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**The Fourth Time's a Charm – Temporary Section 355(e) Regulations
Provide Helpful Guidance to Taxpayers**

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I. BACKGROUND

In 1997, Congress enacted the Taxpayer Relief Act of 1997 (“TRA 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)”

* Note: The temporary regulations discussed herein were finalized in January 2006. Please see the article, “Final Section 355(e) Plan Regulations - The Final Chapter in the Saga,” by Mark J. Silverman and Lisa M Zarlenga for a discussion of the changes made in the final regulations.

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. We discussed section 355(e) as enacted by TRA 1997 in detail in Mark J. Silverman et al., The New Anti-Morris Trust and Intragroup Spin Provisions, 49 TAX EXEC. 455 (1997).

(referred to herein as a “plan”) that was in place at the time of the distribution.⁴ Section 355(e) also creates a rebuttable presumption that any acquisition occurring two years before or after a section 355 distribution is part of such a plan “unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.”⁵

The language of section 355(e) is deceptively broad and offers no real guidance to taxpayers. There is an obvious disconnect between the apparent breadth of section 355(e) and the legislative history of section 355(e), which clearly indicates that the statute was intended to prevent tax-free disguised sales. Section 355(e) does, however, authorize Treasury and the Internal Revenue Service (the “Service”) to issue regulations “necessary to carry out the purposes” of the legislation. Treasury and the Service have been struggling to reconcile the purposes of the statute with its overly broad language, and their latest attempt seems to have achieved this goal. On April 23, 2002, Treasury and the Service issued their fourth set of regulations to define “plan.”⁶ Summarized below are the first three attempts to define plan, followed by a discussion of the purpose of section 355(e) and an analysis of the new temporary regulations.

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.

⁵ Code § 355(e)(2)(B).

⁶ 67 Fed. Reg. 20,632 (2002).

II. EVOLUTION OF PLAN REGULATIONS

On August 19, 1999, Treasury and the Service issued proposed regulations under section 355(e) that provided guidance as to what constitutes a plan (the “1999 proposed regulations”).⁷ The 1999 proposed regulations created a complicated series of elements that the distributing corporation had to establish to rebut the two-year presumption. The particular rebuttal that applied depended upon when the acquisition occurred relative to the distribution. Not only were the rebuttals the exclusive means of overcoming the two-year presumption but the taxpayer also had to establish that it satisfied the rebuttals by a high burden of proof – clear and convincing evidence. As a result, the 1999 proposed regulations expanded the scope of an already overly broad statute.⁸

On December 29, 2000, Treasury and the Service withdrew the 1999 proposed regulations,⁹ and issued new proposed regulations in their place (the “2000 proposed regulations”).¹⁰ The 2000 proposed regulations adopted a facts-and-circumstances approach, which is consistent with the statute.¹¹ The 2000 proposed regulations contained six safe harbors

⁷ 1999 Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. 46,155, 46,160 (1999).

⁸ We discussed the 1999 proposed regulations in detail in Mark J. Silverman & Lisa M. Zarlenga, The Proposed Section 355(e) Regulations: Broadening the Traditional Notions of What Constitutes a Plan, 52 TAX EXEC. 20 (2000).

⁹ 66 Fed. Reg. 76 (2001).

¹⁰ 2000 Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. 66 (2001).

¹¹ See 2000 Prop. Treas. Reg. § 1.355-7(b)(1). Section 355(e)(2)(B) provides that acquisitions during the two years before and after a spin-off “shall be treated as pursuant to a plan . . . unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions.” Thus, the statute clearly contemplates that taxpayers will be permitted to establish that the distribution and the acquisition were not part of a plan. Neither the statute nor the legislative history limits the manner in which the taxpayer may make this showing. The statute seems to contemplate a facts-and-circumstances approach.

that, when applicable, obviated the need to perform the facts-and-circumstances analysis.¹² If the safe harbors were not satisfied, the 2000 proposed regulations contained a list of nonexclusive factors to consider in determining whether or not there is a plan.¹³ Finally, the 2000 proposed regulations deleted references to a clear and convincing standard of proof.¹⁴

On August 2, 2001, Treasury and the Service issued temporary regulations under section 355(e) (the “2001 temporary regulations”).¹⁵ The 2001 temporary regulations were identical to the 2000 proposed regulations, except that the 2001 temporary regulations reserved section 1.355-7(e)(6) (suspending the running of any time period prescribed in the regulations during which there is a substantial diminution of risk of loss under the principles of section 355(d)(6)(B)) and Example 7 (concluding that multiple acquisitions of target companies using Distributing stock were part of a plan, regardless of whether targets were identified at the time of the spin-off, where purpose for the spin-off was to make such acquisitions). The 2001 temporary regulations were issued in response to numerous comments that immediate guidance was needed.¹⁶ Nevertheless, the preamble to the 2001 temporary regulations states, “The IRS and Treasury will continue to devote significant resources to analyzing the comments and, in the near

¹² 2000 Prop. Treas. Reg. § 1.355-7(f).

¹³ 2000 Prop. Treas. Reg. § 1.355-7(d)(2), (3).

¹⁴ We discussed the 2000 proposed regulations in detail in Mark J. Silverman & Lisa M. Zarlenga, New Proposed Section 355(e) Regulations—A Vast Improvement, 53 TAX EXEC. 55 (2001).

¹⁵ 66 Fed. Reg. 40,590 (2001).

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

future, expect to issue additional guidance regarding the interpretation of the phrase ‘plan (or series of related transactions).’”¹⁷

Finally, on April 23, 2002, Treasury and the Service issued revised temporary regulations to amend the 2001 temporary regulations (hereinafter the revised temporary regulations are referred to as the “temporary regulations”). Although the temporary regulations retain the overall facts-and-circumstances approach of the 2000 proposed regulations and 2001 temporary regulations, they further tighten up the definition of plan by focusing on whether there were bilateral discussions between the acquirer and Distributing or Controlled. In so doing, the temporary regulations carry out the purposes of section 355(e), reflect practical business considerations, and provide a great deal more certainty to taxpayers and the government.

III. HISTORY AND PURPOSE OF SECTION 355(e) AS IT RELATES TO PLAN

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 the enactment of section 355(e) that the legislative history intentionally omitted an explanation of what constitutes a plan.¹⁸ The staff member further stated that whether a plan exists will “always be a matter of facts and circumstances.”¹⁹ Nonetheless, the history of section 355(e) does provide some insight as to what is meant by a plan.

In 1996-1997, several companies undertook high profile leveraged Morris Trust transactions that more closely resembled sales, including Telecommunication, Inc.’s acquisition

¹⁷ 66 Fed. Reg. at 40,590.

¹⁸ See New Corporate Laws Beg For Interpretive Regs, 97 TNT 196-2 (Oct. 9, 1997).

¹⁹ Id.

of Viacom's cable business, Raytheon's acquisition of General Motors' military electronics business, and Knight Ridder's acquisition of Disney's newspaper business. These transactions generally involved borrowing a large sum of cash and separating the proceeds of the debt from the obligation to repay the debt so that the corporation to be acquired retained the liability. Immediately after the distribution of Controlled, either Distributing or Controlled (holding the liability) would effectively be acquired. These transactions drew the attention of lawmakers, who quickly set out to shut them down.

On February 6, 1997, the Clinton Administration, as part of its 1998 budget proposal, proposed anti-Morris Trust legislation to be included in section 355(d).²⁰ The Administration's proposal would have specifically excluded acquisitions of stock that were "unrelated" to the distribution. For this purpose, a transaction would be treated as unrelated if it were not "pursuant to a common plan or arrangement that includes the distribution."²¹ Thus, for example, public trading of the stock in either Distributing or Controlled would be disregarded, even if the trading occurred in contemplation of the distribution.²² Similarly, a hostile acquisition of Distributing or Controlled after the distribution would be disregarded. However, a friendly acquisition would generally be considered related to the distribution if it were "pursuant

²⁰ Department of the Treasury, General Explanation of the Administration's Revenue Proposals (Feb. 1997) (hereinafter Treasury Explanation of Revenue Proposals). This proposal first appeared, in substantially identical form, in the Clinton Administration's 1997 budget proposal, which was publicized in early 1996. See Department of the Treasury, General Explanation of the Administration's Revenue Proposals (Mar. 1996).

²¹ Treasury Explanation of Revenue Proposals, supra note 20, at 62.

²² Id. at 62-63.

to an arrangement negotiated (in whole or in part) prior to the distribution,” even if it were subject to certain conditions (e.g., shareholder approval) at the time of the distribution.²³

The Joint Committee on Taxation, in its analysis of the Administration’s proposal, suggested that the reason for the proposal was the “considerable publicity” surrounding transactions involving significant shifts in debt and creation of stock classes having voting rights disproportionate to the value of the stock, specifically citing the Viacom/TCI and GM/Hughes/Raytheon transactions.²⁴ The Joint Committee also stated:

In those cases in which it is intended that the ownership of a business will change in connection with a spin-off, it is argued that the tax-free provisions of section 355 should not apply at the corporate level, but rather the distributing corporation should be viewed as having disposed of a corporation and thus should not be exempt from tax at the corporate level.²⁵

Acting Assistant Secretary for Tax Policy Donald C. Lubick reiterated the Administration’s concern over disguised sales while testifying before Congress:

If a corporation has two businesses and wants to dispose of one in exchange for shares of another corporation, that cannot be done directly under the reorganization provisions.

Indeed, arrangements have been made for the use of Section 355, which allows divisive split-ups of corporate holdings to the shareholders of the corporation. One of those is carried out, and then the shares are immediately disposed of to a third party

²³ Id.

²⁴ 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 & notes 49-50 (Mar. 11, 1997).

²⁵ Id. at 52 (emphasis added).

corporation. In that case, the corporation avoids gain at the corporate level on the disposition of its assets.²⁶

On April 17, 1997, Bill Archer, Chairman of the House Ways and Means Committee, introduced legislation in the House of Representatives to restrict the use of section 355.²⁷ William Roth, Chairman of the Senate Finance Committee, and Daniel Moynihan, Ranking Minority Member of the Senate Finance Committee, introduced identical legislation in the Senate on the same date (collectively the “Archer/Roth/Moynihan bill”).²⁸ Similar to the Administration’s proposal, the Archer/Roth/Moynihan bill required recognition of corporate-level gain if either Distributing or Controlled was acquired. In their joint statement introducing the Archer/Roth/Moynihan bill, the legislators made it clear that the purpose for the bill was to shut down pre-arranged transactions similar to the highly publicized disguised sale transactions:

Several recent news reports described corporate acquisition transactions in which one corporation distributes the stock of one (or more) of its subsidiaries to its shareholders (in a so-called “spin-off”) and, pursuant to a pre-arranged plan, either the distributed subsidiary or the old parent corporation is acquired by another, unrelated corporation. Often, the corporation that is to be acquired borrows or assumes a large amount of debt incurred prior to the spin-off, while the proceeds of such indebtedness are retained by the other corporation. . . .

²⁶ Statement of Hon. Donald C. Lubick, Acting Assistant Secretary (Tax Policy), Department of the Treasury, Selected Revenue Raising Provisions, Senate Finance Committee (April 17, 1997) (emphasis added); see also Statement of Donald C. Lubick, Acting Assistant Secretary for Tax Policy, Department of the Treasury, Hearing on the Education and Training Tax Provisions of the Administration’s Fiscal Year 1998 Budget Proposal, House Ways & Means Committee (March 5, 1997) (stating that the goal of the proposal was to “prevent tax-free disguised sales of businesses”).

²⁷ H.R. 1365, 105th Cong. (1997).

²⁸ S. 612, 105th Cong. (1997).

Congress did not intend that section 355 apply to insulate these transactions from tax. Section 355 was intended to permit tax-free restructurings of several businesses among existing shareholders The recent transactions that raise concerns have very little to do with individual shareholder tax planning. Rather, they are pre-arranged structures designed to avoid corporate-level gain recognition. In essence, these transactions resemble sales.²⁹

The House and Senate bills were substantially similar to the Archer/Roth/Moynihan bill, and the enacted version of section 355(e) did not differ significantly from the House and Senate versions. Thus, one would infer that Congress' concept of plan likewise did not change. The Committee Reports point to the following "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.³⁰

Accordingly, the anti-Morris Trust provision contained in the Administration's budget proposal and then in the Archer/Roth/Moynihan bill (which was ultimately enacted as section 355(e) in TRA 1997), were clearly in response to certain highly publicized transactions that used significant shifts in debt and creation of stock classes with disproportionate voting rights in an effort to disguise what was, in effect, a sale as a tax-free reorganization (e.g., Viacom/TCI and GM/Hughes/Raytheon transactions). These highly publicized transactions involved prearranged acquisitions, the terms of which had been agreed upon between

²⁹ 143 Cong. Rec. E702 (daily ed. Apr. 17, 1997) (emphasis added).

³⁰ H.R. Rep. No. 105-148, at 462 (1997) (emphasis added); S. Rep. No. 105-33, at 130-40 (1997) (emphasis added).

Distributing and/or Controlled and the acquirer prior to the distribution. The term “plan” as used in section 355(e) must, therefore, be interpreted in light of this history.

IV. DISCUSSION OF TEMPORARY SECTION 355(e) REGULATIONS

In this section, we will briefly summarize the provisions of the temporary regulations, pointing out significant changes, and then analyze specific aspects of the temporary regulations.

A. Summary of Temp. Treas. Reg. § 1.355-7

1. General Rules

In general, whether a distribution and acquisition are part of a plan is determined based on all the facts and circumstances.³¹ As further discussed below, the temporary regulations set forth a number of nonexclusive factors that tend to show the presence or absence of a plan.³² The weight to be given each of the facts and circumstances depends on the particular case.³³ The temporary regulations also provide several safe harbors, which, if satisfied, preclude a finding of plan without the necessity of weighing the facts and circumstances.³⁴ There are also certain operating rules that apply for purposes of the entire regulation.³⁵

³¹ Temp. Treas. Reg. § 1.355-7T(b)(1).

³² Temp. Treas. Reg. § 1.355-7T(b)(3), (4).

³³ Temp. Treas. Reg. § 1.355-7T(b)(1).

³⁴ Temp. Treas. Reg. § 1.355-7T(d).

³⁵ Temp. Treas. Reg. § 1.355-7T(c).

A post-distribution acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition³⁶ at some time during the two-year period ending on the date of the distribution. This rule (hereinafter referred to as the “general plan rule”) acts as sort of a super safe harbor. If the requirements for the general plan rule are satisfied, there is no need to do a facts-and-circumstances analysis. The existence of an agreement, understanding, arrangement, or substantial negotiations during the two-year period tends to show that the distribution and acquisition are part of a plan, but such showing may still be rebutted using the safe harbors or the facts-and-circumstances approach. The general plan rule does not apply in the case of public offerings.³⁷ The following example illustrates the general plan rule.

Example 1: D, a publicly traded corporation, owns all of the stock of C. D distributes the C stock in order to reduce its financing costs. X approaches C one month after the distribution and acquires C five months after the distribution.

Because no agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition occurred during the two-year period ending on the date of the distribution, the acquisition is not part of a plan. As further discussed below, it is this rule, and the changes stemming therefrom, that set the temporary regulations apart from their predecessors.³⁸

³⁶ As further discussed below, the temporary regulations narrowed the definition of “similar acquisition.” See Part IV.B.4., infra.

³⁷ Temp. Treas. Reg. § 1.355-7T(b)(2).

³⁸ See Part IV.B.1., infra.

2. Safe Harbors

The temporary regulations contain seven safe harbors. If an acquisition and distribution fall within one of the safe harbors, then they are not treated as part of a plan, and the distributing corporation need not apply the facts-and-circumstances test, which is described below in Part IV.A.3.

a. Safe Harbor I – Non-acquisition business purpose

Safe Harbor I provides that a distribution and an acquisition occurring after the distribution are not part of a plan if: (i) the distribution was motivated in whole or substantial part by a business purpose other than a business purpose to facilitate an acquisition of the acquired corporation, and (ii) the acquisition occurred more than six months after the distribution (and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins one year before and ends six months after the distribution).³⁹

Example 2: D, a publicly traded corporation, owns all of the stock of C. D distributes the C stock in order to facilitate a 20% IPO by C. X approaches D eight months after the distribution and acquires D 12 months after the distribution.

In this example, D is the acquired corporation. Because the business purpose was not to facilitate the acquisition of the acquired corporation, and the acquisition occurred more than six months after the distribution, Safe Harbor I applies to the acquisition of D by X.⁴⁰ Nonetheless,

³⁹ Temp. Treas. Reg. § 1.355-7T(d)(1).

⁴⁰ Note that the general plan rule would also protect the acquisition of D by X in this example. See Part IV.B.3., infra, for a discussion of the overlap between the general plan rule and Safe Harbors I, II, and III.

Safe Harbor I would not protect either C's IPO or a subsequent acquisition of C stock, because the business purpose for the distribution was to facilitate an acquisition of C.

The conclusion in this example represents a change from the 2001 temporary regulations. Under the 2001 temporary regulations, Safe Harbor I referred to a business purpose other than to facilitate "an acquisition of Distributing or Controlled."⁴¹ Thus, Safe Harbor I was not available with respect to the acquisition of D in the example under the 2001 temporary regulations, because there was a business purpose to facilitate an acquisition of C. The temporary regulations fix this by requiring that the business purpose be to facilitate the acquisition of the "acquired corporation."⁴²

Safe Harbor I of the 2001 temporary regulations precluded an agreement, understanding, arrangement, or substantial negotiations "concerning the acquisition before a date that is six months after the distribution."⁴³ Thus, if substantial negotiations occurred several years before the distribution, Safe Harbor I would be unavailable. The temporary regulations appropriately limit the period to one year before the distribution. Further, because the 2001 temporary regulations limited negotiations to "the" acquisition, Safe Harbor I would be available if there were substantial negotiations regarding a similar acquisition. Treasury and the Service believed that Safe Harbor I should not be available in that situation and modified the temporary regulations to refer to a similar acquisition.⁴⁴

⁴¹ 2001 Temp. Treas. Reg. § 1.355-7T(f)(1).

⁴² See Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,634.

⁴³ 2001 Temp. Treas. Reg. § 1.355-7T(f)(1)(i)(A).

⁴⁴ See Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,634.

b. Safe Harbor II – Acquisition business purpose

Safe Harbor II provides that a distribution and acquisition occurring after the distribution will not be considered part of a plan if (i) the distribution was not motivated by a business purpose to facilitate the acquisition or a similar acquisition;⁴⁵ (ii) the acquisition occurred more than six months after the distribution (and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins one year before and ends six months after the distribution);⁴⁶ and (iii) no more than 25 percent of the stock of the acquired corporation was either acquired or subject to an agreement, understanding, arrangement, or substantial negotiations during the period that begins one year before and ends six months after the distribution.⁴⁷ For purposes of the 25-percent test, acquisitions of stock that are treated as not part of a plan pursuant to Safe Harbors V, VI, or VII (discussed below) are disregarded.

Example 3: D, a publicly traded corporation, owns all of the stock of C. D distributes the C stock in order to facilitate a 15% IPO by C. One month after the distribution, C issues 15% of its stock in an IPO. X approaches C eight months after the distribution and acquires C 12 months after the distribution.

In this example, Safe Harbor I would not apply to either the IPO or the acquisition of C by X, because C is the acquired corporation, and the business purpose for the distribution was to

⁴⁵ Note that the business purpose cannot be to facilitate “the” acquisition or a similar acquisition. Thus, Safe Harbor II applies if the distribution is motivated by an acquisition business purpose, as long as such acquisition is not the one being tested.

⁴⁶ The changes discussed above that were made to the time limitation for an agreement, understanding, arrangement, or substantial negotiations in Safe Harbor I were likewise made to Safe Harbor II.

⁴⁷ Temp. Treas. Reg. § 1.355-7T(d)(2).

facilitate an acquisition of C. Likewise, Safe Harbor II would not protect C's IPO. However, Safe Harbor II would protect X's acquisition of C, because the business purpose was not to facilitate that acquisition or a similar acquisition, the acquisition occurred more than six months after the distribution, and less than 25 percent of C's stock was acquired one year before and six months after the distribution.⁴⁸ Note that if C had issued 30 percent of its stock in the IPO, Safe Harbor II would be unavailable to protect X's subsequent acquisition of C.

The temporary regulations simplified Safe Harbor II by adopting a single percentage limitation. The 2001 temporary regulations provided that Safe Harbor II was only available if the amount of stock subject to the acquisition business purpose was not more than 33 percent, and the amount actually acquired before six months after the distribution was not more than 20 percent.⁴⁹

c. Safe Harbor III – Negotiations more that one year out

Safe Harbor III provides that a distribution and acquisition occurring after the distribution will not be considered part of a plan if there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition at the time of the distribution or within one year after the distribution.⁵⁰ This Safe Harbor replaces Safe Harbor III in 2001 temporary regulations, which provided that an acquisition and distribution were not part of a plan if the acquisition occurred more than 2 years after the

⁴⁸ Note that the general plan rule would also protect the acquisition of C by X in this example. See Part IV.B.3., infra, for a discussion of the overlap between the general plan rule and Safe Harbors I, II, and III.

⁴⁹ 2001 Temp. Treas. Reg. § 1.355-7T(f)(2).

⁵⁰ Temp. Treas. Reg. § 1.355-7T(d)(3).

distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within six months thereafter.⁵¹

d. Safe Harbor IV – Acquisitions more than two years before distribution

Safe Harbor IV provides that if an acquisition occurs more than two years before a distribution, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter, the acquisition and distribution are not part of a plan.⁵²

e. Safe Harbor V - Public trading

Safe Harbor V provides a safe harbor for public trading of Distributing or Controlled stock listed on an established market if, immediately before or after the transfer, none of the transferor, transferee, and any coordinating group⁵³ of which either the transferor or transferee is a member is: (i) the acquired corporation (Distributing or Controlled); (ii) a corporation controlled by the acquired corporation; (iii) a member of a controlled group of corporations of which the acquired corporation is a member; (iv) an underwriter with respect to

⁵¹ 2001 Temp. Treas. Reg. § 1.355-7T(f)(3).

⁵² Temp. Treas. Reg. § 1.355-7T(d)(4).

⁵³ A coordinating group is defined as two or more persons that, pursuant to a formal or informal understanding, join in one or more coordinated acquisitions or dispositions of stock of Distributing or Controlled. Temp. Treas. Reg. § 1.355-7T(h)(4). A principal element in determining whether such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more existing or prospective shareholders. Id.

such acquisition; (v) a controlling shareholder⁵⁴ of the acquired corporation; or (vi) a 10-percent shareholder⁵⁵ of the acquired corporation.⁵⁶ Thus, Safe Harbor V does not apply to stock repurchase programs or other redemptions by Distributing or Controlled (or a related corporation) or to underwritten public offerings. Safe Harbor V also does not apply to a transfer of stock by or to a person if the corporation knows or has reason to know that the person intends to become a controlling shareholder or a 10-percent shareholder at any time after the acquisition and before the date that is two years after the distribution.⁵⁷ Note that such acquisitions may still not constitute a plan under the facts-and-circumstances analysis.

If a transfer of stock results immediately, or upon a subsequent event or the passage of time, in an indirect acquisition of voting power by a person other than the transferee, then Safe Harbor V does not prevent the acquisition of voting power by such other person from

⁵⁴ A controlling shareholder of a public corporation is defined as a shareholder who owns, actually or constructively under section 318, stock of the corporation and actively participates in the management or operation of the corporation. Temp. Treas. Reg. § 1.355-7T(h)(3)(i), (h)(7). A controlling shareholder of a non-public corporation is defined as any person that owns, actually or constructively under section 318, stock possessing voting power representing a meaningful voice in the governance of the corporation. Temp. Treas. Reg. § 1.355-7T(h)(3)(ii). Note that the temporary regulations apply attribution rules in determining whether a person is a controlling shareholder, as contrasted with the aggregation-type approach in the 2001 temporary regulations (which counted stock owned by any person, directly or indirectly, or together with related persons). See 2001 Temp. Treas. Reg. § 1.355-7T(k)(3)(i).

⁵⁵ This was increased from five percent in the 2001 temporary regulations. See 2001 Temp. Treas. Reg. § 1.355-7T(f)(5)(i). In determining whether a person is a 10-percent shareholder, the constructive ownership rules of section 318 apply. Absent actual knowledge that a person is a 10-percent shareholder, a corporation may rely on Schedules 13D and 13G (or similar schedules) filed with the Securities and Exchange Commission. Temp. Treas. Reg. § 1.355-7T(h)(9).

⁵⁶ Temp. Treas. Reg. § 1.355-7T(d)(5)(i).

⁵⁷ Temp. Treas. Reg. § 1.355-7T(d)(5)(ii)(A).

being treated as part of a plan.⁵⁸ This limitation was intended to preclude vote-shifting transactions from seeking refuge in Safe Harbor V.

Example 4: D, a publicly traded corporation, owns all of the stock of C. D distributes C to facilitate an acquisition of X, a closely held corporation, using D stock as consideration. Simultaneously with the distribution, in a recapitalization, D creates two classes of stock, Class A and B, each of which is entitled to 10 votes per share. Upon a disposition of a share of Class B stock by its original holder, however, the number of votes is reduced to one. In the spin-off, D's shareholders exchange their existing D stock for Class B shares. After the spin-off, X merges into D, with X's shareholders receiving Class A shares. Immediately after the merger, D's shareholders own 51% of the D stock. However, as expected, D's historic shareholders trade their Class B stock on the market, resulting in an indirect increase in the voting power of the Class A shares to 52%.

Safe Harbor V protects the transferor and transferee in the Class B stock trades, but does not protect the indirect acquisition of voting power by the Class A shareholders.⁵⁹ Query whether the indirect acquisition of voting power constitutes an "acquisition" within the meaning of section 355(e). The temporary regulations do not address the issue of what constitutes an acquisition and thus do not provide guidance on this issue. The shift of voting power may not, itself, be an acquisition, but rather may be viewed as tied to the acquisition of the Class B stock.

This vote-shifting provision was not contained in the 2001 temporary regulations and thus adds an additional limit and an additional layer of complexity to the temporary regulations. During a recent meeting of the American Bar Association Tax Section, government

⁵⁸ Temp. Treas. Reg. § 1.355-7T(d)(5)(ii)(B).

⁵⁹ See Temp. Treas. Reg. § 1.355-7T(j), Ex. 5. This example presents facts very similar to the transaction in which Smuckers acquired Jif. Allan Sloan, Smucker Family Would Preserve Control of its Company in Deal to Buy Jif, THE WASHINGTON POST Oct. 16, 2001, at E03.

representatives indicated that, even though the rule was not explicit in the 2001 temporary regulations, Safe Harbor V did not, by its terms, necessarily apply to the shift in voting rights.⁶⁰ Thus, the government's position appears to be that this provision is a clarification of the 2001 temporary regulations.

The temporary regulations correct a technical glitch with the 2001 temporary regulations. The 2001 temporary regulations applied to transfers "between shareholders," which implies that the public trading must occur between existing shareholders.⁶¹

f. Safe Harbor VI - Compensatory stock arrangements

Safe Harbor VI provides a safe harbor for compensatory stock arrangements. Safe Harbor VI provides that if the stock of the distributing or controlled corporation is acquired by an employee, director, or independent contractor of Distributing, Controlled, or a related person in connection with the performance of services in a transaction to which section 83 or section 421(a) applies, the acquisition is not part of a plan.⁶² Safe Harbor VI does not apply if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a ten-percent shareholder of the acquired corporation immediately after the acquisition.⁶³ This exception was intended to exclude management leveraged buy-outs and going private transactions from the scope of Safe Harbor VI.⁶⁴ The temporary regulations

⁶⁰ American Bar Association, Tax Section, Corporate Tax Committee meeting (May 11, 2002).

⁶¹ See 2001 Temp. Treas. Reg. § 1.355-7T(f)(5).

⁶² Temp. Treas. Reg. § 1.355-7T(d)(6)(i).

⁶³ Temp. Treas. Reg. § 1.355-7T(d)(6)(ii).

⁶⁴ See Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,635.

expanded the scope of Safe Harbor VI contained in the 2001 temporary regulations to apply to independent contractors and incentive stock option plans.⁶⁵

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

g. Safe Harbor VII – Qualified plans

The temporary regulations added a new Safe Harbor VII to provide that an acquisition of stock by a retirement plan of an employer that qualifies under section 401(a) or 403(a) will not be considered part of a plan.⁶⁶ This Safe Harbor does not apply to the extent the stock acquired by all qualified plans of the employer and any other person treated as the same employer under section 414(b), (c), (m), or (o) during the four year period beginning two years before the distribution, in the aggregate, represents 10 percent or more of the stock of the acquired corporation (by vote or value).⁶⁷

3. Facts-and-Circumstances Test

If an acquisition does not fall within one of the Safe Harbors above, then a facts-and-circumstances approach must be applied to determine whether a distribution and acquisition are part of a plan. The temporary regulations set forth a number of non-exclusive factors that tend to show the presence or absence of a plan.⁶⁸ The weight to be given each of the facts and

⁶⁵ See 2001 Temp. Treas. Reg. § 1.355-7T(f)(6).

⁶⁶ Temp. Treas. Reg. § 1.355-7T(d)(7)(i).

⁶⁷ Temp. Treas. Reg. § 1.355-7T(d)(7)(ii).

⁶⁸ Temp. Treas. Reg. § 1.355-7T(b)(3), (4).

circumstances depends on the particular case, and the existence of a plan is not determined merely by comparing the number of plan and non-plan factors.⁶⁹

a. Plan factors

The temporary regulations list five factors that tend to show the existence of a plan:⁷⁰

Post-Distribution Acquisitions:

1. Non-public offering – At some time during the two-year period ending on the date of the distribution, there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition.⁷¹
2. Public offering – At some time during the two-year period ending on the date of the distribution, there were discussions by Distributing or Controlled with an investment banker regarding the acquisition or a similar acquisition.

Pre-Distribution Acquisitions:

3. Non-public offering – At some time during the two-year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with the acquirer regarding a distribution, or a person other than Distributing or Controlled that intends to cause a distribution can, as a result of the acquisition, meaningfully participate in the decision regarding whether to make a distribution.⁷²
4. Public offering – At some time during the two-year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with an investment banker regarding a distribution.

Either Pre- or Post-Distribution Acquisition:

⁶⁹ Temp. Treas. Reg. § 1.355-7T(b)(1).

⁷⁰ Temp. Treas. Reg. § 1.355-7T(b)(3)(i)-(v).

⁷¹ Note that this plan factor mirrors the general plan rule.

⁷² Note that the two-year period is measured from the date of the acquisition and not the date of the distribution. Thus, discussions regarding the distribution can occur after the acquisition, as long as the acquirer cannot meaningfully participate in the decision to distribute.

5. In the case of either a pre- or post-distribution acquisition, the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition.

b. Non-plan factors

The temporary regulations list six factors that tend to refute the existence of a plan:⁷³

Post-Distribution Acquisitions:

1. Public offering – During the two-year period ending on the date of the distribution, there were no discussions by Distributing or Controlled with an investment banker regarding the acquisition or a similar acquisition.
2. In the case of any post-distribution acquisition, there was an identifiable, unexpected change in market or business conditions occurring after the distribution that resulted in the acquisition that was otherwise unexpected at the time of the distribution.

Pre-Distribution Acquisitions:

3. Non-public offering – During the two-year period ending on the date of the acquisition, there were no discussions by Distributing or Controlled with the acquirer regarding a distribution. This factor does not apply if the acquisition occurs after the date of the public announcement of the planned distribution. This factor also does not apply if a person other than Distributing or Controlled that intends to cause a distribution can, as a result of the acquisition, meaningfully participate in the decision regarding whether to make a distribution.
4. In the case of any pre-distribution acquisition, there was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.

Either Pre- or Post-Distribution Acquisition:

5. In the case of any pre- or post-distribution acquisition, the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition.
6. In the case of any pre- or post-distribution acquisition, the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition.

⁷³ Temp. Treas. Reg. § 1.355-7T(b)(4)(i)-(vi).

- c. Summary of changes to factors from 2001 temporary regulations
 - (i) De-emphasize discussions for post-distribution acquisitions

Perhaps the most significant change to the plan and non-plan factors between the temporary regulations and the 2001 temporary regulations is that discussions are no longer a relevant factor in the case of post-distribution acquisitions. This is because of the general plan rule discussed above that a post-distribution acquisition can only be part of a plan if there was an agreement, understanding, arrangement, or substantial negotiations at some time during the two-year period before the distribution.⁷⁴ Mere discussions are insufficient and, therefore, are deleted from the plan and non-plan factors regarding post-distribution acquisitions.

- (ii) Discussions defined

The temporary regulations also provide a definition of “discussions,” which was not present in the 2001 temporary regulations. Discussions by Distributing or Controlled are defined to require discussions by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled. Similarly, discussions with the acquirer generally require discussions with the acquirer or a person with the implicit or explicit permission of the acquirer.⁷⁵ The two-year time limitation contained in the general plan rule has also appropriately made its way into the plan and non-plan factors dealing with discussions in the case of pre-distribution acquisitions and public offerings.

⁷⁴ Temp. Treas. Reg. § 1.355-7T(b)(2).

⁷⁵ Temp. Treas. Reg. § 1.355-7T(h)(5).

(iii) Number of factors reduced

The temporary regulations reduce the number of plan factors from nine to six, and the number of non-plan factors from seven to six. Even though the factors are nonexclusive, the reduction in the number of facts does result in simplified rules. The temporary regulations delete the following plan factors contained in the 2001 temporary regulations: (i) that the acquisition and distribution occur within six months of each other (or there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction within six months after the first transaction); (ii) that the debt allocation between the distributing and controlled corporation make an acquisition of either corporation likely in order to service the debt; and (iii) in the case of a pre-distribution acquisition, that Distributing or Controlled discussed a distribution with a potential acquirer and a similar acquisition occurred.⁷⁶ The non-plan factor relating to discussions in the context of a post-distribution acquisition was deleted because of the adoption of the general plan rule.⁷⁷

(iv) Delete references to auctions and other outside advisors

In the plan and non-plan factors involving public offerings, references to “auctions” and to discussions with “other outside advisers” have been deleted, and the concept of “similar acquisitions” has been added in the case of post-distribution public offerings.⁷⁸ Treasury and the Service eliminated the distinction between auctions and other non-public offering acquisitions, because they believed it was difficult to define auction in a manner that

⁷⁶ 2001 Temp. Treas. Reg. § 1.355-7T(d)(2)(viii), (ix), (v).

⁷⁷ 2001 Temp. Treas. Reg. § 1.355-7T(d)(3)(i).

⁷⁸ 2001 Temp. Treas. Reg. § 1.355-7T(d)(2)(iii), (vi), (d)(3)(ii).

would identify those situations where it was appropriate to apply the special auction rules.⁷⁹

References to other outside advisors were apparently deleted because, unlike investment bankers, other outside advisors cannot assist with the economic terms of the offering or otherwise facilitate the offering.⁸⁰

(v) Eliminate weighing in business purpose non-plan factor

Although the non-plan business purpose factor is substantively the same as it was in the 2001 temporary regulations, the temporary regulations delete the following sentence that appeared in the 2001 temporary regulations: “The presence of a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled is relevant in determining the extent to which the distribution was motivated by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled.”⁸¹ This sentence was apparently deleted because it essentially duplicated the weighing of business purposes required by Treas. Reg. § 1.355-2(b)(2).⁸²

⁷⁹ Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,633.

⁸⁰ American Bar Association, Tax Section, Corporate Tax Committee meeting (May 11, 2002).

⁸¹ 2001 Temp. Treas. Reg. § 1.355-7T(d)(3)(vi).

⁸² American Bar Association, Tax Section, Corporate Tax Committee meeting (May 11, 2002).

(vi) Meaningful participation in distribution decision

Finally, in the context of pre-distribution acquisitions, the temporary regulations have added the concept that where a person that intends to cause a distribution, the fact that that person acquires a sufficient interest to meaningfully participate in the decision regarding whether to make the distribution is evidence of a plan.

4. Operating Rules

Like the 2001 temporary regulations, the temporary regulations contain certain operating rules that apply for purposes of the regulations. The 2001 temporary regulations contained an operating rule stating that reasonable certainty that an acquisition will occur is evidence of an acquisition business purpose.⁸³ In light of the temporary regulations' focus on the need for bilateral negotiations, the temporary regulations delete the reasonable certainty operating rule.⁸⁴ In addition, the 2000 proposed regulations provided as an operating rule that the running of any time period is suspended for any period during which risk of loss is substantially diminished under the principles of section 355(d)(6)(B).⁸⁵ The 2001 temporary regulations "reserved" on the rule.⁸⁶ The temporary regulations completely remove this rule. However, the preamble to the temporary regulations notes that Treasury and the Service continue to consider the proper application of this rule.⁸⁷

⁸³ 2001 Temp. Treas. Reg. § 1.355-7T(e)(1).

⁸⁴ Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,635.

⁸⁵ 2000 Prop. Treas. Reg. § 1.355-7(e)(6).

⁸⁶ 2001 Temp. Treas. Reg. § 1.355-7T(e)(6).

⁸⁷ Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,635.

The temporary regulations retained the other operating rules of the 2001 temporary regulations with a few modifications. First, internal discussions and discussions with outside advisors by or on behalf of officers or directors of Distributing or Controlled may be indicative of one or more business purposes for the distribution.⁸⁸ The 2001 temporary regulations did not provide any guidance as to who had to engage in such internal discussions, but the temporary regulations clarify that such discussions must occur between officers or directors. The temporary regulations also broadened the operating rule by adding the reference to discussions with outside advisors, which was not present in the 2001 temporary regulations.⁸⁹

Second, the temporary regulations provide that if Distributing engages in discussions with a potential acquirer regarding an acquisition of Distributing or Controlled and distributes the Controlled stock intending, in whole or substantial part, to decrease the likelihood of the acquisition of Distributing or Controlled by separating it from another corporation that is likely to be acquired, then Distributing will be treated as having an acquisition business purpose.⁹⁰ The hostile takeover rule differs from that contained in the 2001 temporary regulations in that it refers to discussions between Distributing and a potential acquirer. It is not clear whether the potential acquirer is intended to refer to the hostile acquirer or to some other potential acquirer. The former interpretation seems more reasonable, because the latter would make the hostile takeover rule depend on the happenstance that Distributing engaged in discussions on a completely unrelated acquisition.

⁸⁸ Temp. Treas. Reg. § 1.355-7T(c)(1).

⁸⁹ See 2001 Temp. Treas. Reg. § 1.355-7T(e)(2).

⁹⁰ Temp. Treas. Reg. § 1.355-7T(c)(2).

Third, the temporary regulations retain the rule that all acquisitions of stock that are considered to be part of a plan are aggregated for purposes of the 50-percent test.⁹¹

Fourth, the temporary regulations retain the operating rules that none of (i) the fact that the distribution made Controlled stock available for trading or made it trade more actively, (ii) the consequences of section 355(e), and (iii) the existence of a contractual indemnity by Controlled resulting from the application of section 355(e) to an acquisition of Controlled are taken into account in determining whether there was a plan.⁹²

5. Agreement, Understanding, Arrangement, or Substantial Negotiations

The temporary regulations retain the phrase “agreement, understanding, arrangement or substantial negotiations” contained in the 2001 temporary regulations. Like the 2001 temporary regulations, the temporary regulations state that whether an agreement, understanding, or arrangement exists depends on the facts and circumstances—the parties do not necessarily have to enter into a binding contract or reach an agreement on all significant economic terms.⁹³ Unlike the 2001 temporary regulations, however, the temporary regulations provide some much-needed guidance as to what constitutes “substantial negotiations”:

Substantial negotiations in the case of an acquisition (other than involving a public offering) generally require discussions of significant economic terms, e.g., the exchange ratio in a reorganization, by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or

⁹¹ Temp. Treas. Reg. § 1.355-7T(c)(5).

⁹² Temp. Treas. Reg. § 1.355-7T(c)(3)-(4).

⁹³ Temp. Treas. Reg. § 1.355-7T(h)(1)(i).

Controlled, with the acquirer or a person or persons with the implicit or explicit permission of the acquirer.⁹⁴

In the case of a public offering, an agreement, understanding, arrangement, or substantial negotiations will be based on discussions by one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled, with an investment banker.⁹⁵ The 2001 temporary regulations contained a statement that in the context of a public offering, an agreement, understanding, arrangement, or substantial negotiations could exist even though an acquirer had not been specifically identified, but such statement was removed by the temporary regulations.⁹⁶

Like the 2001 temporary regulations, the temporary regulations treat certain options as agreements. If stock is acquired pursuant to an option, the option is treated as an agreement, understanding, or arrangement to acquire stock on the earliest of (i) the date the option is granted, (ii) the date the option is transferred, or (iii) the date the option is modified. In all three cases, the option must be more likely than not to be exercised as of the relevant date.⁹⁷ This differs from the 2001 temporary regulations, which provided that the option would be treated as an agreement on the date of grant, unless the taxpayer established that the option was not more likely than not to be exercised as of the later of the date of grant or the date of the

⁹⁴ Temp. Treas. Reg. § 1.355-7T(h)(1)(ii) (emphasis added).

⁹⁵ Temp. Treas. Reg. § 1.355-7T(h)(1)(iii).

⁹⁶ Compare Temp. Treas. Reg. § 1.355-7T(h)(1)(iii), with 2001 Temp. Treas. Reg. § 1.355-7T(k)(1).

⁹⁷ Temp. Treas. Reg. § 1.355-7T(e)(1)(i).

distribution.⁹⁸ This change was in response to comments that the date of the distribution should not be relevant in testing for the existence of a plan.⁹⁹

As in the 2001 temporary regulations, the term “option” is defined broadly to include call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements (including rights to cause the redemption of stock), any other instrument that provides for the right or possibility to issue, redeem, or transfer stock (including an option on an option), or any other similar interests.¹⁰⁰ Certain instruments continue to be excluded from the definition of an option, unless such instruments are granted, transferred, modified, or listed with a principal purpose of avoiding the application of section 355(e). Excluded instruments include options provided to employees, directors, or independent contractors of Distributing, Controlled, or a related corporation in connection with the performance of services that (i) is described in section 421(a), or (ii) is nontransferable within the meaning of § 1.83-3(d) and does not have a readily ascertainable fair market value as defined in § 1.83-7(b).¹⁰¹ Excluded instruments also include options that are part of a security arrangement in a typical lending transaction, options that are exercisable only upon death, disability, mental incompetency, or separation from service, bona fide rights of first refusal, and any other

⁹⁸ 2001 Temp. Treas. Reg. § 1.355-7T(g)(1)(i).

⁹⁹ Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,635.

¹⁰⁰ Temp. Treas. Reg. § 1.355-7T(e)(2).

¹⁰¹ Temp. Treas. Reg. § 1.355-7T(e)(3)(ii). Note that, as with the Safe Harbor VI, the temporary regulations expanded the rule to apply to options granted to independent contractors and incentive stock options under section 421(a).

instrument designated by the Service in revenue procedures, notices, or other published guidance.¹⁰²

6. Effective Date

The temporary regulations are generally effective for distributions occurring after April 26, 2002.¹⁰³ For distributions occurring prior to that date, taxpayers may apply the temporary regulations retroactively. Any retroactive application of the temporary regulations must, however, be in whole and not in part. If the distribution occurs after August 3, 2001 (the effective date of the 2001 temporary regulations) and before April 26, 2002, the 2001 temporary regulations apply if the taxpayer does not apply the temporary regulations.¹⁰⁴

B. Analysis of Certain Provisions in the Temporary Regulations

1. General Plan Rule

Perhaps the most significant change that the temporary regulations made was to tighten up the definition of plan (in the context of non-public offering transactions) by adopting the general plan rule, which focuses on whether there was a bilateral agreement, understanding, arrangement, or substantial negotiations between the acquirer and Distributing or Controlled concerning the significant economic terms of the acquisition.¹⁰⁵ Even if such an agreement,

¹⁰² Temp. Treas. Reg. § 1.355-7T(e)(3)(i), (iii), (iv), and (v).

¹⁰³ Temp. Treas. Reg. § 1.355-7T(k).

¹⁰⁴ Id.

¹⁰⁵ See Temp. Treas. Reg. § 1.355-7T(b)(2) (providing that a post-distribution acquisition (other than one involving a public offering) can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the two-year period ending on the date of the distribution); Temp. Treas. Reg. § 1.355-7T(h)(1)(ii) (providing that substantial negotiations generally require

(Continued ...)

understanding, arrangement, or substantial negotiations were entered into, it is not fatal to the distribution. The taxpayer can still rebut the presumption of a plan using the Safe Harbors or the facts-and-circumstances approach.

Example 5: D, a publicly traded corporation, owns all of the stock of C. D announces that it will distribute C because D's customers compete with C and as a result are threatening to discontinue business with D. After the announcement, X unexpectedly becomes available as an acquisition target, and D and X enter into an agreement for the acquisition of X by D using D stock as consideration. D spins off C as planned and acquires X one month later.

Because the distribution was (and continues to be) motivated by a non-acquisition business purpose and would have occurred at approximately the same time and in similar form regardless of the acquisition, the fact that an agreement existed at the time of the distribution should not cause the acquisition to be part of a plan.¹⁰⁶

Some practitioners have suggested that the general plan rule is too pro-taxpayer, because it permits Distributing or Controlled to “shop” themselves before doing the spin-off as long as they do not go too far in the negotiations.¹⁰⁷ However, during a recent meeting of the American Bar Association Tax Section, government representatives indicated that the general

discussions of significant economic terms between officers or directors of Distributing or Controlled and the acquirer).

¹⁰⁶ See Temp. Treas. Reg. § 1.355-7T(b)(2); cf. Temp. Treas. Reg. § 1.355-7T(j), Ex. 4 (involving a pre-spin acquisition).

¹⁰⁷ See Sheryl Stratton, New Anti-Morris Trust Rules Please Practitioners, 2002 TNT 81-4 (Apr. 25, 2002) (hereinafter “New Anti-Morris Trust Rules”).

plan rule was not viewed as a substantial change—instead of forcing taxpayers into the facts-and-circumstances approach, it provides a bright-line rule.¹⁰⁸

Moreover, the general plan rule is perfectly consistent with the legislative intent of section 355(e). As is clear from the legislative history discussed above, the Clinton Administration and Congress were concerned with pre-arranged transactions that, in effect, were sales disguised as tax-free reorganizations. In the targeted transactions, the distribution was an integral part of the acquisition, and each step was set out in a binding agreement. A corporation intending to engage in such a disguised sale is not likely to incur the time and expense of a distribution absent at least discussion of the significant economic terms of the acquisition.

The requirement of bilateral negotiations provides much-needed certainty to taxpayers and the government in applying section 355(e). It is not uncommon for corporations, as part of their ongoing strategic planning, to consider acquisition opportunities to expand their businesses. Such corporations often engage in discussions with many different target corporations with respect to possible acquisitions, most of which never transpire. The 2001 temporary regulations severely limited the ability of corporations to engage in these types of activities. Mere discussions with a potential acquirer, or even purely internal discussions, could have been sufficient to constitute a plan under the 2001 temporary regulations. The uncertainty was even greater if the corporation was operating in a hot market. In such case, under the 2001 temporary regulations, the taxpayer would have to show that its stated business purpose for the distribution remained substantial in light of the reasonable certainty that the corporation would

¹⁰⁸ American Bar Association, Tax Section, Corporate Tax Committee meeting (May 11, 2002).

be acquired and/or that the distribution would have occurred at the same time and in similar form regardless of the acquisition.¹⁰⁹ Under the temporary regulations, merely distributing a controlled corporation into a hot market does not give rise to a plan.¹¹⁰

Accordingly, by requiring bilateral negotiations on significant economic terms, the temporary regulations carry out the purposes of section 355(e), reflect practical business considerations, and provide a great deal more certainty to taxpayers and the government.

2. Termination of Negotiations

The temporary regulations permit parties to engage in substantial negotiations, provided such negotiations are completely terminated and not resumed for some period of time. This rule is not contained in any particular provision of the temporary regulations but result from several, sometimes overlapping, provisions. First, the general plan rule provides that the distribution and acquisition are not part of a plan if there was no agreement, understanding, arrangement, or substantial negotiations during the two-year period preceding the distribution.¹¹¹ Second, Safe Harbors I and II provide that there can be no agreement, understanding, arrangement, or substantial negotiations during the period that begins one year before, and ends six months after, the distribution.¹¹² Third, Safe Harbor III provides that the distribution and acquisition are not part of a plan if there was no agreement, understanding, or arrangement at the time of the distribution, and there was no agreement, understanding, arrangement, or substantial

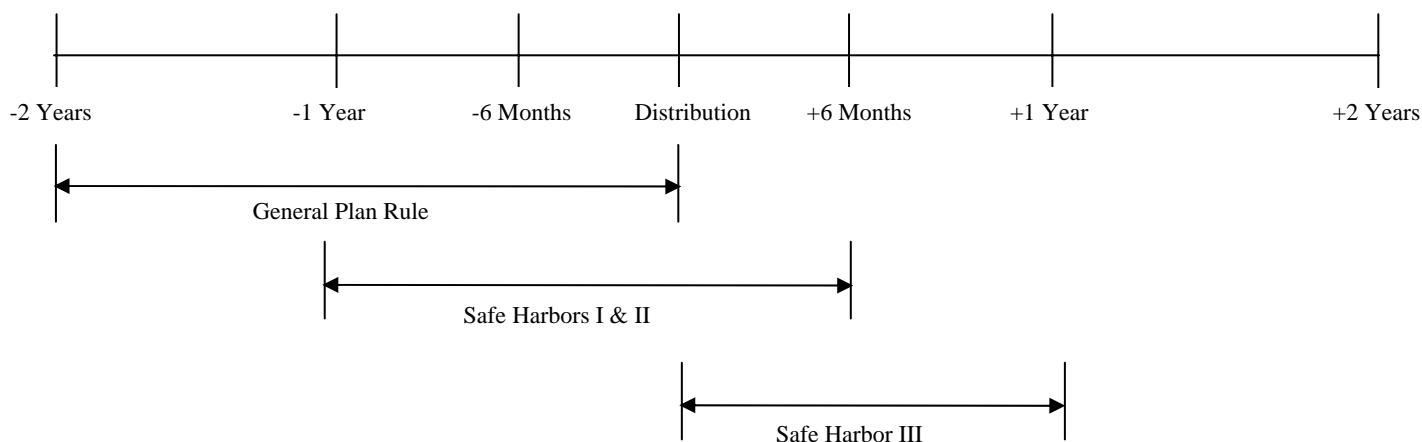
¹⁰⁹ See 2001 Temp. Treas. Reg. § 1.355-7T(m), Ex. 5.

¹¹⁰ See Temp. Treas. Reg. § 1.355-7T(j), Ex. 3.

¹¹¹ Temp. Treas. Reg. § 1.355-7(b)(2).

¹¹² Temp. Treas. Reg. § 1.355-7T(d)(1)(ii), (d)(2)(i)(B).

negotiations within one year after the distribution.¹¹³ Thus, the negotiation “blackout” periods can be illustrated as follows:



Thus, the shorter before the distribution that the parties terminated negotiations, the longer the period after the distribution the parties must wait to resume them.

It is not clear, however, when negotiations will be viewed as having terminated. Will suspension of negotiations for the blackout period be sufficient? Or does Distributing need to show that it rejected the acquirer’s proposal? The language of the provisions imposing the blackout periods suggests that suspension of negotiations is sufficient. Safe Harbors I and II and the general plan rule simply require that there be no substantial negotiations “during” the blackout period.¹¹⁴ The Preamble to the temporary regulations also suggests that this was the intent of the regulations:

¹¹³ Temp. Treas. Reg. § 1.355-7T(d)(3).

¹¹⁴ See Temp. Treas. Reg. §§ 1.355-7T(b)(2) (negotiations “at some time during the 2-year period ending on the date of the distribution”); -7T(d)(1)(ii) (negotiations “during the period that begins 1 year before the distribution and ends 6 months thereafter”); -7T(d)(2)(i)(B) (same).

Safe Harbors I and II of the 2001 proposed regulations, therefore, are not available if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition at any time prior to the distribution. Commentators, however, suggested that not all pre-distribution substantial negotiations should prevent those Safe Harbors from being available. In particular, a number of commentators suggested that, even if the relevant parties engage in substantial negotiations regarding an acquisition prior to a distribution, provided that those negotiations terminate without agreement prior to the distribution and do not resume until 6 months or 1 year after the distribution, those substantial negotiations should not cause Safe Harbors I and II of the 2001 proposed regulations to be unavailable. After consideration of these comments, the IRS and Treasury have decided that an agreement, understanding, arrangement, or substantial negotiations concerning the acquisition should make Safe Harbors I and II unavailable only if such events exist or occur during the period that begins 1 year prior to the distribution and ends 6 months thereafter.¹¹⁵

Safe Harbor III contains somewhat different language—for purposes of Safe Harbor III, there can be no substantial negotiations “within 1 year after the distribution.”¹¹⁶ However, there is no indication that Treasury and the Service intended to incorporate a different rule regarding termination of negotiations. Final regulations should clarify this. Taxpayers should be prepared to show that negotiations were truly suspended. For example, if D and a potential acquirer suspend negotiations with the understanding that such negotiations would resume after the blackout period, the government might assert that there was an understanding or arrangement during the blackout period.

What if negotiations are terminated, but discussions that do not rise to the level of substantial negotiations occur during the blackout period?

¹¹⁵ Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,634 (emphasis added).

¹¹⁶ Temp. Treas. Reg. § 1.355-7T(d)(3).

Example 6: D, a publicly traded corporation, owns all of the stock of C. D distributes the C stock in order to reduce its financing costs. D and X entered into substantial negotiations 15 months before the distribution, but they could not reach any agreement, so negotiations terminated. Then, 10 months before the distribution, X approaches D with a new proposal. The proposal is discussed only in general terms; there is no discussion of significant economic terms. D informs X that it is not interested.

Based on the language of the blackout provisions, the negotiations between D and X should be viewed as terminating 15 months before the distribution, and Safe Harbors I, II, and III ought to be available.

3. Overlap Between General Plan Rule and Safe Harbors I, II, and III

As illustrated in the timelines above, there appears to be significant overlap between the general plan rule and Safe Harbors I, II, and III. The following chart summarizes the requirements of each:

<u>Requirements</u>	<u>General Plan Rule</u>	<u>Safe Harbor I</u>	<u>Safe Harbor II</u>	<u>Safe Harbor III</u>
Post-distribution acquisition	X	X	X	X
Not a public offering	X			
Blackout period	2 years before	1 year before & 6 months after	1 year before & 6 months after	At time of distribution & 1 year after
Non-acquisition business purpose for distribution		X		
Acquisition business purpose for distribution, but different acquisition being tested			X	
Acquisition more than 6 months after distribution		X	X	
Acquisition more than 1 year after distribution				X*
No more than 25% of stock acquired, or subject to an agreement, understanding, arrangement or substantial negotiations 1 year before & 6 months after			X	

* Presumably, if there cannot be an agreement, understanding, arrangement, or substantial negotiations for one year after the distribution, the acquisition cannot occur for one year after the distribution.

As illustrated by the chart, the general plan rule has the fewest requirements to satisfy and thus would appear to be the “safe harbor” of choice in most cases. However, if the acquisition involves a public offering or negotiations occurred during the two-year period before the distribution, the taxpayer will have to look to one of the Safe Harbors. Thus, Safe Harbors I, II, and III do not appear to be relevant unless the acquisition involved a public offering or negotiations occurred between 12 and 24 months before the distribution. In those cases, taxpayers must satisfy additional requirements before they can rebut the existence of a plan.

It is not clear why Treasury and the Service adopted this sliding scale approach. Although complicated, it does appear to offer flexibility to taxpayers while weeding out those

pre-arranged disguised sales that were the intended target of section 355(e). For example, parties can negotiate regarding the significant economic terms up until the date of the distribution, but they cannot enter into an agreement, understanding, or arrangement before the distribution, and they have to wait one full year before resuming substantial negotiations (Safe Harbor III). One year is a long time in the corporate world—a lot of things can change in the interim. An acquisition under such circumstances can hardly be characterized as a pre-arranged disguised sale. On the flip side, parties can begin substantial negotiations immediately after the distribution (the general plan rule). Again, where negotiations do not even begin until after the distribution, an acquisition pursuant to such negotiations can hardly be characterized as a pre-arranged disguised sale.

4. Similar Acquisitions

a. 2000 proposed regulations

The 2000 proposed regulations first introduced the concept of “similar acquisitions.” Certain plan and non-plan factors contained in the 2000 proposed regulations focused on whether there were discussions regarding the acquisition or a similar acquisition before the distribution.¹¹⁷ The 2000 proposed regulations interpreted the term “similar acquisition” broadly, providing that “the actual acquisition and the intended acquisition may be similar even though the identity of the person acquiring stock of Distributing or Controlled

¹¹⁷ See 2000 Prop. Treas. Reg. § 1.355-7(d)(2)(i), (ii), (v), (vii), (d)(3)(i), (vi). Note that the Safe Harbors did not contain a similar reference to similar acquisitions.

(acquirer), the timing of the acquisition or the terms of the actual acquisition are different from the intended acquisition.”¹¹⁸

The breadth of the scope of similar acquisitions was most apparent from Example 7 of the 2000 proposed regulations.¹¹⁹ Example 7 involved a distribution by D for the purpose of using stock of D to expand its business through the acquisition of target corporations. At the time of the distribution, D had no specific goals regarding how much of its stock would ultimately be used. D had identified X and Y as potential targets before the public announcement of the distribution and began negotiations with X after the announcement but before the distribution. D acquired X one month after the distribution, and acquired Y one year after the distribution (negotiations with Y began seven months after the distribution). D identified Z as a potential target after the distribution and acquired Z 18 months after the distribution. The 2000 proposed regulations concluded that the acquisition of X was part of a plan within the meaning of section 355(e) and that, because the acquisitions of Y and Z were “similar” to that of X, they too were part of a plan.¹²⁰

b. Temporary regulations narrow the definition

Treasury and the Service recognized that Example 7 needed further consideration and “reserved” on the example in the 2001 temporary regulations.¹²¹ The temporary regulations finish what was started in the 2001 temporary regulations. They narrow the definition of similar

¹¹⁸ 2000 Prop. Treas. Reg. § 1.355-7(b)(2).

¹¹⁹ 2000 Prop. Treas. Reg. § 1.355-7(m), Ex. 7.

¹²⁰ Id.

¹²¹ See 2001 Temp. Treas. Reg. § 1.355-7T(m), Ex. 7.

acquisition, which has “the effect of reversing the conclusion of Example 7 of the 200[0] proposed regulations that the additional acquisitions (i.e., the Y and Z acquisitions) and the distribution are part of a plan.”¹²² The temporary regulations provide that, in general, an actual acquisition will be similar to another potential acquisition “if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business operations as the combination that would have been effected by such other potential acquisition.”¹²³ An acquisition is not similar if the ultimate owners of the business operations of the actual acquirer are substantially different from the ultimate owners of the business operations of the potential acquirer.¹²⁴ Thus, an acquisition is generally not similar if (i) less than a significant portion of the business operations are the same, or (ii) the ultimate owners are substantially different. For example, an actual acquisition of D by shareholders of X by reason of a merger of X into D is similar to a merger of D into X or a merger of D into a wholly owned subsidiary of X.¹²⁵

c. Examples

(i) Disposition of assets prior to acquisition

Example 7 of the temporary regulations involves the following facts:

Example 7: D is in the business of writing software related to industries 1 through 6. D’s software business related to industries

¹²² Preamble to Temp. Treas. Reg. § 1.355-7T, 67 Fed. Reg. at 20,633.

¹²³ Temp. Treas. Reg. § 1.355-7T(h)(8). In the case of a public offering or other stock issuance for cash, an actual acquisition may be similar to another acquisition, even though there are changes in the terms, class, or price of stock being offered, the size or timing of the offering, or the participants in the offering. Id.

¹²⁴ Id.

¹²⁵ Id.

4, 5, and 6 is significant relative to industries 3, 4, 5, and 6. X is in the business writing software and manufacturing and selling hardware devices. X's software business is significant relative to its hardware business. D and X engage in substantial negotiations regarding X's acquisition of D stock in a stock for stock exchange. Because X does not want D's business related to industries 1 and 2, the negotiations relate to an acquisition of D without industries 1 and 2. Thereafter, D concludes that the licenses central to the industries 1 and 2 are not transferable and that a separation of industry 3 from industry 2 is not desirable. One month after D and X begin negotiations, D contributes industries 4, 5, and 6 to newly formed C and spins off C. In addition, X sells its hardware business. After the distribution, X and C enter into negotiations, and X acquires C.

Is the merger of D and X still similar where D and/or X dispose of some of their assets prior to the merger? What if D contributes assets to a new subsidiary, C, spins off C, and X merges with C? The temporary regulations look at whether the entities that ultimately combine hold a significant portion of the operating assets of the entities that negotiated. Thus, the temporary regulations conclude that X's acquisition of C is similar. This is true even though C is a different entity from D, and D's industry 3 business and X's hardware business are not among the assets combined, because it involves a combination of a significant portion of the business operations that were subject to the original negotiations between D and X.¹²⁶

(ii) Unrelated acquirer

Example 8: Assume the same facts as Example 7, except that instead of X acquiring C, an unrelated corporation Y acquired C. Y is also engaged in the software business.

The temporary regulations draw the line at different, unrelated acquirers, even if they are in the same industry, concluding that such an acquisition would not be similar.¹²⁷ It is not clear,

¹²⁶ Temp. Treas. Reg. § 1.355-7T(j), Ex. 7.

¹²⁷ See Temp. Treas. Reg. § 1.355-7T(j), Ex. 6.

however, whether the temporary regulations' conclusion is based on the fact that Y's assets are different from X's, because Y's owners are different from X's, or both. It seems likely that if X and Y were owned by the same parent company, the government would conclude that the acquisitions are similar, even though Y is a separate corporate entity.

(iii) Rival bidder

Example 9: D, a publicly traded corporation, owns all of the stock of C. D and X entered into substantial negotiations for X's acquisition of D, but X did not want C. D distributes C to facilitate the acquisition. One month after the distribution, negotiations between D and X break down. Y, which unbeknownst to D, had been interested in acquiring D, approaches D two months after the distribution. Y acquires D six months after the distribution.

If X had acquired D, as originally anticipated, section 355(e) would apply.¹²⁸ However, Y's acquisition of D would not be subject to section 355(e), because the substantial negotiations with X were not regarding "the acquisition or a similar acquisition."¹²⁹ It has been argued that the narrower definition of similar acquisition permits a rival bidder to come in with a higher bid after the spin-off and acquire Distributing or Controlled, thus putting every other bidder at a competitive advantage over the original one that negotiated with Distributing.¹³⁰ However, under these facts, D had never engaged in discussions with Y and, indeed, did not even anticipate an acquisition by Y. After the negotiations with X broke down, there was no certainty that

¹²⁸ See Temp. Treas. Reg. § 1.355-7T(j), Ex. 1. None of the Safe Harbors applies, and none of the non-plan factors is present. Two plan factors are present, namely that D and X engaged in substantial negotiations during the two-year period before the distribution, and the business purpose for the distribution was to facilitate the acquisition.

¹²⁹ Temp. Treas. Reg. § 1.355-7T(b)(2).

¹³⁰ See New Anti-Morris Trust Rules, supra note 107.

another acquisition would occur. Thus, it seems appropriate not to apply section 355(e) in this example. Consider the following fact pattern:

Example 10: Assume the same facts as in Example 9, except that Y had approached D before the distribution and expressed an interest in acquiring D, but D rejected Y's proposal in favor of X's proposal. No negotiations occurred between D and Y before the distribution. The day after the distribution, Y approaches D with a higher bid, and D accepts Y's bid.

Under these facts, D has knowledge of the possibility of a competing bid and there is greater certainty of being acquired in the event negotiations with X break down. This example presents facts that are arguably closer to a pre-arranged plan. What if, instead of the business purpose being to facilitate X's acquisition of D, the business purpose is a non-acquisition business purpose and the spin-off would have occurred at approximately the same time and in similar form regardless of the acquisition?

As is apparent from these scenarios, whether an acquisition is similar may depend on the facts. The definition of similar acquisition states that "in general" an acquisition is similar if it involves a combination of the same business operations and is not similar if the ultimate owners are substantially different.¹³¹ Thus, the temporary regulations seem to have provided for sufficient flexibility to address these situations on a case-by-case basis if necessary.

(iv) Ultimate owners do not substantially change

Example 11: A and B own all of the stock of D, and D owns all of the stock of C. D enters into negotiations with X for X's acquisition of C. D distributes the stock of C for a valid business purpose. Instead of X acquiring the C stock, C contributes its assets to a newly formed partnership in exchange for 33-1/3 percent of the partnership interests. X contributes assets to the

¹³¹ Temp. Treas. Reg. § 1.355-7T(h)(8).

partnership in exchange for 66-2/3 percent of the partnership interests.

In this example, X is not acquiring a 50-percent or greater interest in the C stock within the meaning of section 355(e), but rather is acquiring an interest in a partnership that holds C's assets. Is this acquisition similar to the acquisition negotiated with X? Recall that the temporary regulations provide that an acquisition is similar if the actual acquisition combines all or a significant portion of the same business operations as the potential acquisition, and the ultimate owners of the business operations are substantially the same.¹³² The partnership holds significant portion of the business operations that were contemplated to be combined in the original negotiations. Are the ultimate owners of the business operations of the actual acquirer (the partnership) substantially the same as the ultimate owners of the business operations of the potential acquirer (X)? The temporary regulations refer to the ultimate owners of the "business operations" of the acquirer and thus would appear to reach the transfer of assets.¹³³ X (and X's shareholders) owns through the partnership 66-2/3 percent of the combined business operations. This is likely to be considered substantially the same owner. If X acquired a 50-percent interest in the partnership, would it still be considered substantial? Less than 50 percent?

5. Public Offerings

As discussed above, separate rules are generally provided for acquisitions that involve public offerings. Public offerings are excluded from the general plan rule. As a result,

¹³² Temp. Treas. Reg. § 1.355-7T(h)(8).

¹³³ This appears to be an attempt by the government to prevent transactions similar to Example 11. These transactions were generally viewed by practitioners as a way to avoid the application of section 355(e), because X is not acquiring a 50-percent or greater interest in the C stock within the meaning of section 355(e), but rather is acquiring a partnership interest.

discussions with an investment banker need not rise to the level of substantial negotiations before a public offering is considered part of a plan.¹³⁴ An underwritten public offering is also excluded from Safe Harbor V regarding public trading.¹³⁵ Finally, in the case of a public offering (or other stock issuance for cash), a similar acquisition is defined more broadly to encompass changes in the terms, class, or price of stock being offered, the size or timing of the offering, or the participants in the offering.¹³⁶ Presumably, the reason for the different treatment is that public offerings by their nature are unilateral—there are no negotiations between the issuing corporation and the investors. Thus, a bilateral negotiations standard seems inapposite. Treasury and the Service have substituted discussions with the underwriter as a benchmark for bilateral negotiations.

The scope of public offering is not entirely clear. Must the offering be solely for cash? Must it be to an unlimited group of buyers? Must it be underwritten or involve an investment banker? Absent any indication to the contrary, one would assume that Treasury and the Service intended the term “public offering” to have its ordinary meaning. Public offering is defined as “[a]n offering made to the general public,” as contrasted with a “private” offering or placement.¹³⁷ Thus, one would assume that a public offering must be made to an unlimited group of buyers. The temporary regulations also imply that such an offering will be for cash when it refers to “a public offering or other stock issuance for cash” in the definition of similar

¹³⁴ See Temp. Treas. Reg. § 1.355-7T(b)(3)(ii), (iv).

¹³⁵ See Temp. Treas. Reg. § 1.355-7T(d)(5)(i)(D) (excluding transfers to underwriters).

¹³⁶ Temp. Treas. Reg. § 1.355-7T(h)(8).

¹³⁷ BLACK’S LAW DICTIONARY 1112 (7th ed. 1999).

acquisition.¹³⁸ Finally, although the temporary regulations do not limit public offerings to those involving an underwriter or investment banker, the rules seem to contemplate that they ordinarily will involve such a party—the plan and non-plan factors refer to discussions with investment bankers, and Safe Harbor V excludes transfers to underwriters.

V. CONCLUSION

Since the enactment of section 355(e), Treasury and the Service have been struggling to reconcile the purposes of the statute with its overly broad language. Pursuant to the grant of authority to issue regulations to carry out the purposes of section 355(e), Treasury and the Service issued their fourth set of regulations to define plan. These temporary regulations retain the overall facts-and-circumstances approach of the 2000 proposed regulations and 2001 temporary regulations, but they focus on whether there were bilateral negotiations between the acquirer and Distributing or Controlled. In so doing, the temporary regulations carry out the purposes of section 355(e), reflect practical business considerations, and provide a great deal more certainty to taxpayers and the government. Treasury and the Service should be commended for a job well done.

¹³⁸ Temp. Treas. Reg. § 1.355-7T(h)(8).