New Temporary Regulations Under Code Sec. 355(e)

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Todd Maynes, Keith Villmow and Olga Loy describe the substantive and technical changes made by the new Code Sec. 355(e) Temporary Regulations.

Introduction

Code Sec. 355(e)

Following repeal of the *General Utilities* doctrine, distributions under Code Sec. 355 became one of the few remaining avenues for a corporation ("Distributing") to distribute appreciated property, specifically, stock of its controlled subsidiary ("Controlled"), to its shareholders without recognizing corporate-level gain. In 1997, Congress enacted Code Sec. 355(e) in response to a number of publicized spin-off transactions that appeared, based on media reports, to look more like taxable sales than mere separations of corporate enterprises into separate corporate groups.[1]

Code Sec. 355(e) applies to a distribution, to which Code Sec. 355 otherwise applies, that is part of a *plan (or series of related transactions)* (hereinafter referred to as "plan") pursuant to which one or more persons acquire stock representing a 50-percent (or greater) interest in Distributing or Controlled. Distributing (but not Distributing's shareholders) lose the tax-free protection otherwise provided under Code Sec. 355 in the case of a distribution that is part of such a plan. A plan is pre-

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sumed to exist if one or more persons directly or indirectly acquires stock representing a 50-percent (or greater) interest in Distributing or Controlled during the four-year period beginning on the date that is two years before the date of the distribution.[2]

The purpose of Cod Sec. 355(e), as explained in the legislative history of the Taxpayer Relief Act of 1997, is to deny tax-free treatment "in cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin-off" because such a transaction "more closely resembles corporate-level disposition of the portion of the business that is acquired."[3] Specifically, Congress was concerned with transactions in which a corporation (Distributing or Controlled) to be acquired incurred excessive debt prior to the distribution and transferred the proceeds of the borrowing to the other corporation (*i.e.*, Controlled or Distributing).[4] However, Code Sec. 355(e) applies to all distributions and acquisitions that are part of a plan, not just to transactions involving leverage.

> Neither Code Sec. 355(e) nor its legislative history elaborate on what constitutes a "plan."

Evolution of the Regulations Under Code Sec. 355(e)

Neither Code Sec. 355(e) nor its legislative history elaborate on what constitutes a "plan." To provide some certainty to taxpayers engaging in distributions, the IRS has issued three successive sets of regulations providing guidance on the question of when a plan will be deemed to exist. The IRS first issued proposed regulations under Code Sec. 355(e) in August 1999 ("the 1999 Proposed Regulations"),[5] then replaced the 1999 Proposed Regulations with new proposed regulations in January 2001,[6] which were adopted with few changes in temporary form in August 2001 ("the 2001 Temporary Regulations").[7] The IRS then replaced the 2001 Temporary Regulations with new temporary regulations announced on April 23, 2002 ("the 2002 Temporary Regulations").[8] The 2001 Temporary Regulations were viewed as a quantum improvement over the 1999 Proposed Regulations by practitioners, and the 2002 Temporary Regulations reflect further substantial improvements in the IRS's guidance under Code Sec. 355(e).[9]

The 1999 Proposed Regulations adopted a very broad definition of the term "plan," placing a heavy burden of proof ("clear and convincing evidence" test) on the taxpayer seeking to establish that a distribution and an acquisition were not part of such plan and provided only a limited set of facts under which taxpayers could demonstrate that a plan did not exist. The 2001 Temporary Regulations removed the increased burden of proof standard and allowed taxpayers to prove the absence of a plan by using all facts and circumstances.

Like the 2001 Temporary Regulations, the 2002 Temporary Regulations provide:

1. a nonexclusive list of factors
   a. tending to show that a prohibited plan existed ("plan factors") and
   b. tending to show that a prohibited plan did not exist ("nonplan factors");
2. operating rules for applying these factors;
3. several useful safe harbors;
4. special rules addressing the treatment of options and similar interests in stock; and
5. examples illustrating certain provisions of the temporary regulations.

However, the 2002 Temporary Regulations reflect numerous substantive and technical changes from the 2001 Temporary Regulations, which are the focus of this article.

The effective date of the 2002 Temporary Regulations is April 26, 2002. However, a taxpayer may choose to apply the 2002 Temporary Regulations (in their entirety, if at all) to a distribution occurring after April 16, 1997 (*i.e.*, the effective date of Code Sec. 355(e)). The 2001 Temporary Regulations apply to post-April 16, 1997, distributions to which the 2002 Temporary Regulations do not apply.

Analysis of the New Code Sec. 355(e) Regulations

Most Significant Conceptual Differences Between the 2002 Temporary Regulations and the 2001 Temporary Regulations

The principal differences between the 2002 Temporary Regulations and the 2001 Temporary Regulations are as follows:

- The focus of the 2001 Temporary Regulations on the intent of Distributing and Controlled at the time of the distribution has been largely replaced (especially with respect to acquisitions that

follow distributions) with a focus on the objective question of whether a meeting of the minds, or at least substantial negotiations, occurred between Distributing or Controlled and the acquirer prior to the distribution. Consequently, even though a business purpose to facilitate the acquisition (or a similar acquisition) remains a plan factor under the 2002 Temporary Regulations, the existence of such a purpose for a distribution cannot result in a prohibited plan (other than in the case of a public offering) if there was no agreement, understanding or arrangement regarding the acquisition (or a similar acquisition) at any time during the two-year period ending on the distribution date.

- The scope of the term "similar acquisition" is substantially narrowed in the 2002 Temporary Regulations in that an actual acquisition (other than a public offering or other stock issuance for cash) is now treated as 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.
- Acquisitions pursuant to auctions are not treated less favorably than other acquisitions under the 2002 Temporary Regulations, as they were under the 2001 Temporary Regulations.
- In the case of distributions following an acquisition, the intent of a person (other than Distributing or Controlled) to cause the post-acquisition distribution is treated as a fact tending to demonstrate the existence of a plan if such person can "meaningfully participate" in the distribution decision as a result of the acquisition.

In addition to these changes, the 2002 Temporary Regulations made a number of other technical changes which are generally taxpayer-favorable.

Distribution Followed by Acquisition

Precondition for Existence of a Plan—the New "Super-Safe Harbor." Perhaps the most significant change from the 2001 Temporary Regulations reflected in the 2002 Temporary Regulations is a new general rule for determining whether a distribution and a post-distribution acquisition (other than involving a public offering) are part of the plan. The new general rule provides that a distribution and subsequent acquisition "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."[10] This rule, coupled with a substantial tightening of the definition of "similar acquisition" (discussed below), considerably reduces the range of circumstances under which a pre-distribution acquisition is treated as part of a plan under the 2002 Temporary Regulations as compared with the 2001 Temporary Regulations.

Example 1. Distributing's management believes that selling Distributing to a strategic buyer is in the best interests of Distributing and its shareholders, and that Distributing would be a more attractive acquisition candidate if it divested itself of Business X, conducted by Distributing's wholly-owned subsidiary, Controlled. Accordingly, to facilitate a sale of Distributing (and for no other substantial business purpose), Distributing distributes all of the stock of Controlled to Distributing's shareholders in a transaction that qualifies under Code Sec. 355 (without regard to the potential application of Code Sec. 355(e)). Prior to the spin-off, Distributing's management had identified a number of potential acquirers, including corporation P, but no Distributing officer, director or controlling shareholder (or representative of any such person) had discussed a potential sale of Distributing with P (or any representative of P). Two months after the spin-off, Distributing enters into negotiations with P regarding a possible acquisition of Distributing by P. Five months after the spin-off, P acquires all of the stock of Distributing through a tax-free reverse subsidiary merger in which Distributing's shareholders receive 30 percent of P's stock.

Under the 2001 Temporary Regulations, Distributing's spin-off of Controlled and the subsequent acquisition of Distributing by P would probably be treated as part of a plan for the following reasons:

1. The facts indicate that Distributing "intended, on the date of the [spin-off], that the acquisition … occur in connection with the [spin-off],"[11] and

hence the spin-off and P's acquisition of Distributing appear to be part of a plan under the general rule of the 2001 Temporary Regulations.

2. Factors identified in the 2001 Temporary Regulations as tending to demonstrate the existence of a plan (spin-off motivated by business purpose to facilitate the sale of Distributing and acquisition occurring within six months after the spin-off)[12] appear significantly to outweigh the factors identified in the 2001 Temporary Regulations as tending to demonstrate that no plan existed (no discussions between Distributing or Controlled and any acquirer (or any of their respective controlling shareholders) prior to the spin-off).[13]

However, under the 2002 Temporary Regulations, Distributing's spin-off of Controlled and the subsequent acquisition of Distributing by P clearly would not be treated as part of a plan because no *agreement, understanding, arrangement* (hereinafter AUA) or substantial negotiations regarding the acquisition of Distributing by P (or a similar acquisition) occurred prior to the spin-off. As this example illustrates, the new general rule for acquisitions following a distribution effectively constitutes a new "super-safe harbor" in which subjective elements (*i.e.*, intent and business purposes of Distributing and Controlled) have been rendered irrelevant to the determination of whether a distribution and post-distribution acquisition are part of a plan where no AUA or substantial negations occur prior to the distribution.

The 2002 Temporary Regulations do not define AUA, but do state that an agreement short of a binding contract is sufficient, while a binding contract is a conclusive evidence of an AUA.[14] However, an AUA should not exist unless there is at least a meeting of the minds between the parties concerning some significant economic terms.

"Substantial negotiations" are deemed to occur if one or more officers, directors or controlling shareholders of Distributing or Controlled, or other persons with implicit or explicit permission of such a person, discussed significant economic terms of the transaction, *e.g.*, an exchange ratio.[15] While this definition assures that preliminary discussions between relevant parties of nonsignificant terms of the transaction, *e.g.*, potential synergies of the acquisition or engaging in due diligence would not be treated as giving a rise to "substantial negotiations," the scope of this concept remains uncertain. For example, would negotiations be deemed "substantial" if the relevant parties identified wanted and unwanted assets but did not discuss the price and the type of consideration? The 2002 Temporary Regulations do not elaborate on what types of negotiations would be deemed unsubstantial. To provide taxpayers with more certainty, the IRS should provide additional guidance regarding the definition of "substantial negotiations."

Similar Acquisitions. Another significant change reflected in the 2002 Temporary Regulations is a much narrower definition of "similar acquisition" (except in the case of a public offering of stock for cash) than the definition of that term contained in the 2001 Temporary Regulations. The concept of a "similar acquisition" is important in determining whether a plan exists because an AUA or substantial negotiations regarding a potential acquisition can taint a different actual acquisition if the two acquisitions are "similar." Under the 2001 Temporary Regulations, the actual post-distribution acquisition could be similar to the intended acquisition even though (among other differences) the identity of the actual post-distribution acquirer differed from the identity of the intended acquirer at the time of the distribution.[16] Commentators heavily criticized this definition as unnecessarily broad and neither correct as a policy matter nor compelled by the statute or its legislative history.[17]

The IRS responded to these comments by substantially narrowing the definition of "similar acquisition." The 2002 Temporary Regulations provide that "[in] general, an actual acquisition (other than a public offering or other stock issuance for cash) 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."[18] In addition, an actual acquisition (other than a public offering or other stock issuance for cash) is not treated as 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 with which Distributing or Controlled was to be combined in such other acquisition."[19] Although the 2002 Temporary Regulations do not explain under what circumstances

ultimate owners in the actual acquisition will be treated as "substantially different" from ultimate owners in the proposed acquisition, the IRS appears to have intended for the rules under Code Secs. 267(b) and 707(b) to apply in making such a determination.[20]

Example 2. Corporations X, Y and Z are widely held, publicly traded corporations, each of which operates in the same industry. Distributing and X enter into an agreement pursuant to which Distributing will acquire all of the stock of X in exchange for 30 percent of Distributing's stock. One of the conditions that must be satisfied prior to consummation of this acquisition is the spin-off of Distributing's wholly owned subsidiary, Controlled. The business purpose for the spin-off is to facilitate the acquisition, because common ownership of X and Controlled would create an antitrust issue. Distributing spins off Controlled, but the agreement between Distributing and X is terminated before the acquisition is consummated due to an unanticipated material adverse change in X's financial condition. Two months after the spin-off, Distributing begins negotiating a potential acquisition of Y. Five months after the spin-off, Distributing acquires Y in exchange for 40 percent of Distributing's stock. At the time the Y acquisition is consummated, Distributing enters into negotiations to acquire Z. Three months after those negotiations begin, Distributing acquires Z in exchange for 25 percent of Distributing's stock.

Under the 2002 Temporary Regulations, neither the Y acquisition nor the Z acquisition is "similar" to the potential X acquisition, because neither such acquisition involves a substantial portion of X's business operations. Since no AUA was reached or substantial negotiation conducted, with respect to either the Y acquisition or the Z acquisition prior to the spin-off of Controlled, neither such acquisition it treated as part of a plan that includes the spin-off.

Facts and Circumstances Test. Even if an AUA existed or substantial negotiations regarding an acquisition occurred during the two-year period preceding a distribution (so that the new super-safe harbor does not apply), a taxpayer may still be able to establish that the distribution and acquisition are not part of a plan under the general facts and circumstances test. To facilitate the application of this test, the 2002 Temporary Regulations, like the 2001 Temporary Regulations, describe several nonexclusive factors tending to show the existence of a plan and several nonexclusive factors tending to show that a plan did not exist, and state that:

- the relevant weight to be accorded these factors must be determined on a case-by-case basis, and
- the determination of whether a plan did or did not exist is not based simply on a numerical comparison of the number of factors tending to show the existence of a plan with the number of factors tending to show that no plan existed.[21]

The factors listed in the 2002 Temporary Regulations as tending to demonstrate the existence of a plan in the case of acquisitions following a distribution are as follows:

- In the case of acquisitions other than a public offering, an AUA or substantial negotiations regarding the acquisition or a similar acquisition during the two-year period ending on the date of the distribution existed.[22] In contrast to the 2001 Temporary Regulations, pre-distribution "discussions" between Distributing or Controlled and the acquirer are not treated as a fact tending to demonstrate the existence of a plan.
- In the case of acquisitions involving a public offering, discussions occurred between Distributing or Controlled and an investment banker regarding the acquisition during the two-year period ending on the date of the distribution.[23] In contrast to the 2001 Temporary Regulations, discussions between Distributing or Controlled and an investment banker regarding a potential auction of Distributing or Controlled are not treated as a fact tending to demonstrate the existence of a plan. The treatment of public offerings and auctions under the 2002 Temporary Regulations is discussed in more detail below.
- The distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition.[24] In contrast to the 2001 Temporary Regulations, (1) the existence of a "hot market" for either Distributing or Controlled is not treated as evidence of a business purpose to facilitate an acquisition,[25] and (2) mere intent by Distributing to avoid a hostile takeover of Distributing or Controlled through the distribution is not

treated as evidence of a business purpose to facilitate an acquisition. However, the 2002 Temporary Regulations do state that such intent coupled with pre-distribution discussions with a potential acquirer regarding such an acquisition is treated as evidence of a business purpose to facilitate an acquisition.[26]

The factors listed in the 2002 Temporary Regulations as tending to demonstrate that a plan did not exist in the case of acquisitions following a distribution are as follows:

- In the case of acquisitions involving a public offering, no discussions occurred between Distributing or Controlled and an investment banker regarding the acquisition during the two-year period ending on the date of the distribution.[27]
- An identifiable change in market or business conditions occurred following the distribution that was unexpected at the time of the distribution and that resulted in the distribution.[28]
- The distribution was motivated in whole or substantial part by a business purpose other than a purpose to facilitate the acquisition or a similar acquisition.[29] As noted above, the 2002 Temporary Regulations reflect certain changes from the 2001 Temporary Regulations with respect to the facts and circumstances that are relevant to the determination of the business purpose(s) for a distribution.
- The distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition.[30]

To illustrate the application of the facts and circumstances test, the 2002 Temporary Regulations provide that a taxpayer may be able to establish the absence of the plan even if an AUA existed, or substantial negotiations were conducted, prior to a distribution if (1) the distribution was motivated in whole or substantial part by a corporate business purpose other than facilitating the acquisition or a similar acquisition; and (2) the distribution would have occurred at approximately the same time and in similar form regardless of whether the acquisition or a similar acquisition was effected.[31] Presumably, a taxpayer can establish that a plan did not exist using other combinations of nonplan factors.

In practice, a taxpayer who engages in substantial negotiations with a potential acquirer that are broken off before the distribution may find it difficult to prove the absence of a plan if the taxpayer decides to proceed with the distribution and the acquirer subsequently acquires Distributing or Controlled.

> **Example 3.** Distributing desires to separate its core business X from Controlled's noncore business Y and to facilitate the acquisition of Distributing by Acquirer, which is also engaged in business X. At some point during the two years prior to the distribution, the officers and directors of Distributing engage in substantial negotiations with Acquirer. For business reasons, the negotiations are broken off before the distribution. Distributing believes that the distribution of Controlled will improve corporate fit and focus and accordingly distributes Controlled to Distributing's shareholders. Within six months following the distribution, Distributing and Acquirer resume negotiations and effect an acquisition of Distributing in which Acquirer's shareholders receive 55 percent of Distributing's stock.

Because officers and directors of Distributing engaged in substantial negotiations with Acquirer during the two-year period ending on the date of the distribution, the super-safe harbor does not apply (and, none of the enumerated safe harbors apply because, as discussed below, the acquisition was agreed to within six months after the distribution). Even assuming Distributing can establish that the distribution was motivated, in whole or in substantial part, by a "fit-and-focus" business purpose, it normally will be difficult to establish that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition (assuming Distributing must establish both of those nonplan factors to outweigh the fact that substantial negotiations occurred during the two-year period ending on the distribution date), unless, *e.g.*, Distributing had announced the distribution or obtained board approval for the distribution prior to entering into negotiations with Acquirer, and the distribution occurred in the manner described in such announcement or board resolution.

Safe Harbors. The 2002 Temporary Regulations provide three safe harbors (Safe Harbors I, II and III) that apply to acquisitions following distributions. Because of the new super-safe harbor, taxpayers

do not need to rely on any of the enumerated safe harbors for an acquisition following a distribution unless an AUA existed or substantial negotiations were conducted, regarding the acquisition during the two-year period ending on the date of the distribution.

Under Safe Harbor I, a distribution and a post-distribution acquisition are not treated as part of a plan if (1) the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate an acquisition of the acquired corporation; and (2) the acquisition occurred more than six months after the distribution, and there was no AUA or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins one year before the distribution and ends six months thereafter.[32] Hence, Safe Harbor I applies to acquisitions with respect to which substantial negotiations occurred at some point during the two-year period prior to the distribution, so long as such negotiations terminated without agreement more than one year prior to the distribution and did not resume until more than six months after the distribution.

Example 4. Same facts as Example 3, except that Distributing and Acquirer do not resume negotiations until more than six months after the Distribution.

If Distributing and Acquirer terminated substantial negotiations more than one year prior to the distribution and did not otherwise reach an AUA during the one-year period ending on the date of the distribution, then Safe Harbor I applies if the distribution was motivated "in whole or substantial part" by the asserted "fit-and-focus" business purpose. However, because the test for determining business purpose (which is the same test applied under Reg. §1.355-2 to determine the existence of a corporate business purpose for a distribution) is subjective, a taxpayer will rarely have complete certainty that it will be able to prove that a distribution was motivated "in whole or substantial part" by a nonacquisition business purpose.

Following repeal of the *General Utilities* doctrine, distributions under Code Sec. 355 became one of the few remaining avenues for a corporation ... to distribute appreciated property ... to its shareholders without recognizing corporate-level gain.

Under Safe Harbor II, a distribution and a post-distribution acquisition are not treated as part of a plan if (1) the distribution was not motivated by a business purpose to facilitate the acquisition or a similar acquisition; (2) the acquisition occurred more than six months after the distribution, and there was no AUA or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins one year before the distribution and ends six months thereafter; and (3) no more than 25 percent of the stock of the acquired corporation was either acquired or was the subject of an AUA or substantial negotiations during the period that begins one year before the distribution and ends six months thereafter.[33] Any acquisitions that are treated as not part of the plan under Safe Harbors V, VI or VII (discussed below) are not counted toward the 25-percent limitation.[34] Safe Harbor II was broadened in the 2002 Temporary Regulations to allow acquisitions of 25 percent (as opposed to 20 percent) of Distributing's or Controlled's stock and to remove the requirement in the 2001 Temporary Regulations that the acquisition business purpose must not exceed 33 percent of the stock of Distributing or Controlled.

The principal distinction between Safe Harbor I and Safe Harbor II is that in Safe Harbor II (but not Safe Harbor I), the distribution may be motivated solely by a business purpose to facilitate "an acquisition," so long as that acquisition is different from the acquisition to which Safe Harbor II is being applied. For example, assume the sole business purpose for a distribution is to facilitate a third-party strategic investor's purchase of a significant (but not more than 25 percent) equity stake in Controlled. If Controlled later acquires a different third party more than six months after the distribution occurs, then that acquisition will not be considered part of a plan that included the distribution (if the other requirements of Safe Harbor II are met), even though the distribution was motivated solely by the business purpose of facilitating an acquisition of Controlled's stock.

Under Safe Harbor III, a distribution and a post-distribution acquisition are not treated as part

of a plan if there was no AUA concerning the acquisition or a similar acquisition at the time of the distribution and no AUA or substantial negotiations within one year after the distribution.[35] This safe harbor applies where parties engaged in substantial negotiations at any time prior to the distribution or had an AUA that was "broken off" prior to the distribution, as long as such negotiations do not resume for one year after the distributions (or an AUA does not exist otherwise during the one-year period following the distribution).

Treatment of Shares of Controlled Retained by Distributing. In a number of recent spin-offs, Distributing has retained some Controlled stock after the spin-off for purposes of retaining value to help it sustain its credit rating. Under Code Sec. 355(a), a distribution of less than all of Controlled's stock will qualify as tax-free if Distributing distributes at least an amount of Controlled's stock constituting "control" within the meaning of Code Sec. 368(c), *i.e.*, at least 80 percent of the total combined voting power of all voting stock of the subsidiary and at least 80 percent of the total number of shares of all other classes of stock. If less than all of the Controlled stock and securities owned by Distributing are distributed, Distributing must establish that Controlled stock was not retained in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax, *i.e.*, that a substantial business purpose exists for retaining Controlled stock.[36] The retention of Controlled stock for purposes of sustaining Distributing's credit rating should constitute such a substantial business purpose.[37]

As a condition for obtaining a favorable ruling, the IRS requires that the retained stock must "be disposed of as soon as a disposition is warranted consistent with the business purpose [for retention of stock] but in any event, not later than 5 years after the distribution."[38] This raises the issue, which has not been addressed in any of the regulations issued to date under Code Sec. 355(e), of whether such an agreement constitutes an "agreement, understanding, or arrangement" within the meaning of Temporary Reg. §1.355-7T(h)(1)(i).

Example 5. Distributing desires to separate its core business X from Controlled's noncore business Y solely for the purpose of facilitating a combination of Controlled and T, which is also engaged in business Y. Distributing also desires to retain an interest in Controlled for the purpose of sustaining its credit rating. Thus, Distributing distributes 90 percent of the stock of Controlled to its shareholders and represents in its request for a private letter ruling under Code Sec. 355 that it will dispose of the retained stock within five years after the distribution. Immediately thereafter, T merges into Controlled, with T's shareholders receiving 45 percent of the stock of Controlled. Within the five years after the distribution, Distributing sells the retained shares of Controlled stock to an unrelated purchaser.

On these facts, the distribution of Controlled stock would be treated as part of a plan involving the acquisition of a 50-percent or greater interest in Controlled if the ultimate sale of the retained shares of Controlled stock, in addition to the issuance of Controlled shares in the merger with T, are treated as part of a plan that includes the distribution.[39] Although Distributing's later sale of retained shares is agreed to as a condition of receiving an IRS private letter ruling, the authors believe that the retained shares should not be "tainted" for purposes of Code Sec. 355(e) where Distributing is permitted to hold the shares for up to five years with no AUA and no substantial negotiations to sell those shares with any particular acquirer prior to the distribution. For example, in Rev. Rul. 66-23,[40] the IRS concluded that stock received in a reorganization that the recipient was required by a court order to dispose of within seven years nevertheless satisfied the pre-1998 "continuity of interest" requirement for tax-free reorganizations on the basis that the requirement to sell the stock within seven years did not constitute a "plan or arrangement for disposition" of the stock. The IRS has apparently adopted this view: In a very recent private letter ruling,[41] the IRS concluded that the retention by Distributing of Controlled shares for purposes of maintaining Distributing's credit rating will not be treated as (1) in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax within the meaning of Code Sec. 355(a)(1)(D)(ii), and (2) part of a plan described in Code Sec. 355(e)(2) that includes the Distribution.[42]

Acquisition Followed by a Distribution

Facts and Circumstances Test. The differences between the 2002 Temporary Regulations and the 2001 Temporary Regulations are less pro-

nounced in the case of acquisitions that precede distributions than in the case of distributions that precede acquisitions. In particular, no super-safe harbor is provided in the case of an acquisition before a distribution; hence, a prohibited plan can exist under the 2002 Temporary Regulations even though no AUA or substantial negotiations regarding the distribution occurs prior to the acquisition, if all relevant plan factors outweigh all relevant nonplan factors. However, in contrast to the 2001 Temporary Regulations, the 2002 Temporary Regulations do not contain a general rule that a prohibited plan exists where the distribution was intended by Distributing or Controlled at the time of the acquisition. In addition, the narrower definition of "similar acquisition" applies to distributions that follow acquisitions as well as to acquisitions that follow distributions.

With one notable exception (discussed below), the plan and nonplan factors that apply in the case of an acquisition before a distribution remain essentially unchanged from those set forth in the 2001 Temporary Regulations. The plan factors are (1) discussions regarding a possible distribution between Distributing or Controlled and the acquirer prior to the distribution (although the 2002 Temporary Regulations add the restriction that such discussions must have occurred within two years prior to the acquisition), with the weight accorded to this factor depending on the nature, extent and timing of the discussion; and (2) the distribution was motivated by a business purpose to facilitate the acquisition.[43] The nonplan factors are:

1. absence of discussions regarding a possible distribution between Distributing or Controlled and the acquirer within two years prior to the acquisition;
2. existence of an "identifiable, unexpected change in market or business conditions" that occurs after the acquisition and that caused an otherwise unexpected distribution;
3. 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"; and
4. the distribution "would have occurred at the same time and in similar form regardless of the acquisition or a similar acquisition."[44]

As in the case of the 2001 Temporary Regulations, the 2002 Temporary Regulations provide that nonplan factor (1) above does not apply if the distribution is announced to the public prior to the acquisition. However, in an important change from the 2001 Temporary Regulations, the 2002 Temporary Regulations also provide that the fact that "a person other than Distributing or Controlled intends to cause a distribution and, as a result of the acquisition, can meaningfully participate in the decision regarding whether to make a distribution" negates nonplan factor (1) above and instead is treated as tending to demonstrate the existence of a plan.[45]

Example 6. Distributing is engaged in the business of manufacturing high-end video monitors, and Distributing's wholly owned subsidiary Controlled is engaged in the business of operating a number of middle market radio stations. P is engaged in the business of manufacturing certain components for personal computers. Individual Q is a managing director of an investment fund that owns 80 percent of the stock of P and Q also sits on P's board of directors. Q has given speeches and authored an article in which she espouses the view that corporations maximize shareholder value by focusing on a single line, or on closely related lines, of business. P acquires Distributing in a tax-free merger of Distributing into P in which Distributing's former shareholders receive 25 percent of P's stock. Four months after P's acquisition of Distributing, P distributes 100 percent of the stock of Controlled to P's shareholders in a transaction intended to qualify as a tax-free spin-off under Code Sec. 355.[46] Neither Distributing nor Controlled discussed a potential spin-off of Controlled with P prior to P's acquisition of Distributing, and the sole business purpose for Distributing's spin-off of Controlled is "fit and focus."

The fact that neither Distributing nor Controlled discussed the distribution with P within the two-year period ending on the date of the acquisition would indicate that no plan exists under the 2001 Temporary Regulations, assuming the distribution was not publicly announced prior to the acquisition. However, there is strong circumstantial evidence that a person (*i.e.*, Q) intended to cause the distribution to occur and it seems reasonable to conclude that Q is in a position to "participate meaningfully" in that decision. In addition, while the spin-off is not

motivated by the purpose of facilitating the acquisition, the business purpose appears to constitute further circumstantial evidence that Q intended to cause the distribution to occur. In the absence of one or more reasonably strong nonplan indicators (*e.g.*, an unexpected event that caused the distribution to occur), application of the facts and circumstances test under the 2002 Temporary Regulations appears more likely than not to lead to the conclusion that the acquisition and distribution were part of a plan because of the of the new "intent" plan factor in those regulations. By contrast, it is unlikely that that conclusion would be reached under the 2001 Temporary Regulations because of the absence of pre-acquisition discussions between Distributing or Controlled and P regarding the distribution and the fact that the distribution was not made for the purpose facilitating the acquisition.

The 2002 Temporary Regulations unfortunately do not provide any guidance regarding either (1) the circumstances under which a person will be deemed to be able to "participate meaningfully" in the decision to cause a distribution or (2) the manner in which the "intent" of such a person is to be determined. Indeed, the facts of Example 6 probably reflect an easier case than is likely to be encountered most of the time in practice, and yet the conclusion under those facts is, in the view of the authors, far from certain. Consequently, in contrast to most of the other significant changes reflected in the 2002 Temporary Regulation, the addition of the limited "intent" plan factor in the case of distributions following an acquisition increases, in certain cases, the level of uncertainty taxpayers will face in planning transactions to avoid Code Sec. 355(e).

Safe Harbors. One safe harbor in the 2002 Temporary Regulations (Safe Harbor IV) applies exclusively to acquisitions followed by a distribution. Under this safe harbor, an acquisition and a distribution will not be treated as part of the plan if a distribution occurs more than two years after the acquisition and there was no AUA or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter.[47] Thus, any discussions regarding a distribution that occur prior to the acquisition will not be taken into account, as long as such discussions did not rise to the level of substantial negotiations. In addition, it appears that any AUA or substantial negotiations prior to the acquisition will not be taken into account, as long as such negotiations or AUA were terminated prior to the acquisition. This safe harbor was also provided under the 2001 Temporary Regulations.

Treatment of Public Offerings and Auctions

The 2002 Temporary Regulations continue to treat public offerings (but not, as discussed below, auctions) differently than other types of acquisitions in certain important respects. With respect to distributions that precede an acquisition:

1. The super-safe harbor described above does not apply to public offerings.[48]
2. Pre-distribution discussions between Distributing and Controlled and an investment banker regarding a possible post-distribution public offering are treated as a fact tending to demonstrate the existence of a plan.[49]
3. The absence of such discussions during the two-year period preceding a distribution is treated as a fact tending to demonstrate that a plan did not exist.[50]

In the case of a public offering before the distribution, discussions regarding a distribution by Distributing or Controlled with an investment banker during the two-year period ending on the date of the acquisition tend to indicate the existence of a plan[51] (but the absence of such discussions is not accorded any significance as a factor tending to indicate that no plan existed).

With the exception of Safe Harbor V, all of the safe harbors apply to public offerings, with the following general modification: the existence of an AUA or substantial negotiations will be based on discussions by one or more officers, directors or controlling shareholders of Distributing or Controlled, or another person with their implicit or explicit permission, with an investment banker.[52] Safe Harbor V does not apply to public offerings because the transferor of stock in the public offering is necessarily the acquired corporation.[53]

While the 2001 Temporary Regulations generally treated auctions the same way public offerings were treated, the 2002 Temporary Regulations treat acquisitions pursuant to auctions under the same rules that apply to all other acquisitions not involving a public offering. The preamble to the 2002 Temporary Regulations explains that this change was made because "it is difficult to define an auction in a manner that identifies those situations to which it is appropriate to apply [special rules]."[54] Hence, the occurrence of pre-distribution discussions with an investment banker regarding a possible post-distribu-

tion auction of Distributing or Controlled is no longer a plan factor (although such discussion are treated both as evidence of a business purpose for a distribution and as evidence of the relative importance of all claimed business purposes).[55]

Safe Harbors Applicable to Distributions and Acquisitions in Either Order

Safe Harbors V, VI and VII apply to acquisitions and distributions that occur in either order. Safe Harbor V provides an important exception for acquisitions resulting from market trading among small shareholders. Under Safe Harbor V, an acquisition of Distributing's or Controlled's 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, the transferee and any coordinating group of which either the transferor or transferee is a member is:

- the acquired corporation;
- a corporation that the acquired corporation controls;
- a member of a controlled group of which the acquired corporation is a member;
- an underwriter with respect to such acquisition;
- a controlling shareholder of the acquired corporation; or
- a 10-percent shareholder (increased from the five-percent threshold set forth in the 2001 Temporary Regulations) of the acquired corporation.[56]

For purposes of this test, a controlling shareholder is defined as a five-percent shareholder who actively participates in the management or operation of the corporation (including a corporate director).[57]

The 2002 Temporary Regulations modified Safe Harbor V to prevent the use of a device intended to ensure that an acquirer of just under 50 percent of Distributing or Controlled will subsequently obtain control of publicly-traded Distributing or Controlled by arranging for the voting rights associated with the publicly traded stock to decrease upon certain transfers.[58] The modification clarifies that Safe Harbor V does not apply to public trading of stock if a transfer of such 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.[59] A new example (Example 5) has been added to illustrate this device and how the 2002 Temporary Regulations apply to it.

In determining whether "voting power" was acquired by a person other than the transferor, the IRS will presumably focus on the power of stock to elect members of the board of directors of either Distributing or Controlled.[60] Example 5 in the 2002 Temporary Regulations describes a situation in which the voting power of a share of stock that was initially entitled to 10 votes in election of each director of Distributing was reduced as a result of transfer to only one vote. Example 5 concludes that no safe harbor is available to such transfers. This new rule in Safe Harbor V may be more difficult to apply in a situation where the acquired corporation has outstanding several classes of stock with disparate voting rights, or where restrictions are placed on directors' right to exercise control over the acquiring corporation, *e.g.*, if certain directors are given veto rights on significant matters. The IRS will likely scrutinize any arrangements involving such restrictions.

Safe Harbor VI applies to stock acquired by a person in connection with such person's performance of services as an employee, director or independent contractor for either Distributing or Controlled, or a related person, in a transaction to which Code Sec. 83 or Code Sec. 421(a) applies, provided that such compensation is not excessive by reference to the services performed.[61] Stock acquired by a 10-percent shareholder or a controlling shareholder[62] is not eligible for Safe Harbor VI.

The 2002 Temporary Regulations added a new Safe Harbor VII, which provides an exception for stock of Distributing or Controlled acquired by a retirement plan of an employer that qualifies under Code Sec. 401(a) or 403(b).[63] The amount of stock that can be acquired under Safe Harbor VII during the four-year period beginning two years before the distribution is limited, in the aggregate, to 10 percent of vote or value.[64]

Conclusion

On an overall basis, the authors believe that the 2002 Temporary Regulations provide sensible and workable guidance regarding the determination of whether a distribution and acquisition will be treated as part of a plan under Code Sec. 355(e). In particular, the authors applaud the new general rule for determining whether a distribution and post-distribution acquisition are part of a plan and the substantial narrowing of the definition of "similar acquisition," the combination of which should greatly increase taxpayers' level of certainty as to whether a plan will or will not be deemed to exist

with respect to acquisitions following a distribution. Our principal recommendation regarding changes prior to finalization of these temporary regulations is for further clarification in those parts of the 2002 Temporary Regulations identified in this article as creating uncertainty to taxpayers, *e.g.*, the application of the plan factor relating to "intent" by a person able to "participate meaningfully" in the decision to cause a post-acquisition distribution and the definition of "substantial negotiations."

ENDNOTES

1 Taxpayer Relief Act of 1997 (P.L. 105-34).

2 Code Sec. 355(e)(2)(B).

3 H.R. REP. NO. 105-148, at 462 (1997).

4 Joint Committee on Taxation, *Description and Analysis of Certain Revenue-Raising Provisions Contained in the President's Fiscal Year 1998 Budget Proposals*, at 51–52 (Mar. 11, 1997).

5 REG-116733-98, 64 FR 46,155 (Aug. 20, 1999).

6 REG-107566-00, 66 FR 66 (Jan. 2, 2001).

7 REG-107566-00, 66 FR 40,590 (Aug. 3, 2001).

8 REG-163892-01, 67 FR 20,632–20,642 (Apr. 26, 2002), corrected in 67 FR 38,199 (June 3, 2002).

9 *See* MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS AND BUYOUTS, at ¶1010.1.2.4.2 (June 2002 ed.).

10 Temporary Reg. §1.355-7T(b)(2).

11 2001 Temporary Reg. §1.355-7T(b)(1).

12 2001 Temporary Reg. §1.355-7T(b)(2)(vii) and (viii).

13 2001 Temporary Reg. §1.355-7T(b)(3)(i). This nonplan factor would not be present if Distributing had discussed a potential sale of Distributing with *any* potential acquirer prior to the spin-off.

14 Temporary Reg. §1.355-7T(h)(1)(i).

15 Temporary Reg. §1.355-7T(h)(1)(ii).

16 Proposed Reg. §1.355-7(b)(2) and (m) (Example 7).

17 *See ABA Comments Concerning Proposed Regulations Under Section 355(e) Defining a "Plan (or Series of Related Transactions),"* 2001 TNT 149-26 (July 23, 2001); *see also* MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS AND BUYOUTS, at ¶1010.1.2.4.2 (Dec. 2001 ed.); *see also* Mark J. Silverman, *Proposal to Modify Section 355(e) Temporary Regulations*, 2001 TNT 201-22 (Oct. 17, 2001).

18 Temporary Reg. §1.355-7T(h)(8) (emphasis added). Two new examples (Examples 6 and 7) have been added to illustrate this rule.

19 Temporary Reg. §1.355-7T(h)(8).

20 *See* Temporary Reg. §1.355-7T(h), Preamble, where the IRS stated that "certain comments suggested that where there is a change in acquirer and the new acquirer is not related to the originally intended acquirer under section 267(b) or 707(b), the new acquisition should not be treated as similar to the originally intended acquisition. Consistent with comments' suggestions, the revised temporary regulations set forth a definition of a similar acquisition that is narrower." Thus, although the IRS did not expressly authorize the use of the tests under Code Secs. 267(b) and 707(b), this statement in the Preamble can be interpreted as implicit endorsement of these tests for purposes of determining whether ultimate actual owners of the business are substantially similar to the ultimate owners in the proposed acquisition.

21 Temporary Reg. §1.355-7T(b)(1).

22 Temporary Reg. §1.355-7T(b)(3)(i).

23 Temporary Reg. §1.355-7T(b)(3)(ii).

24 Temporary Reg. §1.355-7T(b)(3)(v).

25 *Cf.* 2001 Temporary Reg. §1.355-7T(e)(1).

26 Temporary Reg. §1.355-7T(c)(2).

27 Temporary Reg. §1.355-7T(b)(4)(i).

28 Temporary Reg. §1.355-7T(b)(4)(ii).

29 Temporary Reg. §1.355-7T(b)(4)(v).

30 Temporary Reg. §1.355-7T(b)(4)(vi).

31 *Id.* This example seems to apply only to acquisitions following distributions. *See* Temporary Reg. §1.355-7T(b)(2) ("[f]or example, in the case of an acquisition (other than involving a public offering) after a distribution …"). However, because these nonplan factors apply both to acquisitions and distributions, taxpayers should be able to rely on this example regardless of the order of the transactions. *See also* Example 4 of Temporary Reg. §1.355-7T(j) (concluding that a predistribution acquisition is not part of the plan where taxpayer establishes presence of both of these factors).

32 Temporary Reg. §1.355-7T(d)(1).

33 Temporary Reg. §1.355-7T(d)(2).

34 Temporary Reg. §1.355-7T(d)(2)(ii).

35 Temporary Reg. §1.355-7T(d)(3).

36 *See* Code Sec. 355(a)(1)(D)(ii); Reg. §1.355-2(d)(3). *See also* Rev. Rul. 75-321, 1975-2 CB 123, where the IRS permitted Distributing to retain Controlled stock "to serve as collateral so as to enable [Distributing] to obtain short-term financing for its remaining business enterprise."

37 *See* LTR 8405017 (Oct. 28, 1983), where Distributing distributed 90 percent of the common stock of Controlled, and the IRS permitted Distributing to retain the remaining 10 percent "for the purpose of raising needed capital by selling such stock in the public market for a period of time after the proposed distribution." *See also* LTR 8836046 (June 15, 1988), where Distributing contributed common stock representing 2.07 percent of the voting power of Controlled to a wholly-owned subsidiary of Distributing in order to "provide a source of liquidity" subsequent to a spin-off. *See also* LTR 200126012 (Mar. 28, 2000), supplementing LTR 200044017 (July 14, 2000), where the IRS permitted Distributing to retain temporarily less than five percent of the stock of Controlled. Distributing was allowed to retain the stock because retention (and, presumably, the subsequent sale) of the stock furthered Distributing's original business purpose for undertaking the spin-off, *i.e.*, providing additional capital to Distributing to protect and grow its business.

38 Rev. Proc. 96-30, 1998-1 CB 456. Distributing retaining Controlled stock must also (1) represent to the IRS that "except under certain limited circumstances, none of Distributing's directors or officers may serve as directors or officers of Controlled," and (2) agree to vote the retained stock in proportion to the votes cast by Controlled's other shareholders.

39 All acquisitions of stock "that are considered to be part of a plan with a distribution" are aggregated for purposes of the 50-percent test. Temporary Reg. §1.355-7T(c)(5).

40 Rev. Rul 66-23, 1966-1 CB 67. Although Rev. Rul. 66-23 was made obsolete as a result of changes in the continuity of interest regulations, the reasoning adopted in the ruling should remain applicable to the issue of retained shares.

41 Not released as of the date of this publication.

42 In addition, where Distributing retains less than 10 percent of Controlled's stock following the distribution, it may be able to rely on the Safe Harbor V to establish that the ultimate disposition of the retained shares is not part of a plan that includes the distribution.

43 Temporary Reg. §1.355-7T(b)(3)(iii) and (v).

44 Temporary Reg. §1.355-7T(b)(4)(iii)–(vi).

45 Temporary Reg. §1.355-7T(b)(3)(iii) and (4)(iii).

46 P is treated as the distributing corporation for purposes of applying Code Sec. 355(e). Code Sec. 355(e)(4)(D).

47 Temporary Reg. §1.355-7Td)(4).

48 Temporary Reg. §1.355-7T(b)(2).

49 Temporary Reg. §1.355-7T(b)(3)(ii).

50 Temporary Reg. §1.355-7T(b)(4)(i).

51 Temporary Reg. §1.355-7T(b)(3)(iv).

52 Temporary Reg. §1.355-7T(h)(1)(iii).

53 *See* Temporary Reg. §1.355-7T(d)(5)(A).

54 Temporary Reg. §1.355-7T, Preamble.

55 Temporary Reg. §1.355-7T(c)(1).

56 Temporary Reg. §1.355-7T(d)(5).

57 Temporary Reg. §1.355-7T(h)(3).

ENDNOTES

[58] *See* Temporary Reg. §1.355-7T, Preamble. This technique apparently had been used in the Procter & Gamble/Smucker's spin-off.

[59] Temporary Reg. §1.355-7T(h)(3)(ii)(B).

[60] *See* Rev. Rul. 69-126, 1969-1 CB 218; *cf. Alumax Inc.*, CA-11, 99-1 USTC ¶50,210, 165 F3d 822, aff'g, 109 TC 133, Dec. 52,279 (1997) (holding that the 80-percent-by-vote test of Code Sec. 1504(a)(2) requires taking into account not only a shareholder's power to elect 80 percent of the votes on the corporation's board of directors, but also the extent to which those directors elected by such shareholder have the authority to manage the corporation's business).

[61] Temporary Reg. §1.355-7T(d)(6).

[62] Temporary Reg. §1.355-7T(d)(6)(ii). For purposes of this test, a controlling shareholder is a five-percent shareholder who actively participates in the management or operations of a corporation (in the case of a corporation the stock of which is listed on an established market) or any person that owns, actually or constructively under the rules of Code Sec. 318, stock possessing voting power representing a meaningful voice in the governance of the corporation (in the case of a corporation the stock of which is not listed on an established market).

[63] Temporary Reg. §1.355-7T(d)(7)(i).

[64] Temporary Reg. §1.355-7T(d)(7)(ii).

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