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Final Section 355(e) Plan Regulations – The Final Chapter in the Saga

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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)" (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]

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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. 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).

[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).

Section 355(e) authorizes Treasury and the Internal Revenue Service (the "Service") to issue regulations "necessary to carry out the purposes" of the legislation.[6]

Section 355(e) was enacted in response to several high profile leveraged Morris Trust transactions occurring during 1996 and 1997 that more closely resembled sales, including Telecommunication, Inc.'s acquisition 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. It is important to keep in mind that these transactions involved prearranged acquisitions, the terms of which had been agreed upon between Distributing and/or Controlled and the acquirer prior to the distribution. The legislative history similarly points 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 <u>new shareholders will acquire ownership</u> of a business in connection with a spin off, the transaction more closely <u>resembles a corporate level disposition</u> of the portion of the business that is acquired.[7]

The term "plan" as used in section 355(e) should be interpreted in light of this purpose.

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[6] Code § 355(e)(5).

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

Treasury and the Service have been struggling to provide guidance on how to establish that a distribution and acquisition are not part of a plan. On April 19, 2005, after four previous attempts to issue guidance in this area, Treasury and the Service issued final plan regulations. The latest regulations represent the final chapter in what had been an ongoing saga. Over the past six years, Treasury and the Service have considered numerous comments from practitioners and have modified the regulations as appropriate. As a result, the plan regulations have evolved from an extremely rigid set of rules that defined plan broadly to include the intent of either party without regard to whether there had been any bilateral discussions or negotiations to a very administrable set of rules that reflect both the purpose of section 355(e) and business realities.

Below, we briefly summarize the first four sets of regulations and then analyze the changes made by the final set of regulations.

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").[8] 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

[8] 1999 Prop. Treas. Reg. § 1.355-7, 64 Fed. Reg. 46,155, 46,160 (1999).

convincing evidence. As a result, the 1999 proposed regulations expanded the scope of an already overly broad statute.[9]

On December 29, 2000, Treasury and the Service withdrew the 1999 proposed regulations,[10] and issued new proposed regulations in their place (the "2000 proposed regulations").[11] The 2000 proposed regulations adopted a facts-and-circumstances approach, which is consistent with the statute.[12] The 2000 proposed regulations contained six safe harbors that, when applicable, obviated the need to perform the facts-and-circumstances analysis.[13] 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.[14] Finally, the 2000 proposed regulations deleted references to a clear and convincing standard of proof.[15]

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[9] 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).

[10] 66 Fed. Reg. 76 (2001).

[11] 2000 Prop. Treas. Reg. § 1.355-7, 66 Fed. Reg. 66 (2001).

[12] 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.

[13] 2000 Prop. Treas. Reg. § 1.355-7(f).

[14] 2000 Prop. Treas. Reg. § 1.355-7(d)(2), (3).

[15] 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).

On August 2, 2001, Treasury and the Service issued temporary regulations under section 355(e) (the "2001 temporary regulations").[16] 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 reserved on 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 the 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.[17] 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 future, expect to issue additional guidance regarding the interpretation of the phrase 'plan (or series of related transactions).'"[18]

On April 23, 2002, Treasury and the Service issued revised temporary regulations to amend the 2001 temporary regulations (the "2002 temporary regulations").[19] Although the 2002 temporary regulations retained the overall facts-and-circumstances approach of the 2000

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[16] 66 Fed. Reg. 40,590 (2001).

[17] 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, e.g., 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).

[18] 66 Fed. Reg. at 40,590.

[19] 67 Fed. Reg. 20,632 (2002).

proposed regulations and 2001 temporary regulations, they further tightened up the definition of plan by focusing on whether there were bilateral discussions between the acquirer and Distributing or Controlled. In so doing, the 2002 temporary regulations more clearly carried out the purposes of section 355(e), reflected practical business considerations, and provided a great deal more certainty to taxpayers and the government.[20]

Finally, on April 19, 2005, Treasury and the Service issued final regulations, adopting the 2002 temporary regulations with certain amendments (hereinafter referred to as the "final plan regulations").[21] The final plan regulations are effective for distributions occurring after April 19, 2005. The 2002 temporary regulations continue to apply to distributions after April 26, 2002 and before the effective date of the final regulations; however, taxpayers may apply the final regulations in whole, but not in part, to such distributions.[22]

III. DISCUSSION OF FINAL SECTION 355(e) PLAN REGULATIONS

A. Summary of Final Plan Regulations and Significant Changes Made to the 2002 Temporary Regulations

In general, whether a distribution and acquisition are part of a plan is determined based on all the facts and circumstances.[23] The regulations set forth a number of nonexclusive factors that tend to show the presence or absence of a plan.[24] The weight to be given each of the

[20] We discussed the temporary regulations in detail in Mark J. Silverman & Lisa M. Zarlenga, The Fourth Time's a Charm—New Temporary Section 355(e) Regulations Provide Helpful Guidance to Taxpayers, 54 TAX EXEC. 238 (2002).

[21] 70 Fed. Reg. 20,279 (2005).

[22] Treas. Reg. § 1.355-7(k).

[23] Treas. Reg. § 1.355-7(b)(1).

[24] Treas. Reg. § 1.355-7(b)(3), (4).

facts and circumstances depends on the particular case.[25] The regulations also provide several safe harbors, which, if satisfied, preclude a finding of plan without the necessity of weighing the facts and circumstances.[26] There are also certain operating rules that apply for purposes of the entire regulation.[27]

The most significant change made by the 2002 temporary regulations, which is retained by the final plan regulations, was the addition of a "super safe harbor" for post-distribution acquisitions not involving a public offering. The super safe harbor provides that a post-distribution acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations[28] regarding the acquisition or a similar

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[25] Treas. Reg. § 1.355-7(b)(1).

[26] Treas. Reg. § 1.355-7(d).

[27] Treas. Reg. § 1.355-7(c).

[28] "Substantial negotiations" is defined as follows:

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

Treas. Reg. § 1.355-7(h)(1)(iv). As further discussed below, the final plan regulations modify the definition of substantial negotiations to further clarify that, on the acquirer's side, the discussions must be with an officer, director, controlling shareholder of the acquirer, or someone with the implicit or explicit permission of such persons. Treas. Reg. § 1.355-7(h)(1)(v). The final plan regulations also provide a more detailed definition of "agreement, understanding, or arrangement." Treas. Reg. § 1.355-7(h)(1)(i)(A) & (B).

acquisition[29] at some time during the two-year period ending on the date of the distribution.[30] This rule is referred to as the super safe harbor, because if its requirements are satisfied, there is no need to look at the other safe harbors or to do a facts-and-circumstances analysis. The importance of the super safe harbor is that it generally requires bilateral negotiations on significant economic terms, which provides more certainty to taxpayers and the government by eliminating ongoing strategic planning, including preliminary discussions or purely internal discussions, from the definition of plan.

The problem with the 2002 temporary regulations was that the rules governing pre-distribution acquisitions and public offerings were much less clear. This was remedied in large part in the final regulations. With respect to pre-distribution acquisitions, the final plan regulations modify and expand the one safe harbor that applies to pre-distribution acquisitions and adopt a new safe harbor for acquisitions before pro rata distributions. With respect to public offerings, which did not have the benefit of any safe harbor in the 2002 temporary regulations, the final plan regulations adopt a safe harbor to govern pre-distribution public offerings. The final plan regulations also clarify the definition of public offering and provide guidance as to when an acquisition is "similar" to an acquisition involving a public offering. The final plan

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[29] A "similar acquisition" in the context of an acquisition not involving a public offering is defined as follows:

> [A]n actual acquisition (other than involving a public offering) is 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.

Treas. Reg. § 1.355-7(h)(12).

[30] Treas. Reg. § 1.355-7(b)(2).

regulations further apply these rules to certain publicly offered options. Finally, the final regulations make certain miscellaneous modifications and clarifications, which are discussed further below.

B. Pre-Distribution Acquisitions

The 2002 temporary regulations provided certain rules relating to pre-distribution acquisitions, although they were not nearly as extensive as the rules provided for post-distribution acquisitions. The authors believe that this is not because there was anything inherently abusive about pre-distribution acquisitions, but rather because such acquisitions were less common and the plan-like characteristics were less obvious.

1. Pre-Distribution Acquisition Safe Harbor

The 2002 temporary regulations provided one safe harbor for pre-distribution acquisitions, Safe Harbor IV—it provided only that if a distribution occurs more than two years after an acquisition, 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 would not be considered part of a plan.[31] The waiting period for pre-distribution acquisitions was disproportionately long compared to the waiting period for post-distribution acquisitions—two years for pre-distribution acquisitions (and no negotiations for six months) and at most six months for post-distribution acquisitions (and no negotiations for one to two years).[32] The reason for the difference was not apparent.

[31] 2002 Temp. Treas. Reg. § 1.355-7T(d)(4).

[32] Compare 2002 Temp. Treas. Reg. § 1.355T(b)(2) and (d)(1)-(3) with 2002 Temp. Treas. Reg. § 1.355-7T(d)(4).

The final plan regulations remove the arbitrary two-year waiting period and amend Safe Harbor IV to provide that a pre-distribution acquisition not involving a public offering will not be considered part of a plan if the acquisition occurs before the date of the "first disclosure event" regarding the distribution.[33] A disclosure event is defined as any communication by an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor on behalf of any of those persons regarding the distribution, or the possibility thereof, to the acquiror or any other person.[34] However, certain limitations apply. First, Safe Harbor IV does not apply to an acquisition if the acquiror or a coordinating group[35] of which the acquiror is a member is a controlling shareholder[36] or a 10-percent shareholder of the acquired corporation (i.e.,

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[33] Treas. Reg. § 1.355-7(d)(4)(i).

[34] Treas. Reg. § 1.355-7(h)(5).

[35] A "coordinating group" is defined to include 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. Treas. Reg. § 1.355-7(h)(4). A principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders. Id. This is essentially the same as the definition of "plan or arrangement" for purposes of section 355(d), see section 355(e)(7)(B), and should be interpreted in the same manner. Examples in the regulations under section 355(d) illustrate that a formal or informal understanding exists where D's management, concerned that D might become subject to a takeover bid, assembles a group of friendly investors to acquire 50 percent of D's stock, but that a formal or informal understanding does not exist where an investment advisor, believing that D's stock is undervalued, advises several different clients to purchase D stock. Treas. Reg. § 1.355-6(c)(4)(iii), Exs. 2 & 3.

[36] A "controlling shareholder" of a public corporation is a five-percent shareholder who actively participates in the management or operation of the corporation (including a director). Treas. Reg. § 1.355-7(h)(3)(i). A "controlling shareholder" of a non-publicly traded corporation is any person who owns stock possessing voting power representing a meaningful voice in the governance of the corporation. Treas. Reg. § 1.355-7(h)(3)(ii).

Distributing or Controlled) at any time during the period beginning immediately after the acquisition and ending on the date of the distribution.[37] Second, Safe Harbor IV does not apply to an acquisition that occurs in connection with a transaction in which the stock acquisitions aggregate 20 percent or more of the total vote or value of the stock of the acquired corporation (Distributing or Controlled).[38]

The preamble to the final plan regulations explains that Treasury and the Service generally believe that if an acquiror had no knowledge of Distributing's intention to effect a distribution and had no intention or ability itself to cause a distribution, then a pre-distribution acquisition and a distribution should not be considered part of a plan, regardless of whether the distribution occurs more than two years after the acquisition.[39] Because knowledge and intention are fact intensive and difficult to prove, the regulations adopt the first disclosure event as the cut-off to achieve administrability.[40] In addition, to ensure that the safe harbor is not available for acquisitions by persons who could participate in the decision to effect a distribution, the regulations provide that the safe harbor is not available for acquisitions by significant shareholders (i.e., controlling or 10-percent shareholders) and significant acquisitions (i.e., 20 percent or greater in the aggregate).[41]

The following example illustrates Safe Harbor IV.

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[37] Treas. Reg. § 1.355-7(d)(4)(ii)(A).

[38] Treas. Reg. § 1.355-7(d)(4)(ii)(B).

[39] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,280.

[40] Id.

[41] Id.

> Example 1: D, a publicly traded corporation, has been negotiating with its controlling shareholder to redeem its interest in D by splitting off one of its businesses to the shareholder in exchange for its interest in D. The business that D plans to split off is one that generates a lot of cash that D usually uses for operating its other businesses. As such, D wants to raise some cash in anticipation of the split-off, so D issues new stock in a private placement constituting just under 20 percent of D's outstanding stock. No single shareholder acquires more than 4 percent of the D stock in the offering. One month later, after it has finalized the terms of the split-off with its controlling shareholder, D issues a press release announcing the split-off. The split-off occurs 6 months later.

Because the private placement occurred before the first disclosure event (i.e., the press release), and none of the acquiring shareholders are controlling or 10-percent shareholders, the acquisition falls within Safe Harbor IV and, therefore, is not part of a plan.

Unlike old Safe Harbor IV, new Safe Harbor IV does not impose any time limitations on when a pre-distribution acquisition and distribution can occur. Thus, it appears at first glance to provide a much more useful safe harbor for taxpayers. However, the limitations on the amount that may be acquired (i.e., no more than 10 percent (or 5 percent in the case of a shareholder who actively participates in management or operations) by any shareholder and no more than 20 percent in the aggregate) effectively limit the use of this safe harbor to very small acquisitions. The authors agree with Treasury and the Service's reasoning that that if an acquiror had no knowledge of Distributing's intention to effect a distribution (as indicated by a disclosure event) and had no intention or ability itself to cause a distribution, then a pre-distribution acquisition and a distribution should not be considered part of a plan. However, the authors do not agree that ownership of 10 percent (or 5 percent if the shareholder actively participates in management or operations) itself is indicative of an intent or ability to effect the distribution. If the planning or negotiation of the distribution is already underway at the time of the acquisition,

then as long as the acquiror had no knowledge of the distribution (as indicated by a disclosure event) at the time of the acquisition, it should not be considered part of a plan, regardless of how much stock is acquired by the acquiror. If, on the other hand, the acquiror acquires 10 percent of the stock at a time when no distribution was anticipated by Distributing, and the planning or negotiations began after the acquisition, it is much more difficult to rule out the fact that a significant shareholder influenced the distribution. Accordingly, the authors would suggest applying the 10-percent limit only in cases where the distribution had not been anticipated by Distributing, as evidenced by negotiations or other plans undertaken by Distributing. The authors fail to see how a 20-percent aggregate acquisition is indicative of a plan, unless the acquirors were acting in concert. Because this concept is already captured by including coordinating groups in the 10-percent limitation, the authors view the aggregate acquisition limitation as unnecessary.

Finally, the authors believe that if the parties are willing to wait two years after the acquisition to do the distribution (which was required under old Safe Harbor IV), the acquisition and distribution should not be part of a plan, regardless of amount acquired in the pre-distribution acquisition. Two years is a long time in the business world—many things can happen to affect the feasibility or desirability of a distribution. As such, the authors believe that the original 2-year safe harbor for pre-distribution acquisitions should have been retained.

2. New Safe Harbor for Acquisitions Before Pro Rata Distributions

In addition, the final plan regulations add a new safe harbor for acquisitions before pro rata distributions. New Safe Harbor V provides that a pro rata distribution and an acquisition not involving a public offering before that distribution will not be considered part of

a plan if (i) the acquisition occurs after the date of a "public announcement" regarding the distribution, and (ii) there were no discussions by Distributing or Controlled with the acquiror regarding a distribution on or before the date of the first public announcement regarding the distribution.[42] A public announcement regarding a distribution is defined as any communication by Distributing or Controlled regarding Distributing's intention to effect the distribution where the communication is generally available to the public.[43] For example, a public announcement includes a press release or a conversation between an officer of Distributing and stock analysts in which the officer communicates Distributing's intent to effect a distribution.[44] Similar to Safe Harbor IV, Safe Harbor V does not apply to an acquisition if the acquiror or a coordinating group of which the acquiror is a member is a controlling shareholder or a 10-percent shareholder of Distributing at any time during the period beginning immediately after the acquisition and ending on the date of the distribution.[45] In addition, Safe Harbor V does not apply to an acquisition that occurs in connection with a transaction in which the stock acquisitions aggregate 20 percent or more of the total vote or value of the stock of Distributing.[46]

The preamble to the final plan regulations explains that Treasury and the Service believe that acquisitions of Distributing that occur before a pro rata distribution are not likely to be part of a plan where there has been a public announcement of the distribution, there were no

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[42] Treas. Reg. § 1.355-7(d)(5)(i).

[43] Treas. Reg. § 1.355-7(h)(10).

[44] See Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,280.

[45] Treas. Reg. § 1.355-7(d)(5)(ii)(A).

[46] Treas. Reg. § 1.355-7(d)(5)(ii)(B).

discussions regarding the acquisition prior to the announcement, and the acquiror did not have the ability to participate in or influence the distribution decision.[47] The preamble points out that the facts that the distribution was publicly announced and the acquisition was small in size suggest that the distribution would have occurred regardless of the acquisition.[48] In addition, the fact that a pre-distribution shareholder of Distributing has the same interest in both Distributing and Controlled immediately before and immediately after the pro rata distribution reduces the likelihood that the acquisition and distribution were part of a plan.[49] The limitations on the size of the shareholder and aggregate acquisition were imposed to ensure that Safe Harbor V applies only to acquisitions by persons who do not have the ability to effect the distribution.[50]

The following example illustrates Safe Harbor V.

> Example 2: D, a publicly traded corporation, has announced that it plans to distribute the stock of C pro rata to its shareholders. After the announcement, widely held X becomes available as an acquisition target. There were no discussions by D or C with X before the date of the public announcement. X merges into D, with X's shareholders receiving 10 percent of the stock of D. Six months later, D distributes the stock of C pro rata to its shareholders. No shareholder of X was a controlling or 10-percent shareholder of D at any time after the merger and ending on the date of the distribution.

Because the distribution was pro rata, the merger occurred after the date of the public announcement of the distribution, there were no discussions with X before the public

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[47] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,280.

[48] Id.

[49] Id.

[50] Id.

announcement, no acquiror was a controlling or 10-percent shareholder, and not more than 20 percent of D's stock was acquired in the merger, the acquisition falls within Safe Harbor V and, therefore, is not part of a plan.[51]

The Service recently issued a revenue ruling that illustrates the application of the plan regulations to a pro rata spin-off that does not satisfy the requirements of Safe Harbor V.

> Example 3: D, a publicly traded corporation, conducts a pharmaceuticals business, and C, its wholly owned subsidiary, conducts a cosmetics business. In order to eliminate the competition for capital between D and C, D decides and publicly announces that it intends to distribute the stock of C pro rata to its shareholders. After the announcement but before the distribution, X and D begin discussions regarding an acquisition, and X merges into D. D would have been able to continue its business successfully without combining with X. There were no discussions before the announcement, and although X favored the distribution, nothing in the merger agreement required the distribution. As a result of the merger, X's former shareholders receive 55 percent of D's stock. In addition, X's chairman of the board and CEO become chairman of the board and CEO, respectively, of D. Six months after the merger, D spins off C.

Because more than 20 percent of D's stock was acquired in the merger, Safe Harbor V does not apply. Nonetheless, the Service ruled under these facts that the acquisition and distribution were not part of a plan.[52] The Service noted that the fact that D discussed the distribution with X during the two-year period before the acquisition, and that X's shareholders may constitute acquirors who could meaningfully participate in the decision regarding whether to distribute C (through the chairman of the board and CEO) was a factor indicating a plan.[53] However, the fact

[51] See Treas. Reg. § 1.355-7(j), Ex. 4.

[52] Rev. Rul. 2005-65, I.R.B. 2005-41.

[53] Treas. Reg. § 1.355-7(b)(3)(iii).

that D publicly announced the distribution before discussions with X suggests that this plan factor should be accorded less weight. The Service further noted that the non-plan factor involving the absence of discussions during the two-year period before the public announcement[54] may not be present, because X's chairman of the board and CEO may have the ability to meaningfully participate in the decision to distribute C. However, the following non-plan factors were present: (i) the distribution was motivated by a non-acquisition business purpose, as evidenced by the fact that the public announcement of the distribution preceded the discussions and D's business would have continued to operate successfully without the merger; and (ii) the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition, as evidenced by the fact that D decided to distribute C and announced the distribution before the discussions.[55]

The limitations on the amount that may be acquired are the same for Safe Harbor V as they are for Safe Harbor IV. Thus, this safe harbor suffers from the same problems identified above. We believe the limitations are even less justified in Safe Harbor V than they were for Safe Harbor IV. Safe Harbor IV is based on the notion that if the acquiror did not know about the distribution and could not effect a distribution, the acquisition and distribution should not be considered part of a plan. Safe Harbor V is based on the notion that once a pro rata distribution is publicly announced (and was not previously discussed with the acquiror), it is likely to occur regardless of the acquisition. Although a significant enough acquisition might permit an acquiror to effect a distribution (Safe Harbor IV), it is unlikely to have any effect on an

[54] Treas. Reg. § 1.355-7(b)(4)(iii).

[55] Treas. Reg. § 1.355-7(b)(4)(v), (vi).

already planned and announced distribution (Safe Harbor V). This is particularly true, where there were no discussions with the acquiror regarding the distribution before the public announcement, as required by Safe Harbor V. Moreover, the fact that the distribution is pro rata, so that the acquiror has the same interest in Distributing and Controlled before and after the distribution, further minimizes any chance that the acquisition and distribution were part of a plan.

One should keep in mind that there is still a safe harbor for public trading (now Safe Harbor VII), which provides that an acquisition of Distributing or Controlled stock that is listed on an established market is not part of a plan if, immediately before or after the transfer, none of the transferor, transferee, or any coordinating group of which the transferor or transferee is a member is: (i) the acquired corporation (Distributing or Controlled) (i.e., a redemption or original issuance); (ii) a corporation that the acquired corporation controls; iii) a member of a controlled group of corporations (within the meaning of section 1563) of which the acquired corporation is a member; (iv) a controlling shareholder of the acquired corporation; (v) a 10-percent shareholder of the acquired corporation.[56] Safe Harbor VII is intended to exempt normal trading in publicly traded Distributing or Controlled stock by non-controlling shareholders. This safe harbor is likely to take precedence where it applies, because it does not impose the additional limitation that the acquisition must occur before or after disclosure of the distribution. However, where the stock is not traded on an established market, or it is acquired directly from Distributing or Controlled, Safe Harbor VII will not apply, and the taxpayer will have to look to Safe Harbors IV or V. Note that even the public trading safe harbor is unavailable if the acquiror

[56] Treas. Reg. § 1.355-7(d)(7)(i).

is a controlling or 10-percent shareholder. This limitation makes sense in the context of a public trading safe harbor, because it was intended to exempt small market trades.

3. Modifications to No Discussion Non-Plan Factor

In addition to the single safe harbor for pre-distribution acquisitions, the 2002 temporary regulations contained several plan and non-plan factors relevant to pre-distribution acquisitions:

Plan Factors:

- At some time during the two-year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with the acquiror regarding a distribution, or a person who intends to cause a distribution can, as a result of the acquisition, meaningfully participate in the decision regarding the distribution.[57]

Non-Plan Factors:

- During the two-year period ending on the date of the acquisition, there were no discussions by Distributing or Controlled with the acquiror regarding a distribution. This factor does not apply if the acquisition occurred after the date of the public announcement of the planned distribution. In addition, the factor does not apply if a person who intends to cause a distribution can, as a result of the acquisition, meaningfully participate in the decision regarding the distribution.[58]

- There was an identifiable, unexpected change in the market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.[59]

The final regulations retain these factors, except that they delete the public announcement restriction in the first non-plan factor listed above. This is because Treasury and the Service

[57] 2002 Temp. Treas. Reg. § 1.355-7(b)(3)(iii).

[58] 2002 Temp. Treas. Reg. § 1.355-7(b)(4)(iii).

[59] 2002 Temp. Treas. Reg. § 1.355-7(b)(4)(iv).

believe that the occurrence of a public announcement of a distribution before the discussion of an acquisition suggests that the distribution would have occurred regardless of the acquisition.[60] The authors agree with this reasoning and the deletion of the public announcement restriction.

C. Public Offerings

The legislative history of section 355(e) states that "a public offering of a sufficient size can result in an acquisition that causes gain recognition under [section 355(e)]."[61] The government appears to have treated this statement as a mandate that public offerings contemplated at the time of the distribution must be treated as part of a plan. However, it is not entirely clear that a public offering should per se be treated as part of a plan. The legislative history's statement that a public offering of sufficient size "can result in an acquisition" that triggers section 355(e)[62] implies that further testing of the public offering is necessary to see if the requisite plan exists. In a public offering, there are no negotiations between the issuing corporation and the actual public acquirors as there is in the typical section 355(e) plan. Could Congress have intended to use the underwriter as the proxy for the participants in the public? One would then test the level of negotiations or agreement as between Distributing and/or Controlled and the underwriter in the case of a public offering. This is the approach adopted by the 2002 temporary regulations.[63] Alternatively, could Congress have intended the statement to

[60] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,280.

[61] H.R. Conference Rep. No. 105-220, at 533 (1997).

[62] H.R. Conference Rep. No. 105-220, at 533.

[63] See NYSBA Report on Section 355 Plan Issues, supra note 142 (recommending that regulations require negotiations or an agreement with an underwriter before a public offering may be treated as part of a plan). Note that the 2002 temporary regulations adopt a somewhat

(Continued …)

be in the nature of an anti-abuse rule, warning that the government would scrutinize public offerings to see if, in substance, they amounted to a pre-arranged acquisition?[64] Recall that the Viacom transaction, which was one of the highly publicized transactions that prompted the enactment of section 355(e), involved the use of stock offerings to shift control of Controlled to TCI. First, Viacom offered its public shareholders a right to exchange their Viacom stock for Controlled Class A common stock; second, Controlled offered its newly issued Class B common stock to TCI, which caused Controlled's Class A stock to automatically convert into nonvoting stock.

In general, the 2002 temporary regulations provided separate, more stringent rules for acquisitions that involve public offerings, thus generally treating public offerings as part of a plan. First, public offerings were excluded from the Super Safe Harbor. As a result, discussions with an investment banker need not rise to the level of substantial negotiations before a public offering is considered part of a plan.[65] A public offering was also excluded from Safe Harbor V (now Safe Harbor VII) regarding public trading.[66] Finally, in the case of a public offering (or other stock issuance for cash), a similar acquisition was defined more broadly to encompass

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lower threshold – mere discussions with the underwriter are sufficient. Temp. Treas. Reg. § 1.355-7T(b)(3)(ii), (b)(3)(iv), & (j), Ex. 2.

[64] See Luc Moritz and Robert F. Fisher, Los Angeles County Bar Association Taxation Section Corporate Tax Committee, Anti-Morris Trust Legislation: Common Plan, Plan and Nonplan Factors, and Letter Rulings, reprinted in Distinguishing Between Related and Unrelated Acquisitions and Distributions in Controlled Firm Stock, 1999 TNT 125-42 (June 22, 1999) (hereinafter LA County Bar Morris Trust Comments) (taking the position that Congress must have intended to warn taxpayers that it would scrutinize public offerings to see if, in substance, they were pursuant to a common plan).

[65] See 2002 Temp. Treas. Reg. § 1.355-7T(b)(3)(ii), (iv).

[66] See 2002 Temp. Treas. Reg. § 1.355-7T(d)(5)(i).

changes in the terms, class, or price of stock being offered, the size or timing of the offering, or the participants in the offering.[67] The 2002 temporary regulations also contained an example that made clear that a distribution to facilitate a public offering will be treated as part of a plan. In the example, Distributing's managers and directors discuss a public offering of Distributing stock with an investment banker. One month later, to facilitate a public offering of 20 percent of Distributing's stock, Distributing distributes the stock of Controlled. Distributing issues 20 percent of its stock in a public offering seven months later. The example concludes that the public offering is part of a plan.[68]

1. Definition of Public Offering

Some commentators requested clarification of the scope of term "public offering."[69] 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

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[67] See 2002 Temp. Treas. Reg. § 1.355-7T(h)(8).

[68] Temp. Treas. Reg. § 1.355-7T(j), Ex. 2. The result was the same under the prior regulations. 2001 Temp. Treas. Reg. § 1.355-7T(m), Ex. 3; see also 2001 Temp. Treas. Reg. § 1.355-7T(m), Ex. 4(ii). The Service's ruling position has been consistent with this conclusion. See, e.g., P.L.R. 200001027 (Oct. 8, 1999); P.L.R. 200001011 (Sept. 30, 1999). But see P.L.R. 200118050 (Feb. 6, 2001) (ruling that public offering more than 18 months after a spin-off to meet capital needs that arose after the spin-off were not part of a plan); P.L.R. 200118044 (Feb. 5, 2001) (same). Private placements are also viewed by the Service as prohibited acquisitions. See, e.g., P.L.R. 200044019 (Aug. 3, 2000); P.L.R. 200001011.

[69] See American Bar Association Section of Taxation, Comments Concerning the Revised Proposed and Temporary Regulations Under Section 355(e) to Define a "Plan (or Series of Related Transactions)" (Nov. 18, 2002); Samuel J. Dimon, New York State Bar Association Tax Section, Letter (Untitled) (Oct. 28, 2002).

contrasted with a "private" offering or placement.[70] Thus, one would assume that a public offering must be made to an unlimited group of buyers. The 2002 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 acquisition.[71] Finally, although the 2002 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—for example, the plan and non-plan factors refer to discussions with investment bankers.

The final regulations provide the requested clarification by adopting an explicit definition of public offering. An acquisition involving a public offering means "an acquisition of stock for cash where the terms of the acquisition are established by the acquired corporation (Distributing or Controlled) or the seller with the involvement of one or more investment bankers and the potential acquirors have no opportunity to negotiate the terms of the acquisitions."[72] Thus, an initial public offering and a secondary offering will be treated as public offerings, whereas a private placement and a stock issuance for assets or stock in a tax-free reorganization will not be treated as public offerings.[73]

2. Definition of Similar Acquisition Relating to Public Offerings

In the plan and non-plan factors as well as several of the safe harbors, the 2002 temporary regulations referred to "similar acquisitions." The 2002 temporary regulations

[70] BLACK'S LAW DICTIONARY 1112 (7th ed. 1999).

[71] 2002 Temp. Treas. Reg. § 1.355-7T(h)(8).

[72] Treas. Reg. § 1.355-7(h)(11).

[73] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,280-81.

adopted a rather detailed definition of similar acquisition in the context of acquisitions not involving public offerings. In that case, an acquisition was similar to another potential acquisition if the actual acquisition effected 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. However, an acquisition was not similar to another acquisition if the ultimate owners of the business operations with which Distributing or Controlled is combined in the actual acquisition are substantially different from the ultimate owners of the business operations in the other acquisition.[74] With respect to public offerings, however, the 2002 temporary regulations adopted a rather broad definition of similar acquisition, simply stating that "an actual acquisition may be similar to another acquisition, even though there are changes in the terms of the stock, the class of stock being offered, the size of the offering, the timing of the offering, the price of the stock, or the participants in the offering."[75] Is this intended to encompass only changes in the original public offering that motivated the distribution, or does it encompass additional public offerings?

The final regulations clarify the definition of similar acquisition as it relates to public offerings. First, the rule in the 2002 temporary regulations, providing that an acquisition involving a public offering may be similar to another potential public offering even though there are changes in the terms of the stock, etc., is modified to apply only in the case of a single public offering.[76] Where there is more than one public offering, the final regulations limit the definition

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[74] 2002 Temp. Treas. Reg. § 1.355-7T(h)(8).

[75] Id.

[76] Treas. Reg. § 1.355-7(h)(13)(i).

of similar acquisition to include only a second public offering that occurs close in time to the first public offering and whose purpose is similar to that of the potential public offering.[77] In both cases, the potential public offering must have been discussed by Distributing or Controlled with an investment banker, must have motivated the distribution, or must have been the subject of an agreement, understanding, arrangement, or substantial negotiations.[78]

The definition of similar acquisition in the context of more than one public offering can be illustrated by the following examples:

> Example 4: D's managers and directors discuss with an investment banker the possibility of offering 20 percent of D's stock to the public for the purpose of funding the acquisition of the assets of X. One month later, to facilitate the public offering, D distributes the stock of C pro rata to its shareholders. Two months after the distribution, D issues 20 percent of its stock in a public offering (the first public offering). Four months after the distribution, D acquires the assets of X. Seven months after the distribution, D's managers and directors discuss with an investment banker the possibility of offering D stock to the public for the purpose of funding the acquisition of the assets of Y, a corporation unrelated to X. One year after the distribution, D issues 40 percent of its stock in a public offering (the second public offering). One month after the second public offering, D acquires the assets of Y.

The first public offering is the same as the potential acquisition that D's managers and directors discussed with the investment banker prior to the distribution; therefore, it is part of a plan. However, the purpose of the second public offering (to fund the acquisition of Y's assets) is not

[77] Treas. Reg. § 1.355-7(h)(13)(ii).

[78] Treas. Reg. § 1.355-7(h)(13)(iii).

similar to that of the potential acquisition (to fund the acquisition of X's assets); therefore, it is not similar to the potential acquisition.[79]

> Example 5: D's managers and directors discuss with an investment banker the possibility of offering 20 percent of D's stock to the public for the purpose of raising funds for general corporate purposes. One month later, to facilitate the public offering, D distributes the stock of C pro rata to its shareholders. Two months after the distribution, D issues 20 percent of its stock in a public offering (the first public offering). After the first public offering, D's managers and directors discuss with an investment banker the possibility of another public offering of D stock for the purpose of raising additional funds for general corporate purposes. Eight months after the distribution, D issues 10 percent of its stock in a public offering (the second public offering).

The first public offering is the same as the potential acquisition that D's managers and directors discussed with the investment banker prior to the distribution; therefore, it is part of a plan. The purpose of the second public offering is the same as that of the potential acquisition. In addition, the second public offering occurred close in time to the first public offering (six months). Therefore, the second public offering is similar to the potential acquisition.[80] However, the regulations conclude that if the second public offering occurs 12 months after the first public offering, it is not close in time and, therefore, is not a similar acquisition.[81]

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[79] See Treas. Reg. § 1.355-7(j), Ex. 8.

[80] See Treas. Reg. § 1.355-7(j), Ex. 9.

[81] See Treas. Reg. § 1.355-7(j), Ex. 10.

3. New Safe Harbor for Public Offerings

The 2002 temporary regulations contained no safe harbors relating to public offerings. The final regulations add a safe harbor for pre-distribution public offerings, Safe Harbor VI, which provides that a public offering and a distribution will not be considered part of a plan if the acquisition occurs before the date of the first disclosure event regarding the distribution in the case of an acquisition of stock that is not listed on an established market immediately after the acquisition,[82] or before the date of the first public announcement regarding the distribution in the case of an acquisition of stock that is listed on an established market immediately after the acquisition.[83] New Safe Harbor VI is based on the view of Treasury and the Service that a public offering and a distribution are not likely to be part of a plan if the acquirors in the offering are unaware that a distribution will occur.[84]

The focus of the safe harbor is somewhat different from the previous rules relating to public offerings, but it reaches the desired result. A public offering is a unique type of acquisition in that it is essentially unilateral—there are no negotiations between Distributing or Controlled and the public acquirors as there is in the typical section 355(e) acquisition. The plan and non-plan factors relating to public offerings reflect a decision on the part of Treasury and the Service to use the underwriter as the proxy for the public acquirors. The focus of Safe Harbor IV, however, is on the public acquirors—if the public acquirors did not know about the

[82] This is not likely to occur frequently, but could occur, for example, if the company's stock does not satisfy the minimum requirements for listing on an exchange.

[83] Treas. Reg. § 1.355-7(d)(6).

[84] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,281.

distribution, then the acquisition and distribution should not be considered part of a plan. Such knowledge is imputed through disclosure or public announcement. The authors agree with this reasoning and believe that it should likewise apply to post-distribution public offerings—if the public acquirors did not know of the public offering at the time of the distribution, then the distribution and acquisition should not be considered part of a plan.

4. Acquisitions Pursuant to Publicly Offered Options

In general, stock that is acquired pursuant to the exercise of an option is tested under section 355(e) as any other stock acquisition. The 2002 temporary regulations did not provide any special rules regarding the testing of acquisitions pursuant to options. Treasury and the Service believed, however, that publicly offered options closely resembled public stock offerings—there is generally no discussion or negotiation between the option acquiror and Distributing or Controlled; instead discussions occur between Distributing or Controlled and an investment banker. Thus, Treasury and the Service believed it was appropriate to test acquisition pursuant to publicly offered options under the rules that apply to acquisitions involving public offerings.[85]

Specifically, the final plan regulations provide that if (i) an option is issued for cash, (ii) the terms of the acquisition of the option and the terms of the option are established by the corporation the stock of which is subject to the option (Distributing or Controlled) or the writer of the option with the involvement of one or more investment bankers, and (iii) the potential acquirors of the option have no opportunity to negotiate the terms of the acquisition of

[85] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,281.

the option or the terms of the option, then the acquisition pursuant to that option will be treated as an acquisition involving a public offering.[86] If the option is exercised after the distribution, it will be treated as a post-distribution acquisition; if the option is exercised before the distribution, it will be treated as a pre-distribution acquisition.[87] An option that does not satisfy these requirements is treated as an acquisition not involving a public offering.[88]

D. Miscellaneous Modifications and Clarifications

1. Agreement, Understanding, Arrangement, or Substantial Negotiations

Throughout the regulations, reference is made to the phrase "agreement, understanding, arrangement, or substantial negotiations." The 2002 temporary regulations provided little guidance on what constituted an agreement, understanding, or arrangement, simply providing that whether an agreement, understanding, or arrangement exists depends on the facts and circumstances.[89] The parties do not necessarily have to have entered into a binding contract or have reached agreement on all significant economic terms to have an agreement, understanding, or arrangement, but one will clearly exist if there is a binding contract.[90] The 2002 temporary regulations did, however, provide some much-needed guidance on what constitutes substantial negotiations:

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[86] Treas. Reg. § 1.355-7(e)(2).

[87] Id.

[88] Id.

[89] 2002 Temp. Treas. Reg. § 1.355-7T(h)(1)(i).

[90] Id.

> 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 Controlled, with the acquirer or a person or persons with the implicit or explicit permission of the acquirer.[91]

Finally, in the case of an acquisition involving a public offering, the 2002 temporary regulations provided that the existence of 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 of such persons, with an investment banker.[92]

The final plan regulations retain these definitions, but add further guidance. First, the final plan regulations expand the definition of agreement, understanding, or arrangement to clarify whose agreement, understanding, or arrangement is necessary. An agreement, understanding, or arrangement generally must be made by either (i) one or more officers or directors acting on behalf of Distributing or Controlled, a controlling shareholder of Distributing or Controlled, or another person with the implicit or explicit permission[93] of one of such persons,

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[91] 2002 Temp. Treas. Reg. § 1.355-7T(h)(1)(ii) (emphasis added).

[92] 2002 Temp. Treas. Reg. § 1.355-7T(h)(1)(iii).

[93] The final plan regulations provide that a corporation is treated as having the implicit permission of its shareholders when it engages in discussions or negotiations, or enters into an agreement, understanding, or arrangement. Treas. Reg. § 1.355-7(h)(9). The import of this rule is not clear. Interpreted literally, its effect appears to "undo" the rule stated above by deeming permission any time a corporation engages in discussions or negotiations or enters into an agreement, understanding, or arrangement, regardless of whether they are engaged in by officers, directors, or controlling shareholders. Certainly this could not have been the intent of Treasury and the Service.

with the acquiror or a person with the implicit or explicit permission of the acquiror, or (ii) an acquiror that is a controlling shareholder of Distributing or Controlled immediately after the acquisition that is the subject of the agreement, understanding, or arrangement, or a person with the implicit or explicit permission of such acquiror, with the transferor or a person with the implicit or explicit permission of the transferor.[94] The final plan regulations also added the second category of actor, an acquiror that becomes a controlling shareholder, to the definition of substantial negotiations.[95] This rule reflects the belief of Treasury and the Service that the activities of those who have the authority to act on behalf of Distributing or Controlled, as well as the controlling shareholders of Distributing and Controlled, are relevant to the determination of whether a distribution and acquisition are part of a plan.[96]

Second, the final plan regulations clarify that where the acquiror is a corporation, discussions or substantial negotiations generally must involve one or more officers or directors acting on behalf of the acquiring corporation, controlling shareholders of the acquiring corporation, or another person with the implicit or explicit permission of such persons.[97]

2. Safe Harbor VI of the 2002 Temporary Regulations

Safe Harbor VI of the 2002 temporary regulations (now Safe Harbor VIII) provided that if stock is acquired by a person in connection with such person's performance of services as an employee, director, or independent contractor for Distributing, Controlled, or a

[94] Treas. Reg. § 1.355-7(h)(1)(i)(A) & (B).

[95] Treas. Reg. § 1.355-7(h)(1)(iv)(B).

[96] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,281.

[97] See Treas. Reg. § 1.355-7(h)(1)(v), (h)(6).

related person in a transaction to which section 83 or section 421(a) applies, the acquisition and distribution will not be considered part of a plan.[98] This safe harbor was unavailable if the acquiror or a coordinating group of which the acquiror is a member is a controlling or 10-percent shareholder of the acquired corporation (Distributing or Controlled) immediately after the acquisition.[99]

Commentators had questioned whether this safe harbor is available where the acquiror performs services for a corporation other than Distributing, Controlled, or a related person. For example, X, a corporation unrelated to Distributing and Controlled, grants employee A an incentive stock option in connection with A's performance of services to X. Before A exercises the option, Distributing acquires the assets of X in a section 368(a)(1)(A) reorganization, and A's incentive stock option to acquire stock of X is substituted with an incentive stock option to acquire stock of Distributing.[100] Technically, the safe harbor is unavailable if A exercises the option, because A's services were not performed for Distributing, Controlled, or a related person. However, the final plan regulations modify this safe harbor to permit services to be performed for a corporation the assets of which Distributing, Controlled, or a related person acquires in a section 368(a) reorganization, or a corporation that acquires the assets of Distributing or Controlled in such a reorganization, in order to ensure its availability in this and similar situations.[101]

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[98] 2002 Temp. Treas. Reg. § 1.355-7T(d)(6)(i).

[99] 2002 Temp. Treas. Reg. § 1.355-7T(d)(6)(ii)

[100] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,282.

[101] Treas. Reg. § 1.355-7(d)(8)(i).

The final plan regulations also extend the application of the safe harbor not only to transactions to which section 421(a) applies, but also to transactions to which section 421(b) applies.[102] The preamble to the final plan regulations explained that Treasury and the Service did not believe that the failure to meet the holding period requirement necessary to fall within section 421(a) rather than section 421(b) evidenced that the acquisition of stock pursuant to the option and the distribution were part of a plan.[103]

3. Safe Harbor VII of the 2002 Temporary Regulations

Safe Harbor VII of the 2002 temporary regulations (now Safe Harbor IX) provided that the acquisition of Distributing or Controlled stock by a retirement plan of an employer that qualifies under section 401(a) or 403(a) is not considered part of a plan.[104] However, the safe harbor was unavailable if the aggregate acquisitions by all of the qualified plans of the employer during the four-year period beginning two years before the distribution represents 10 percent or more of the vote or value of the acquired corporation (Distributing or Controlled).[105] Commentators had questioned whether the safe harbor was available at all if the acquisitions by the employer's retirement plans exceeded 10 percent.[106] The final plan regulations clarify that if the aggregate acquisitions exceed 10 percent, the safe harbor is

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[102] Id.

[103] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,282.

[104] 2002 Temp. Treas. Reg. § 1.355-7T(d)(7)(i).

[105] 2002 Temp. Treas. Reg. § 1.355-7T(d)(7)(ii).

[106] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,282.

available for the first 10 percent.[107] The final plan regulations also modified the safe harbor to reflect that it is only available for acquisitions by a retirement plan of Distributing, Controlled, or any person that is treated as the same employer as Distributing or Controlled under section 414(b), (c), (m), or (o).[108]

4. Compensatory Options

The 2002 temporary regulations contained special rules that treated an option as an agreement, understanding, or arrangement to acquire the stock subject to the option on the earliest of the date the option was written, transferred, or modified, if on that date the option was more likely than not to be exercised.[109] Compensatory stock options were exempted from this rule.[110] The final plan regulations retain the general rule treating options as an agreement, understanding, or arrangement, but they delete the exception for compensatory stock options. Thus, compensatory options are now subject to the general rule. The preamble to the final plan regulations explained the reason for the deletion: "The IRS and Treasury Department have become aware that arrangements using compensatory options have been structured to prevent an acquisition of stock from being treated as part of a plan that includes a distribution in avoidance of section 355(e)."[111]

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[107] See Treas. Reg. § 1.355-7(d)(9)(ii).

[108] See Treas. Reg. § 1.355-7(d)(9)(i).

[109] 2002 Temp. Treas. Reg. § 1.355-7T(e)(1)(i).

[110] 2002 Temp. Treas. Reg. § 1.355-7T(e)(3)(ii).

[111] Preamble to Treas. Reg. § 1.355-7, 70 Fed. Reg. at 20,282.

It is interesting that Treasury and the Service decided to delete the compensatory option exclusion entirely, instead of adding them to the anti-abuse rule of Treas. Reg. § 1.355-7(e)(3). That anti-abuse rule provided that "the following are not treated as options unless (in the case of paragraphs (e)(3)(i) [escrow, pledge, or other security arrangements], (iii) [options exercisable upon death, disability, mental incompetency, or separation from service], and (iv) [rights of first refusal] of this section) written, transferred (directly or indirectly), modified, or listed with a principal purpose of avoiding the application of section 355(e) or this section."[112] If Treasury and the Service were concerned about compensatory options structured to avoid section 355(e), it seems the less radical approach would have been to expand the anti-abuse rule to apply to compensatory options.[113]

IV. 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 have recently issued their fifth and final set of regulations to define plan. These regulations represent the final chapter in a saga that has been evolving since the issuance of the initial proposed regulations in 1999. The 2002 temporary regulations had taken a giant leap forward, shifting the focus to whether there were bilateral negotiations between the acquirer and Distributing or Controlled through adoption of the Super Safe Harbor. However, the 2002

[112] Treas. Reg. § 1.355-7(e)(3).

[113] It is not entirely clear to the authors why they were excluded from the anti-abuse rule in the first place.

temporary regulations continued to lack guidance in the context of pre-distribution acquisitions and public offerings, which the final regulations have sought to provide. Although the authors believe that the guidance does not go far enough in some cases, it is nonetheless a step in the right direction and provides very useful guidance to taxpayers. Treasury and the Service should be commended for a job well done.