is met.[130] Thus, A's 10-percent acquisition of D and the 40-percent acquisition of C will be aggregated, and the 50-percent threshold will be met. This is true regardless of whether the acquisitions were, in reality, completely unrelated to one another, as long as the acquisitions were both related to the distribution.[131]

2. Alternative Pre-Spin Rebuttal

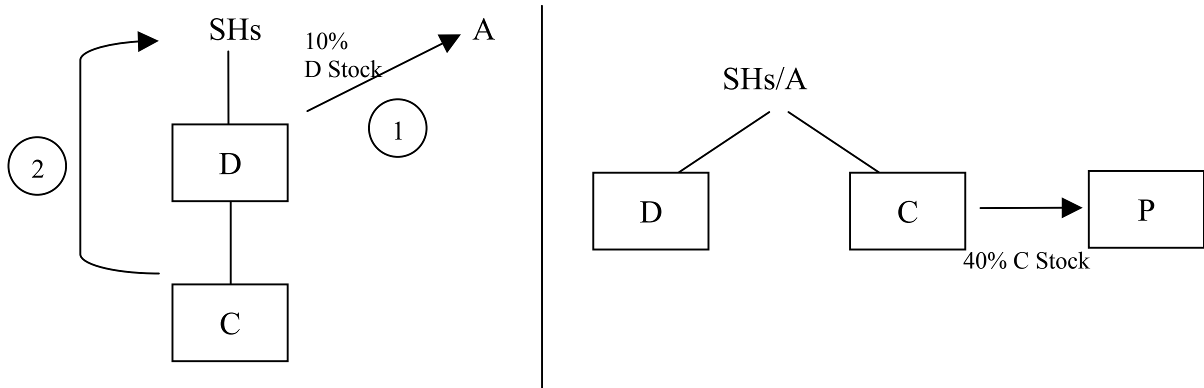
As discussed above, the Alternative Pre-Spin Rebuttal requires that the distributing corporation establish that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of the acquisition.[132] Thus, the Alternative Pre-Spin Rebuttal focuses on whether the acquisition had any effect on the timing and terms of the distribution. However, this rebuttal is not available if a person acquiring an interest in the distributing corporation becomes a controlling shareholder.

[130] Prop. Treas. Reg. § 1.355-7(a)(6). See supra Part II.E. for a description of the rule requiring the aggregation of acquisitions for purposes of determining whether the 50-percent threshold has been met.

[131] The statutory language appears to require that each acquisition be related to the distribution. Section 355(e) requires that the distribution be part of "a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest . . . ." Code § 355(e)(2)(A) (emphasis added). The statute thus seems to contemplate a single plan involving the distribution.

[132] Prop. Treas. Reg. § 1.355-7(a)(2)(v)(B).

a. Example 13 - Definition of Controlling Shareholder (Public Company)



Facts: D, a public company, announces that it plans to distribute the stock of C pro rata to its shareholders. A then acquires 10 percent of D voting common stock. Several months later, D distributes the stock of C. After the distribution, a third party acquires 40 percent of the stock of C in a transaction related to the distribution.

A controlling shareholder in a public company is defined as any person who, directly or indirectly, or together with related persons, owns five percent or more of any class of stock and who actively participates in the management or operation of the corporation.[133] The proposed regulations do not define the phrase "actively participates."[134] An example in the proposed regulations briefly mentions the controlling shareholder rule, but does little to clarify

[133] Prop. Treas. Reg. § 1.355-7(a)(6).

[134] The definition of a controlling shareholder is the same as the definition of a "significant shareholder" for purposes of a public corporation's ability to use the fit and focus business purpose. See Rev. Proc. 96-30, 1996-1 C.B. 696, Appendix A § 2.05(3). The Revenue Procedure also does not define the phrase "actively participates." To be consistent, however, the regulations should use the term "significant shareholder."

the definition of a controlling shareholder.[135] The example involves the acquisition of an unrelated company, X, by D prior to the distribution. The example states that X's sole shareholder, A, "receives 30 percent of D's stock, becoming a controlling shareholder."[136] Thus, the example seems to assume, without any analysis, that A is a controlling shareholder. Moreover, it is not clear from the facts of the example whether the distributing corporation was a publicly traded or non-publicly traded company. In Example 13, above, it would appear that the acquisition by A of a 10-percent voting stock interest in D, without any participation in D's management or operation, would not make A a controlling shareholder.

What if, in addition to holding a 10-percent interest in D, A were a manager or officer of D? A presumably would satisfy the active participation standard as an active participant in the management of D. What if A just sat on the board of directors of D? Presumably the answer would not change. What if A were a mere employee of D? Would A satisfy the standard as an active participant in the operation of the corporation?

Furthermore, it is not clear from the proposed regulations what it means to own five percent of a class of stock. What if A receives an option to acquire 10 percent of D's stock instead of a direct stock interest? What if A, an employee of D, received stock that is subject to a substantial risk of forfeiture within the meaning of section 83 and the regulations thereunder? What if A makes a section 83(b) election to include the value of the stock in his or her gross income? Final regulations should clarify the definition of controlling shareholder.

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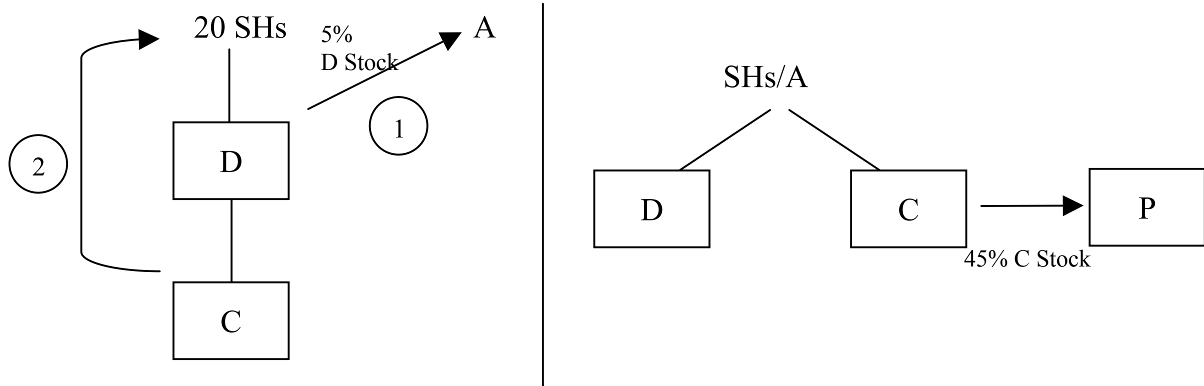
[135] See Prop. Treas. Reg. 1.355-7(a)(8), Ex.7(iii).

[136] Prop. Treas. Reg. 1.355-7(a)(8), Ex.7(i).

b. Example 14 - Definition of Controlling Shareholder (Non-Public Company)



Facts: D has 20 unrelated shareholders, each of which owns five percent of the voting stock of D. D announces that it plans to distribute the stock of C pro rata to its shareholders. A, who is not related to any of D's shareholders, then acquires 5 percent of D voting common stock (which dilutes the other shareholders' interests to 4.75 percent). Several months later, D distributes the stock of C. After the distribution, a third party acquires 45 percent of the stock of C in a transaction related to the distribution.

A controlling shareholder in a non-publicly traded company is defined as any person who, directly or indirectly, or together with related persons, possesses voting power in the distributing or controlled corporation "representing a meaningful voice in the governance of the corporation."[137] The proposed regulations do not define what constitutes a "meaningful voice." However, the same phrase appears in the appendix to Revenue Procedure 96-30 in connection with substantiating the key employee business purpose.[138] In Revenue Procedure 96-30, the Service states that it will consider whether the voting power represents a meaningful voice on a

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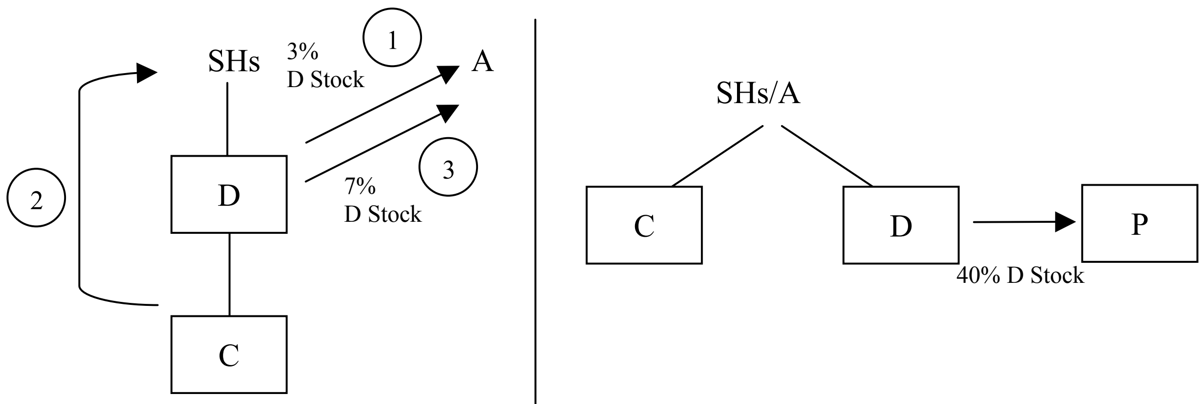
[137] Prop. Treas. Reg. 1.355-7(a)(4).

[138] See Rev. Proc. 96-30, 1996-1 C.B. 696, Appendix A § 2.01(1)(c).

case-by-case basis, "taking into account factors such as the distribution of voting power among the shareholders, family relationships, and competing economic interests."[139] Presumably, the Service would apply the same standard for purposes of the Alternative Pre-Spin Rebuttal. Applying this standard, A's five-percent interest presumably would constitute a meaningful voice, because A has the largest outstanding interest. If the other 20 shareholders were related, it is not clear whether A's interest would constitute a meaningful voice.

c. Example 15 - Acquiring Control Within Two Years After the Distribution



Facts: D, a public company, announces that it plans to distribute the stock of C pro rata to its shareholders. A then acquires three percent of D voting common stock. Several months later, D distributes the stock of C. Within the two-year period after the distribution, A acquires an additional seven percent of D's voting common stock. After the distribution, a third party acquires 40 percent of the stock of D in a transaction related to the distribution.[140]

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[139] Id.

[140] Note that if P would have acquired 40 percent of C, section 355(e) would not apply, since P's 40-percent acquisition combined with A's three-percent acquisition of C pursuant to the spin-off would not aggregate to 50 percent of the C stock.

The Alternative Pre-Spin Rebuttal does not apply if the acquiror becomes a controlling shareholder by reason of the acquisition or at any point thereafter and during the two-year period following the distribution.[141] In this example, A acquires an additional amount of stock during the two-year period sufficient to make A a controlling shareholder. Thus, the Alternative Pre-Spin Rebuttal would not be available. There is no reason for such an expansive rule. The focus of the pre-spin rebuttals is on the intent of the controlling shareholder in determining whether a later distribution is part of a plan.[142] A is not a controlling shareholder at the time of the distribution and thus has no influence over the distribution. It should not matter that A acquires a sufficient amount of stock after the distribution to make him or her a controlling shareholder.

There may be a concern, however, that the absence of such a rule could lead to abuse. For example, assume that A wants to acquire a controlling interest, but in order to avoid section 355(e), acquires a three-percent interest before the distribution and acquires an additional seven percent on the day after the distribution. A much more narrow rule could be crafted to address such potential abuses. For example, the Alternative Pre-Spin Rebuttal could be inapplicable where a person becomes a controlling shareholder by reason of the acquisition or during the two-year period after the distribution by reason of acquisitions that are pursuant to the same plan as the original acquisition.

[141] Prop. Treas. Reg. § 1.355-7(a)(2)(v)(B). Note that if A were already a controlling shareholder as defined in Prop. Treas. Reg. § 1.355-7(a)(4) at the time A acquired its three-percent interest, the Alternative Pre-Spin Rebuttal would be available, because A did not become a controlling shareholder "by reason of the acquisition."

[142] Preamble, 64 Fed. Reg. at 46,159.

F. Agreement, Understanding, Arrangement, or Substantial Negotiations

As discussed above, the proposed regulations refer to an "agreement, understanding, arrangement, or substantial negotiations" several times.[143] However, the proposed regulations do not define the terms agreement, understanding, arrangement, or substantial negotiations, except to state that the parties do not necessarily have to have entered into a binding contract or have reached agreement on all terms to have an "agreement, understanding, or arrangement."[144]

1. When are Negotiations Substantial?

There is considerable uncertainty as to when negotiations are substantial. For example, assume that P, a potential acquiror, and D have no negotiations before the distribution, but that within six months after the distribution, P and D discuss the possible benefits of a combination of their operations and engage in due diligence. P and D then merge more than six months after the distribution. Mere due diligence should not constitute substantial negotiations.[145] On the other hand, it would seem that board approval will rise to the level of an agreement, understanding, or arrangement. Thus, substantial negotiations presumably falls somewhere between due diligence and board approval. Considering the difficulty in defining substantial negotiations, the Service should consider deleting it from the final regulations. An

[143] See Part II.D., supra.

[144] Prop. Treas. Reg. § 1.355-7(a)(5).

[145] Representatives of Treasury and the Service informally confirmed this conclusion during a meeting of the D.C. Bar Tax Section's Corporation Tax Committee on Oct. 7, 1999. See also Part III.E.1.b., supra (reaching the same conclusion regarding when intent is formed for purposes of the General Pre-Spin Rebuttal).

agreement, understanding, or arrangement appears to be broad enough to prevent avoidance of section 355(e) without adding further uncertainty.

What if P and D did engage in substantial negotiations within six months after the distribution, but that D ultimately merged with X more than six months after the distribution? Should substantial negotiations with any potential acquiror indicate a plan on the part of the distributing corporation, regardless of whether that party is the ultimate acquiror? What if P and D engaged in negotiations, but had not yet agreed on price, and D's shareholders ultimately accepted P's offer more than six months after the distribution? Whether this constitutes substantial negotiations may depend on the significance of the price term to the negotiations and how close P and D are to agreeing on the price. The final regulations should provide guidance as to what constitutes substantial negotiations.

2. Breaking Off Negotiations

The proposed regulations do not address whether breaking off negotiations removes the taint of such negotiations. For example, assume that D negotiated with P, a potential acquiror, regarding P's acquisition of D prior to the distribution, but that negotiations were broken off. Negotiations were later resumed more than six months after the distribution, and the acquisition was consummated. If the negotiations were truly broken off, then D should not be precluded from using the General Pre-Spin Rebuttal. However, the concern is that negotiations will be broken off with the understanding that the break-off was only temporary until the six-month period elapsed. This presents a factual issue, and the distributing corporation should not be precluded from establishing that the break-off of negotiations was real. What if negotiations were broken off with P prior to the distribution, but were begun with X shortly after

the distribution? Assuming that D engaged in no negotiations with X prior to the distribution, the pre-spin negotiations with P should not taint X's ultimate acquisition of D.

3. Treatment of Options

As discussed above, the proposed regulations treat certain options as agreements entered into on the date of issuance of the option, unless the distributing corporation establishes by clear and convincing evidence that, on the later of the date of the distribution or the date of issuance of the option, the option was not more likely than not to be exercised.[146]

Thus, for example, an option that is issued within two years before a distribution, which is not in-the-money at that time, but is in-the-money at the time of the distribution, is considered an agreement, even if it is not actually exercised until more than two years after the distribution. This result makes little sense, because no relevant party (i.e., the distributing corporation, controlled corporation, or a controlling shareholder) has control over the value of an option at the time of the distribution. An "agreement" necessarily should involve a relevant party. A relevant party does, however, have control over the issuance of the option; thus whether an option is more likely than not to be exercised should be tested at the time of issuance only.

Under the proposed regulations, the term "option" is defined broadly to include, inter alia, redemption agreements (including rights to cause the redemption of stock).[147] The final regulations should clarify that this does not apply to normal stock repurchase programs.

[146] Prop. Treas. Reg. § 1.355-7(a)(7)(i)(A).

[147] Prop. Treas. Reg. § 1.355-7(a)(7)(ii).

G. Issues Left Unanswered by the Proposed Regulations

There are several acquisition-related issues, which are described below, left unanswered by the proposed regulations. However, representatives of Treasury and the Service have informally indicated that they are working on the next set of proposed section 355(e) regulations, which will specifically address what constitutes an acquisition, and that they plan to issue regulations addressing aggregation and attribution rules (including provisions for public trading).[148]

Such future regulations should make it clear that public trading will not be considered in applying section 355(e). There is simply no way for the distributing and controlled corporations to monitor the shares being traded among the public.[149] Moreover, the distributing and controlled corporations are not involved in such acquisitions -- a shareholder sells its stock in the market to a third party. Without such an exception, public companies will always risk application of section 355(e).[150]

[148] These statements were made during a recent meeting of the D.C. Bar Tax Section's Corporation Tax Committee on Oct. 7, 1999; see also More Whinging, supra note 72; Preamble, 64 Fed. Reg. at 46,156.

[149] This, of course, is less of a concern where the trading occurs with respect to five-percent shareholders, because five-percent shareholders are required to file an applicable Schedule 13 with the Securities and Exchange Commission.

[150] Representatives of the Treasury and Service have informally indicated that they do not intend to consider public trading in applying section 355(e). Moreover, favorable private letter rulings have been issued, which involve publicly traded companies, thus implying that section 355(e) does not apply to public trading. See, e.g., P.L.R. 200025001 (July 9, 1999); P.L.R. 199909027 (Dec. 2, 1998); P.L.R. 9819048 (Feb. 2, 1998).

The proposed regulations do not address the exercise of compensatory stock options in applying section 355(e).[151] However, in P.L.R. 200009031 (Dec. 3, 1999), the Service ruled that the issuance or exercise of compensatory stock options is not an acquisition for purposes of section 355(e). Hopefully, this position will be confirmed in future regulations.

In addition, acquisitions by a corporation of its own stock pursuant to a redemption or repurchase should be excluded from section 355(e). The resulting increase in the interests of other shareholders should also generally not be considered an acquisition for purposes of section 355(e), because the ownership of the corporation is not shifting to new shareholders. In limited circumstances, however, such an increase in interest may implicate the purposes of section 355(e). This would occur where the redemption is in connection with another prohibited acquisition. For example, assume that individual A acquires 30 percent of the stock of Distributing within two years after the spin-off of Controlled pursuant to a plan. Distributing later redeems enough of its shares to bring A's ownership interest to 50 percent. To address this and other potentially abusive transactions, the regulations could provide an anti-abuse rule similar to that contained in the proposed section 355(d) regulations.[152]

Moreover, guidance should be issued regarding the acquisition of stock by historic shareholders. For example, assume that A, B, and C owns 25 percent, 25 percent, and 50 percent, respectively, of Distributing's stock. Distributing distributes the stock of Controlled pro rata to its shareholders. Within two years after the distribution, C sells its 50-percent interest in

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[151] The proposed regulations disregard the issuance of compensatory stock options. See Prop. Treas. Reg. § 1.355-7(a)(7)(iii)(B).

[152] Prop. Treas. Reg. § 1.355-6(b)(4).

Controlled to A. Section 355(e)(3)(A)(iv) provides that an acquisition of stock is not taken into account to the extent that the percentage of stock owned by each person owning stock in the corporation immediately before the acquisition does not decrease. This provision seems to adopt a shareholder-by-shareholder approach to determining whether an acquisition occurs. However, the legislative history of section 355(e) provides that the purpose of section 355(e) is to prevent new shareholders from acquiring ownership of a business in connection with a spin-off in a transaction that resembles a disguised sale.[153] Shifts in ownership among historic shareholders do not implicate the purpose behind section 355(e).

IV. SUMMARY

Treasury and the Service should be commended for proposing a six-month rule, which limits the broad application of section 355(e). However, on balance, the proposed regulations are not helpful, but rather exacerbate the problems created by a poorly drafted statute. To improve the regulations, the following is a list of specific recommendations that were made herein.

General Recommendations:

1. The rebuttals provided in the proposed regulations should simply be safe harbors to satisfy the taxpayer's burden of proof -- they should not be exclusive.
2. Given the difficulty in proving intent, reasonable anticipation, etc., the burden of proof should be something less than clear and convincing evidence.
3. The regulations should address the following issues, which were left unanswered by the proposed regulations:

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[153] House Report, at 462; Senate Report, at 139-40. See Mark J. Silverman et al., supra note 3 for a discussion of this provision.

- The regulations should make it clear that public trading will not be considered in applying section 355(e).

- The regulations should make it clear that the exercise of compensatory stock options will be disregarded in applying section 355(e).

- The regulations should disregard the redemption or repurchase of stock by the distributing or controlled corporation in the open market in applying section 355(e).

- The regulations should generally disregard the increase in the interests of other shareholders that results from a redemption in applying section 355(e).

- The regulations should provide guidance regarding the acquisition of stock by historic shareholders.

General Post-Spin Rebuttal:

1. For purposes of the General Post-Spin Rebuttal, an acquisition-related business purpose should taint only those acquisitions related to that purpose. With respect to other unrelated acquisitions, the distributing corporation should be permitted to use the General Post-Spin Rebuttal.

2. The General Post-Spin Rebuttal should be satisfied as long as the distribution was motivated in whole or substantial part by a business purpose other than an intent to facilitate a 50-percent acquisition.[154]

3. The final regulations should clarify that a business purpose to facilitate an acquisition of distributing corporation stock should not preclude use of the General Post-Spin Rebuttal for subsequent acquisitions of controlled corporation stock.

4. Where multiple business purposes exist, the Service should not apply a but-for analysis to determine whether the distribution was motivated in whole or substantial part by the non-acquisition business purpose.

5. Both the General Post-Spin and Alternative Post-Spin Rebuttals should be modified to remove references to hostile takeovers. The taxpayer may be required to establish the existence of certain factors, however, to show that the takeover was, in fact, hostile.

Alternative Post-Spin Rebuttal:

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[154] At a minimum, the General Pre-Spin Rebuttal should contain a de minimis rule, permitting acquisition-related business purposes that involve acquisitions of up to a threshold percentage (e.g., greater than 33 percent).

1. The Alternative Post-Spin Rebuttal should be simplified by deleting the First Prong Facilitation Test.

2. The Reasonable Anticipation Prong should be applied at the time of the announcement of the distribution, rather than at the time of the distribution.

3. The Reasonable Anticipation Prong should be replaced with a test that applies step-transaction principles.

4. The Alternative Post-Spin Rebuttal should be simplified by deleting the Hostile Takeover Prong.

General Pre-Spin Rebuttal:

1. The final regulations should clarify that, for purposes of the General Pre-Spin Rebuttal, mere due diligence regarding the spin-off should not rise to the level of intent.

2. The General Pre-Spin Rebuttal should be modified to provide that an acquiring controlling shareholder must have knowledge of, and involvement with, the distributing corporation's intent to distribute the stock of the controlled corporation.

Alternative Pre-Spin Rebuttal:

1. The final regulations should clarify the definition of controlling shareholder to provide guidance as to the definition of the phrase "actively participates" and what constitutes a "five-percent shareholder."

2. The Alternative Pre-Spin Rebuttal does not apply if the acquiror becomes a controlling shareholder at any point during the two-year period after the distribution. This rule should be modified to require that subsequent acquisitions be part of the same plan as the original acquisition.

Agreement, Understanding, Arrangement, or Substantial Negotiations:

1. The final regulations should provide additional guidance as to what constitutes "substantial negotiations."

2. For purposes of the definition of "agreement," whether an option is more likely than not to be exercised should be tested at the time of issuance only.

3. Normal stock repurchase programs should be excluded from the definition of "option."