Report on Proposed Section 355(e) "Plan" Regulations

This report[1] comments on the regulations proposed December 29, 2000, to interpret the concept of "plan (or series of related transactions)" for purposes of Code § 355(e)(2)(A)(ii), (B) and (C),[2] as enacted by Section 1012 of the Taxpayer Relief Act of 1997 (the "2000 Proposed Regulations"). The 2000 Proposed Regulations replace regulations proposed on August 19, 1999 (the "1999 Proposed Regulations").[3]

The 2000 Proposed Regulations are a well written, thoughtful response to commentators who urged implementation of Code § 355(e) in a manner that permits taxpayers to conclude, with reasonable certainty, that some categories of transactions are not within the purview of Code § 355(e), and permits taxpayers and IRS personnel to rebut the statutory presumption of a plan or series of related transactions by resort to all relevant facts and circumstances. The Tax Section, together with other commentators, previously noted the importance of providing workable bright-line guidance in this area, given the vague standard employed in the legislation and the frequent impracticability of seeking a private letter ruling for transactions that might

1. The principal authors of this report are Lawrence Garrett, Kathleen Ferrell, Jorge Ramirez and Bonnie O'Brien. Helpful comments were received from Michael Schler, Jason Factor, Robert A. Jacobs, Deborah Paul, Michael Humphreys, Stuart Finkelstein and Philip Wagman.

2. Unless otherwise noted, "Code §" references are to the Internal Revenue Code of 1986 and the Treasury Regulations promulgated thereunder.

3. Withdrawal of Notice of Proposed Rulemaking, 66 Fed. Reg. 76 (2001).

implicate Code § 355(e).[4] The Tax Section Report on the 1999 Proposed Regulations criticized the exclusive rebuttal approach of those regulations, but commended the effort to identify safe harbors for certain transactions, and suggested how guidance might be made more meaningful. The 2000 Proposed Regulations adopt many of the commentators' specific suggestions by abandoning the "clear and convincing evidence" standard and the exclusive rebuttal approach of the 1999 Proposed Regulations in favor of a "facts and circumstances" approach, supplemented by a number of safe harbors and enumerated "plan" and "nonplan" factors. We endorse the basic approach of the 2000 Proposed Regulations and focus our comments on certain technical points raised by the particular provisions in the 2000 Proposed Regulations. We recommend some revisions and additional safe harbors intended to enhance the intent of the 2000 Proposed Regulations to provide workable guidance. We also have included a list of nonplan issues with respect to which additional guidance under Code § 355(e) should be provided.

I. THE 1999 PROPOSED REGULATIONS

Legislative Background

If certain conditions for tax free treatment are satisfied (*e.g.*, satisfaction of the "no-device" requirement of Code § 355(a)(1)(B), the five year active business requirement of Code § 355(b) and the continuity of interest test), Code § 355 generally permits a corporation to

---

4. "Defining 'Plan' in the Anti-Morris Trust Provisions," NYSBA Tax Section Committees on Corporations and Reorganizations, Dec. 8, 1998, as reprinted in Tax Notes, Jan. 11, 1999; "NYSBA Tax Section Urges Treasury to Revise Proposed Anti-Morris Trust Regs.," NYSBA Tax Section Committees on Corporations and Reorganizations, Mar. 22, 2000, as reprinted in Tax Notes, Apr. 13, 2000 (hereinafter, the "Tax Section Report on the 1999 Proposed Regulations"). See also Michael L. Schler, "What is a 'Plan (or Series of Related Transactions)' Under Section 355(e)?," Oct. 4. 1999, as reprinted in two parts in Tax Notes, Nov. 12 and 22, 1999; "Anti-Morris Trust Regulations: Broadening the Traditional Notions of What Constitutes a Plan," Mark J. Silverman and Lisa M. Zarlenga, Mar. 31, 2000, as reprinted in Tax Notes, Apr. 3, 2000; "NYC Bar Committee Criticizes Proposed Anti-Morris Trust Regs.," Committee on Taxation of Business Entities of the Association of the Bar of the City of New York, Aug. 25, 2000 as reprinted in Tax Notes, Sep. 21, 2000; "AICPA Suggests Changes to Proposed Anti-Morris Trust Regs.," AICPA, Oct. 31, 2000, as reprinted in Tax Notes, Nov. 16, 2000; "PricewaterhouseCoopers Suggests Changes to Anti-Morris Trust Regs.," Kenneth J. Kies and Gary B. Wilcox, Jan. 18, 2000, as reprinted in Tax Notes, Feb. 18, 2000; "EEI Criticizes Proposed Anti-Morris Trust Regs.," Edison Electric Institute, Jan. 5, 2000, as reprinted in Tax Notes, Jan. 13, 2000; Attorney Criticizes Proposed Anti-Morris Trust Regs.," Candace A. Ridgeway, Jan. 5, 2000, as reprinted in Tax Notes, Feb. 3, 2000; "Suggestions for Morris Trust Regs 'Plan' Determination Rules," Herbert N. Beller, Mar. 31, 2000, as reprinted in Tax Notes, Apr. 3, 2000; "Attorneys Suggest Changes to Anti-Morris Trust Regs.," Robert H. Miller and Lea Ann Storum, Jan. 4, 2000, as reprinted in Tax Notes, Jan. 13, 2000; "Proposed Morris Trust Regs Make the Situation Murkier," Robert Willens, Oct. 29, 1999, as reprinted in Tax Notes, Nov. 1, 1999.

distribute to its shareholders stock of a controlled corporation without requiring gain recognition at the corporate or shareholder levels. But, where the distribution resembles a sale, Code § 355(d) and Code § 355(e) impose limitations on the ability of the distributing corporation to escape corporate level taxation. Code § 355(d), enacted in 1990, identifies disqualified distributions in the case of distributions to shareholders that are treated as having purchased stock of the distributing or controlled corporation within 5 years of the distribution. Code § 355(e), enacted in 1997, provides for corporate level taxation if the distribution is "part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation."[5] Code § 355(e)(2)(B) establishes the presumption that a "plan (or series of related transactions)" (hereinafter, "plan") is present if the acquisition or acquisitions being tested occur during the 4-year period beginning on the date that is 2 years before the distribution date. Although the statute does not provide further guidance to determine when a plan is deemed to exist, Code § 355(e)(5) empowers the Secretary of the Treasury to promulgate regulations to implement the goals of Code § 355(e).

The 1999 Proposed Regulations

The 1999 Proposed Regulations addressed the statutory presumption of Code § 355(e)(2)(B), providing the presumption could be overcome only by demonstrating, by "clear and convincing evidence," each of the elements of one of the rebuttal tests prescribed by the regulations. The 1999 Proposed Regulations prescribed separate rules for post-distribution acquisitions and pre-distribution acquisitions. Two rebuttal methods were set forth for each: a "general rebuttal" and an "alternative rebuttal."

The "general rebuttal" for post-distribution acquisitions focused on the motivation for the distribution and the timing of the acquisition. For acquisitions occurring within the two-year presumption period, this test could not be satisfied unless the taxpayer could establish that (i) the acquisition occurred more than six months after the distribution, (ii) there was no "agreement,

---

5. In some factual settings, Code § 355(e) may overlap with Code § 355(d), such as with certain acquisitions of stock constituting a 50-percent or greater interest in the distributing or controlled corporation occurring within the two year period prior to the distribution. Code § 355(e) does not apply to any distribution to which Code § 355(d) applies. Code § 335(e)(2)(D).

NY2:#4408230v1

understanding, arrangement, or substantial negotiations" at the time of the distribution or within six months after the distribution and (iii) the distribution was motivated in whole or in substantial part by an acceptable "nonacquisition" corporate business purpose (other than an intent to facilitate an acquisition or decrease the likelihood of the acquisition of one or more businesses by separating those businesses from others that are likely to be acquired).

The "alternative rebuttal" for post-distribution acquisitions required satisfaction of a three-part test. First, the taxpayer must establish that either (i) at the time of the distribution, the distributing corporation, the controlled corporation, and their controlling shareholders did not intend that any one or more persons would acquire the proscribed 50-percent or greater interest in the distributing corporation during the two-year presumption period or (ii) the distribution was not motivated in whole or in part by an intention to facilitate an acquisition of any interest in the distributing corporation or the controlled corporation. The second part of the test, the "reasonable anticipation test," required the taxpayer to show that at the time of the distribution, neither the distributing corporation, the controlled corporation, nor their controlling shareholders would reasonably have anticipated that it was more likely than not that one or more persons would acquire a prohibited interest during the two-year presumption period (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or six months thereafter) who would not have acquired the interests absent the distribution. Finally, under the third prong of the "alternative rebuttal" test, the taxpayer had to establish that the distribution was not motivated in whole or in substantial part by an intent to decrease the likelihood that one or more businesses would be acquired by separating them from other businesses that were likely to be acquired.

The rebuttals for pre-distribution acquisitions also involved an examination of intent and timing. For acquisitions occurring up to two years prior to a distribution, the "general rebuttal" required the taxpayer to establish that, at the time of the acquisition, the distributing corporation and its controlling shareholders did not intend to effectuate a distribution. Under the "alternative rebuttal" for those acquisitions, taxpayers had to establish that the distribution would have occurred at approximately the same time and under substantially the same terms regardless of the acquisition. However, if by reason of the acquisition or if at any point after the acquisition but before two years after the distribution (or later pursuant to an agreement, understanding, or arrangement existing at the time of the distribution or six months thereafter) the person acquiring

an interest in that acquisition became a controlling shareholder, the "alternative rebuttal" was not available.

The 1999 Proposed Regulations were heavily criticized for, among other reasons, (i) creating an exclusive rebuttal system that excluded too many transactions not involving an abuse Congress intended to curtail and unfairly limited the evidence taxpayers could produce to determine whether transactions are part of a plan, (ii) adopting a "clear and convincing evidence" standard that was poorly defined and potentially unduly burdensome, and (iii) incorporating a "reasonable anticipation test" that was impractical and believed to be nearly impossible to satisfy.[6] Commentators also asserted that requiring the distributing and controlled corporations to foresee actions others might take in response to a distribution exceeded Congressional intent.[7] Commentators further asserted the 1999 Proposed Regulations exceeded Congressional intent by allowing a "plan" to exist unilaterally.[8] Moreover, the general rebuttals were unavailable in many cases where there would appear to be no real abuse but where the admitted purpose of the spin-off was to facilitate a less than 50-percent acquisition of either the distributing or controlled corporation, such as to permit the controlled company to acquire a smaller target or to facilitate a small stock issuance, as for example to an ESOP or to one or more key employees. The problem was further aggravated by the impracticable requirements of the "alternative rebuttal" for post-

---

6. See, *e.g.*, Tax Section Report on the 1999 Proposed Regulations, *supra* note 4; "LA Bar Tax Section Report on Spin-offs After Anti-Morris Trust Regs.," LACBA Taxation Section Corporate Tax Committee, May 16, 2000, as reprinted in Tax Notes, Oct. 26, 2000 (hereinafter "LACBA Taxation Section Report on the 1999 Proposed Regulations"); "ABA Tax Section Members Weigh in on Anti-Morris Trust Regs.," ABA Section of Taxation, Dec. 19, 1999, as reprinted in Tax Notes, Jan. 3, 2000. For example, attempted application of the reasonable anticipation test could involve complex calculations of the probability that one or more persons would acquire 50-percent of the distributing or controlled corporations as a result of the distribution, including, for example, calculating the probability that two completely independent parties would each acquire 25-percent of one of the corporations, or that a 20-percent pre-distribution initial public offering of the controlled corporation's stock would be followed by a 30-percent post-distribution acquisition.

7. According to the preamble to the 1999 Proposed Regulations, the Treasury Department relied on the statement contained in the General Explanation of the Staff of the Joint Committee on Taxation that "[a] public offering of a sufficient size can result in an acquisition" described in section 355(e) and in the change in concept of "a person" as the acquiror in section 355(d) to "1 or more persons" in section 355(e) to justify a broad interpretation of "plan (or series of related transactions)" and the lack of a requirement of negotiations between the distributing corporation and the eventual acquiror. See Tax Section Report on the 1999 Proposed Regulations, *supra* note 4.

8. Regrettably, the unilateral plan concept is continued in the 2000 Proposed Regulations.

distribution acquisitions, which required taxpayers to prove a negative proposition pursuant to the "reasonable anticipation test."[9] As a practical matter, under the 1999 Proposed Regulations, every distribution would be taxable if there was a 50-percent ownership change in the distributing or controlled corporation either (i) within six months after the distribution or (ii) within seven months to two years after the distribution if the only significant purpose of the distribution was to facilitate a stock issuance or acquisition of any size.[10] Although the 1999 Proposed Regulations attempted to create workable safe harbors within the statutory presumption period, the onerous burden of proof imposed on taxpayers, combined with the exclusiveness of the rebuttal system led commentators to recommend creating more meaningful safe harbors and a nonexclusive "facts and circumstances" test.

II. THE 2000 PROPOSED REGULATIONS

Summary of the 2000 Proposed Regulations

The 2000 Proposed Regulations adopt a "facts and circumstances" approach, guided by two nonexclusive lists of "plan" and "nonplan" factors, supplemented by six safe harbor provisions. "Operating rules" elaborate on certain factors that evidence a business purpose to facilitate an acquisition as well as to identify other factors to be disregarded in making the basic Code § 355(e) determination.

Generally, whether an acquisition and a distribution will be considered part of a plan depends upon whether, based on all the facts and circumstances, the transactions were intended to occur in connection with each other. In the case of a post-distribution acquisition, the 2000 Proposed Regulations state the basic Code § 355(e) inquiry is whether the distributing corporation, the controlled corporation, or any of their respective controlling shareholders "intended, on the date of the distribution, that the acquisition or a similar acquisition occur in connection with the distribution."[11] The preamble to the 2000 Proposed Regulations says the reference to "similar acquisition" is designed to ensure that changes in the terms of the

---

9. Schler, *supra* note 4, at 58-60.

10. *Id.* at 17.

11. Prop. Regs. §1.355-7(b)(1).

acquisition intended at the time of the distribution (including, in certain circumstances, the substitution of a different acquiror) do not prevent the distribution and the acquisition that actually occurs from being considered part of a plan in place at the time of the distribution. In the case of a pre-distribution acquisition, the test is whether the distributing corporation, the controlled corporation, or any of their respective controlling shareholders intended, on the date of the acquisition, that a distribution would occur in connection with the acquisition.

The determination of intent to be made under the facts and circumstances test is guided by nine "plan" factors, tending to show that a distribution and acquisition are part of a plan, and by seven "nonplan" factors, tending to implicate the opposite result. Many of the "plan" and "nonplan" factors focus on whether the distributing corporation, controlled corporation or their respective controlling shareholders participated in discussions with outside parties regarding the second transaction before the first transaction occurred. If any discussions did take place, the weight to be accorded to the discussions depends on their "nature, extent and timing."[12] In addition, each set of factors inquires into the business purpose of the transactions and whether the business purpose of the distribution was to facilitate the acquisition.[13] Other "plan" factors include whether the transactions occurred within six months of each other or whether there was an agreement, understanding, arrangement or substantial negotiations regarding the second transaction at any time before the date that is six months after the first transaction,[14] and whether the debt allocation between the distributing and controlled corporations resulting after the distribution made an acquisition of either of the corporations likely to service the debt.[15] The remaining "nonplan" factors include whether an unexpected change in market or business conditions occurring after the first transaction prompted the second, unexpected transaction,[16] and whether, regardless of the acquisition or similar acquisition and the timing of the

12. Prop. Regs. §1.355-7(d)(2)(i)-(vi).

13. Prop. Regs. §1.355-7(d)(2)(vii) and (d)(3)(vi).

14. Prop. Regs. §1.355-7(d)(2)(viii).

15. Prop. Regs. §1.355-7(d)(3)(ix).

16. Prop. Regs. §1.355-7(d)(3)(iii) and (v).

transactions, the distribution would have occurred at approximately the same time and in similar form.[17]

The 2000 Proposed Regulations supplement the "facts and circumstances" test with safe harbors under which a distribution and an acquisition will not be considered part of a plan. The first four safe harbors maintain many key elements of the "general rebuttal" for post-distribution acquisitions under the 1999 Proposed Regulations while also relaxing the standards employed. Acquisitions occurring more than six months after a distribution fall within a safe harbor if there was no agreement, etc., concerning the acquisition within six months after the distribution and either (i) the distribution was motivated in whole or substantial part by a corporate business purpose other than to facilitate the acquisition[18] or (ii) the distribution was motivated by a corporate business purpose to facilitate an acquisition of no more than 33-percent of the stock of the acquired corporation, and no more than 20-percent of the stock of the acquired corporation was either acquired or subject to an agreement, etc., within six months after the distribution.[19] If the transactions are more than two years apart, they will not be considered to be part of a plan unless there was an agreement, etc., concerning the later transaction within six months of the earlier transaction.[20] The fifth safe harbor, which generally is intended to prevent public trading from creating a Code § 355(e) issue, essentially provides, with certain restrictions, that an acquisition of stock listed on an established market is not part of a plan if the acquisition is pursuant to a transfer between shareholders, neither of whom owns 5-percent or more of the stock of the outstanding listed stock.[21] This safe harbor does not apply to public offerings or redemptions. The final safe harbor protects acquisitions of Code § 83 stock by employees and directors of, and by persons related to, the distributing or controlled corporation from being considered part of a plan.[22] Further protection for compensatory options is provided by

---

17. Prop. Regs. §1.355-7(d)(3)(vii).

18. Prop. Regs. §1.355-7(f)(1)(i)(B).

19. Prop. Regs. §1.355-7(f)(2)(ii).

20. Prop. Regs. §1.355-7(f)(3) and (4).

21 Prop. Regs. §1.355-7(f)(5).

22. Prop. Regs. §1.355-7(f)(6).

exempting them from the general treatment of options as agreements to acquire stock, subject to certain limitations.[23]

The 2000 Proposed Regulations, also provide operating rules to aid in the divining of taxpayer intent, a significant component of the "facts and circumstances" test and of many safe harbors. A purpose to facilitate an acquisition of the distributing or controlled corporation will be deemed to have been present, if at the time of the first transaction, it was "reasonably certain" that within six months the second transaction would occur, an agreement, etc., would exist or substantial negotiations would occur regarding the second transaction.[24] The preamble to the proposed regulations notes this rule is a significant modification of the "reasonable anticipation" standard of the 1999 Proposed Regulations and states this rule will apply only when there was a "strong probability" of those factors occurring or existing. Also, internal corporate discussions regarding an acquisition may be indicative of the business purpose that motivated the distribution.[25] Additionally, if the distribution of controlled corporation stock was intended by the distributing corporation to decrease the likelihood of acquisition of either the distributing or controlled corporation by separating it from another corporation that is likely to be acquired, the distributing corporation is treated as having a business purpose to facilitate the acquisition of the corporation that was likely to be acquired.[26] The operating rules further provide that neither the effect of a distribution on trading in the stock of the distributing or controlled corporation nor the consequences of the application of Code § 355(e) and the existence of any contractual indemnity by the controlled corporation for tax resulting from application of that section are relevant in determining the intention of the parties.[27]

In the case of multiple acquisitions of stock of the distributing or controlled corporations, the 2000 Proposed Regulations require each acquisition to be tested by the distributing corporation to determine whether it is part of a plan that includes a distribution. All acquisitions

---

23. Prop. Regs. §1.355-7(g)(3)(ii).

24. Prop. Regs. §1.355-7(e)(1).

25. Prop. Regs. §1.355-7(e)(2).

26. Prop. Regs. §1.355-7(e)(3).

27. Prop. Regs. §1.355-7(e)(4) and (5).

NY2:#4408230v1

of stock of the distributing or controlled corporations that are considered part of a plan with a distribution are aggregated for purposes of the 50-percent threshold.[28]

Summary of Conclusions

The 2000 Proposed Regulations provide much improved guidance in determining what constitutes a "plan (or series of related transactions)." We commend the Service and the Treasury for their efforts in this area. Several of the comments made by the Tax Section and others have been incorporated into the new proposed regulations, from broad methodology recommendations, such as the adoption of a "facts and circumstances" test accompanied by safe harbors, to more specific recommendations, such as the exclusion of small acquisitions and compensatory options from being considered part of a "plan." We believe further guidance should address lingering policy issues, and certain technical revisions should be made. For example: (i) the "motivated in whole or substantial part" standard for satisfying the nonacquisition-related business purpose requirement of the principal safe harbor should be clarified; (ii) the safe harbor regarding distributions undertaken to facilitate small acquisitions should be revised to more clearly reach the kinds of transactions intended to be covered; (iii) the safe harbor dealing with compensatory arrangements should be revised to cover a wider range of common compensatory schemes that will be excluded from being part of a "plan"; (iv) acquisitions of stock made significantly before pro rata distributions should be protected; (v) the treatment of options should be revised to address options that are significantly out-of-the money on issuance or transfer that become in-the-money by the time of the distribution for independent reasons; (vi) certain issuances of tracking stock should not necessarily be treated as part of a "plan;" and (vii) the principles underlying examples in the proposed regulations should be identified. Both these policy recommendations and our technical comments are discussed in greater detail below.

---

28. Prop. Regs. §1.355-7(c).

III. COMMENTS ON THE 2000 PROPOSED REGULATIONS

For ease of reference, this report is divided into two sections: (1) comments that raise important policy issues, and (2) comments identifying technical issues and suggesting clarifications. While the Tax Section Executive Committee acknowledges these comments are not, and are not intended to be, comprehensive, we address what we believe are the most salient issues arising under the 2000 Proposed Regulations.

A. Comments Raising Significant Policy Issues

Safe Harbor I

We believe Safe Harbor I could be improved by providing further guidance as to when a distribution will be considered to be "motivated in whole or substantial part" by a nonacquisition corporate business purpose, and focusing that inquiry on the corporation whose stock is being acquired. In addition, we recommend Safe Harbor I not apply to an acquisition that occurs pursuant to an agreement, understanding, or arrangement entered into, or where substantial negotiations concerning the acquisition *or a substitute acquisition* have occurred within the 6 months after the distribution. Given the importance Safe Harbor I is likely to have in practice, we believe high priority should be given to publishing clarified guidance.

1. "Motivated in Whole or Substantial Part"

Safe Harbor I applies to an acquisition consummated more than 6 months after a distribution provided (i) there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before the date that is 6 months after the distribution (the "six-month rule"), and (ii) the distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of Treas. Reg. §1.355-2(b)) other than a business purpose to facilitate an acquisition of the distributing or controlled corporation (the "substantially motivated requirement"). The nonacquisition corporate business purpose is supposed to be considered in light of any business purpose to facilitate an acquisition and in light of the operating rule that it is evidence of an acquisition business purpose if there is a reasonable certainty an acquisition will occur within six months after the distribution.

While the reference to Treas. Reg. § 1.355-2(b) is helpful, if the distribution is undertaken both for nonacquisition- and acquisition-related business purposes, that provision does not provide sufficient guidance for taxpayers to determine the weight the nonacquisition-related business purpose must have to satisfy the "substantially motivated" requirement of Safe Harbor I. The examples under Treas. Reg. § 1.355-2(b)(5) offer limited guidance in this regard, including an ineffectual suggestion that all facts and circumstances must be weighed to determine if the nonacquisition-related business purpose substantially motivated the distribution.[29] As a result, the relative importance the nonacquisition-related business purpose must bear to the acquisition-related business purpose remains uncertain.

Although there are several possible interpretations of the "substantially motivated" requirement, the most troubling possibility is that a taxpayer would be required to demonstrate either that the distribution would not have occurred but for the existence of the nonacquisition-related business purpose, or that the distribution would have occurred even in the absence of the acquisition-related purpose. The final regulations should specifically state that this is not the test.

Instead, having satisfied the "six-month rule" as the threshold for entry into Safe Harbor I, the taxpayer should be required to demonstrate only that the nonacquisition-related business purpose was a real and substantial business purpose, *i.e.*, one which standing alone would have been sufficient to satisfy the business purpose requirement for Code § 355 and which was a significant factor in the decision to pursue the distribution, but not necessarily that the nonacquisition-related business purpose was the one most important motivating factor, or that the distribution would have occurred even if the acquisition-related business purpose had not been present. As Examples 5 and 6 appear to demonstrate, the ability to show the distribution would have occurred regardless of the acquisition is sufficient to satisfy the basic Code § 355(e) inquiry even if the "six-month rule" cannot be satisfied. For instance, Example 5 concludes that an acquisition that was reasonably certain to occur at the time of the distribution and that, in fact, occurs within 6 months thereof, is not related to the distribution if the nonacquisition business purpose is substantial and the distribution would have occurred regardless of the acquisition.

---

29. Treas. Reg. §1.355-2(b)(5) ex. 8.

The test suggested in Example 5 may be appropriate in the context of an acquisition that occurs soon after the distribution, and as we recommend below, the principles underlying the example should be elevated to an operating rule or a nonplan factor, rather than remaining as a principle that must be extracted from an example. However, if the "six-month rule" is satisfied, a less stringent standard for evaluating the strength of the nonacquisition-related business purpose is appropriate. For example, assume the business purposes for a spin-off are to enhance the controlled corporation's access to capital markets (including equity markets), better position the controlled corporation to participate in a consolidating industry, and alleviate competitive issues faced by the controlled corporation as a result of its ownership by the distributing corporation, and that an acquisition of the controlled corporation occurs one year after the distribution in circumstances that otherwise satisfy the "six-month rule". The acquisition should be covered by Safe Harbor I, assuming the "competitive issues" business purpose is real and substantial, regardless of whether that business purpose can be shown to have been the most important of the several reasons for the spin-off.

2. Focus on Corporation to which Business Purpose Relates

The business purpose test for Safe Harbor I should be refined to disregard an acquisition-related business purpose relevant only to the controlled corporation if the acquisition being tested is of distributing stock, and vice versa. For example, if the business purposes for a spinoff relate to the controlled corporation and include acquisition- and nonacquisition-related business purposes, Safe Harbor I should apply to an acquisition of stock of the distributing corporation (assuming satisfaction of the "six-month rule") if there was no acquisition-related business purpose related to the distributing corporation, without regard to whether there were nonacquisition-related business purposes related specifically to the distributing corporation. Also, if there is an acquisition-related business purpose related to the corporation whose stock is the subject of the acquisition being tested, Safe Harbor I should be available only if there is a substantial nonacquisition-related business purpose related to that corporation.

3. Substitute Acquisitions

Finally, we recommend Safe Harbor I not protect an acquisition that is a substitute for an acquisition with respect to which there have been substantial negotiations within 6 months of the

distribution.[30] Adding this limitation should prevent unintended overbreadth of the safe harbor. For example, Safe Harbor I clearly cannot apply if an acquisition is negotiated before the distribution, or shortly thereafter, even if the transaction is not completed within six months of the distribution. Nevertheless, as written, Safe Harbor I could be satisfied, even though an acquisition had been negotiated at the time of the distribution, if a "substitute acquiror" (say, a higher bidder) appeared more than six months after the distribution and succeeded in completing the acquisition, because substantial negotiations regarding an acquisition other than "the" acquisition that is being tested do not prevent satisfaction of the "six-month rule," a result inconsistent with the purpose of Code § 355(e) as well as inconsistent with the "facts and circumstances" test, which asks whether it was intended that the distribution and the acquisition occur in connection with one another, and which clearly would be failed in this case. Additionally, this unintended result raises competitiveness issues, as any new bidder, shielded from Code § 355(e) risk by Safe Harbor I, could more easily outbid the original bidder. We do not believe the exclusion of a substitute acquisition from Safe Harbor I should prevent the safe harbor from applying where substantial negotiations with one party begin within six months of the distribution, completely break off, and long thereafter, a similar acquisition with a different acquiror occurs. It would be helpful in this regard if the enumerated plan factors mentioned that a history of negotiations with a potential acquiror are less relevant (or not relevant at all) if it can be demonstrated those negotiations were completely broken off and played an insignificant (or no) role in the ultimate acquisition.

Safe Harbor II

Safe Harbor II applies to an acquisition of stock if (i) the acquisition occurs more than 6 months after the distribution, (ii) the acquisition is not made pursuant to an agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before 6 months after the distribution, (iii) the distribution was undertaken in whole or in substantial part to facilitate an acquisition or acquisitions of no more than 33-percent of the stock of the distributing or controlled corporation (the "33-percent Limit"), and (iv) no more than 20-percent of the stock of such corporation is actually acquired or subject of such an agreement,

---

30. See discussion in part B below recommending further guidance as to the meaning of "similar" acquisition.

understanding, arrangement, or substantial negotiations before 6 months after the distribution (the "20-percent Limit").

Safe Harbor II should be simplified by eliminating the two-tier numerical test, specifically dropping the 20-percent Limit. While we appreciate the genesis of this safe harbor is the paradigm case of a controlled corporation desiring to issue less than 20-percent of its stock in an initial public offering ("IPO") in connection with the distribution, this limitation is arbitrary, and a distribution intended to facilitate an acquisition of up to 33-percent in the first six months is no more troublesome than 20-percent in terms of the operation of Code § 355(e).[31] For example, if a 25-percent equity carve out of the controlled corporation was effected immediately following a distribution, and one year after the distribution, an unrelated and unexpected acquisition of any amount of the stock of the controlled corporation occurred, Safe Harbor II would not be available because of the 20-percent Limit, and Safe Harbor I would not be available because of the acquisition-related business purpose of the distribution.

In addition, as we have recommended for Safe Harbor I, Safe Harbor II should not be available where the acquisition is a substitute for one which had been negotiated before six months after the distribution.

Finally, the regulations should clarify whether Safe Harbor II is intended to apply to the acquisition that was intended to be facilitated by the distribution if the acquisition occurs more than six months after the distribution.

Safe Harbor VI

Safe Harbor VI applies to an acquisition of the stock of the distributing or controlled corporation (i) by an employee or director of the distributing corporation, the controlled corporation, or a related person (under Code§ 355(d)(7)(A)), (ii) in connection with the performance of services as an employee or director for the corporation or a related person, (iii) in a transaction to which Code § 83 applies, and (iv) that is not excessive by reference to the services performed. Safe Harbor VI appropriately recognizes that a distribution intended to

---

31. If the 20-percent Test is retained, the regulation language should be revised to clarify that the 20-percent Test is measured by reference only to stock acquisitions intended to be facilitated by the distribution; other acquisitions should not count toward the 20-percent Test.

facilitate delivery of equity-based incentives to service providers is rooted in the need to provide proper compensation and incentives and does not effect a disposition of a business unit equivalent. Consistent with this underlying rationale, Safe Harbor VI should be broadened to cover a wider range of bona fide compensatory arrangements, whether or not Code § 83 technically applies to them.

In particular, we recommend Safe Harbor VI be revised to encompass the following stock acquisitions: (i) compensatory stock issuances to independent contractors, (ii) acquisitions of stock pursuant to the exercise of incentive stock options under Code § 422 and stock purchase plans under Code § 423, and (iii) acquisitions of stock by qualified plans under Code § 401, including acquisitions of stock by employee stock ownership plans ("ESOPs"), in each case so long as the acquisition intended to be covered by Safe Harbor VI is no more than a certain percentage (e.g., 33-percent to be consistent with Safe Harbor II) of the stock of the issuing corporation. In addition, the regulations should be clarified to assure that, in circumstances in which compensatory stock options of the distributing corporation are split into stock options of the distributing and controlled corporations pursuant to the distribution, the exercise of a controlled corporation stock option by an employee of the distributing corporation (and vice versa) would continue to qualify under Safe Harbor VI; it is not clear whether Safe Harbor VI, as currently written, covers this situation because the distributing corporation and the controlled corporation frequently will not be related when the options are subsequently exercised.[32]

At the same time, we recommend the Safe Harbor VI language be tightened to prevent it being abused. In particular, care needs to be taken so the safe harbor does not protect management leveraged buy-outs or going private transactions undertaken in connection with a distribution. Under the Tax Court's interpretation of the scope of Code § 83 in *Alves v. Commissioner*, 79 T.C. 864 (1982), *aff'd* 734 F.2d 478 (9th Cir. 1984), shares purchased for fair value can be considered transferred in connection with the performance of services. Thus, stock acquired by management in connection with a leveraged buy-out might be considered to be effected in connection with the performance of services and thus protected by Safe Harbor VI, an unintended and inappropriate result. One possible approach would be to exclude from Safe

32. Regulations dealing with the scope of the term "acquisition" for purposes of Code § 355(e) should address the extent to which compensatory stock issuances should be excepted.

Harbor VI compensatory stock acquisitions in which the service provider is making a coordinated acquisition with other service providers or investors, who together will acquire 50-percent or more of the stock of the distributing or controlled corporation in connection with the distribution (determined without regard to Safe Harbor VI).

Safe-Harbor for Certain Pre-Distribution Acquisitions

Safe Harbor IV applies where (i) the acquisition occurs more than 2 years before a distribution, and (ii) there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter. This safe harbor is helpful, but it could be improved by clarifying what is meant by "agreement, understanding, arrangement or substantial negotiations" in this context, and by expanding the scope of the safe harbor to cover pre-distribution acquisitions that occur closer in time to the distribution, so long as the distribution is pro rata to the distributing shareholders.

Acquisitions made prior to a distribution, in combination with the distribution, can have the effect of a disposition of a business. This effect would occur if, for example, an acquiror acquires stock of the distributing corporation and causes the distributing corporation to effect a non-pro rata split-off distribution to the acquiror in redemption of its distributing corporation shares. By contrast, acquisitions of the distributing corporation's stock made significantly before a pro rata distribution appear far less susceptible to abuse. Accordingly, we recommend the final regulations expand the protection of Safe Harbor IV to include an acquisition of the stock of the distributing corporation (i) that occurs before the earlier of (a) six months before the distribution, or (b) in the case of a distributing corporation whose stock is traded on an established securities market, six months before a public announcement of its intention to effect the distribution, (ii) where there was no "agreement, understanding, arrangement, or substantial negotiations" concerning the distribution at the time of the acquisition or within 6 months thereafter, and (iii) where the distribution is substantially pro rata as to all of the distributing corporation's shareholders.

Treatment of Options

The 2000 Proposed Regulations, like the 1999 Proposed Regulations, generally provide that, if stock of the distributing or controlled corporation is acquired pursuant to an option exercise, the option will be treated as an agreement to acquire the stock on the date the option is

written, unless the distributing corporation establishes that, *on the later of the date of the distribution or the writing of the option*, the option was not more likely than not to be exercised. Certain types of options are excepted from the general rule, including certain security arrangements, compensatory options, and other options. We believe the likelihood of exercise generally should be tested for this purpose only when the option is written. To prevent abuse, it may also be necessary to test for likelihood of exercise when the option is transferred to another holder or modified in such a way as to materially increase its likelihood of exercise.[33] Moreover, we believe whether an actual acquisition of stock pursuant to the exercise of an option should be treated as part of a plan with the distribution should be tested by reference to the state of affairs (*e.g.*, intentions of the parties, likelihood of exercise, etc.) at the time the option was acquired, if earlier than the distribution date.

Both recommended changes address problems that may arise where an option that is significantly out-of-the-money at the time of issuance or transfer becomes in-the-money by the time of the distribution, often for reasons having nothing to do with the distribution. For example, the first recommended change in the 2000 Proposed Regulations would permit Safe Harbor I to apply, in appropriate circumstances, to acquisitions of the distributing corporation's stock pursuant to the conversion of garden-variety convertible debt that was issued well before, and not in anticipation of, the distribution, but that became in-the-money by the time of distribution and is converted more than 6 months after the distribution. The second recommended change would operate under the "facts and circumstances" test to avoid tainting the acquisition of stock pursuant to an option exercise close in time to the distribution, if the option were not, in fact, issued or transferred in anticipation of the distribution.

Operating Rule 6 and Tracking Stock

Operating Rule 6 of the 2000 Proposed Regulations[34] was issued pursuant to regulatory authority granted under Code § 355(e)(5)(C) and tolls the running of any time period (*e.g.*, the 6-month period in Safe Harbor I) prescribed under the 2000 Proposed Regulations where the risk of loss is substantially diminished under the principles of Code 355(d)(6)(B). We understand

---

33. A substituted option rule similar to Treas. Reg. "1.355-6(c)(3)(iii)(C) could be applied.

34. Prop. Regs. " 1.355-7(e)(6).

IRS and Treasury may revise this rule in the final regulations to address a number of points. One point of particular interest is how this tolling rule is intended to apply in the case of "tracking stock," *e.g.*, stock issued by the distributing corporation that tracks the economic performance of a controlled corporation. Is it intended that the issuance of tracking stock toll the running of safe harbor periods with respect to an acquisition of stock other than the tracking stock itself or stock of the "tracked" subsidiary? Is the rule intended to suggest that a split-off in redemption of tracking stock will always be treated as a "plan"?

Final regulations should provide specific guidance regarding the application of this rule in the context of tracking stock, and should clarify that a split-off distribution of controlled corporation stock in redemption of tracking stock (pursuant to the terms thereof) does not automatically result in the acquisition of stock of the "tracked" subsidiary being considered to be part of a plan under the "facts and circumstances" test. While we believe tolling the running of safe harbor periods is appropriate, it does not necessarily follow that the issuance of tracking stock which, by its terms, the issuer may redeem in a split-off transaction, should cause the acquisition of the tracking stock and the distribution to be treated as "a plan." Redemption provisions of this type are standard features of tracking stock and typically merely preserve the flexibility of the issuer to engage in a later distribution, rather than evidence an intention to do so. At the time of issuance, the issuer may be equally likely to redeem the tracking stock or convert it into another class of common stock having a pro rata interest in all of the issuer's businesses. The issuance of the tracking stock simply may be intended to allow the issuer's stock to properly reflect the value of the tracked business in the marketplace. We believe factors such as the length of time the tracking stock is outstanding, among other factors, are more relevant to the determination of whether the issuance of the tracking stock and an ultimate distribution are truly part of a plan. In appropriate circumstances, tracking stock should not be so treated.

Principles Underlying Examples 5 and 6

Examples 5 and 6 address fact patterns outside the safe harbors and illustrate application of the basic "facts and circumstances" test of the regulations. Example 5 deals with an acquisition reasonably certain to occur at the time of the distribution (presumably because there was a "hot market" for companies like the controlled corporation, although there was no contact

with a potential acquiror prior to the distribution), and the envisioned acquisition, in fact, occurs within 6 months following the distribution. (As discussed below, the regulations could be improved by identifying the circumstances that produce a "reasonable certainty" determination). The example concludes the acquisition will not be treated as related to the distribution if the nonacquisition business purpose is substantial and the taxpayer can show the distribution would have occurred regardless of the subsequent acquisition.

Example 6 deals with an acquisition of a greater than 50-percent interest in the distributing corporation (by the target's shareholders) that occurs after the distribution is announced but before the distribution is effected. There were no discussions concerning an acquisition before the announcement date. The acquisition resulted from an unexpected opportunity for the distributing corporation to acquire the target that arose after the announcement. Example 6 concludes the acquisition and the distribution are not part of a plan if the distributing corporation can show the distribution was motivated by a substantial nonacquisition purpose and would have occurred regardless of the acquisition.

These examples provide insights as to the principles underlying the proposed regulations, but the relative importance of the particular facts in the examples and the applicability of the conclusions reached in the examples to other factual situations are unclear because they are examples, not operating rules. Final regulations should provide clarification in this regard and, if possible, enunciate the governing principle(s). The weighing principles set forth in these examples could be elevated to the level of operating rules or an expanded non-plan factor discussion. For example, consistent with one reading of Examples 5 and 6, final regulations could describe circumstances in which an acquisition before or after the distribution would not be considered to occur "in connection" with the distribution, *e.g.*, where (i) a substantial business purpose other than to facilitate the acquisition or a similar acquisition is the motivation for the distribution, (ii) at the earlier of the time of the announcement or the record date for the distribution there was no intent to facilitate an acquisition and no discussions with a potential acquiror had occurred, and (iii) the taxpayer can demonstrate that the distribution would have occurred regardless of the acquisition.[35]

---

35. Note that Example 6 as currently arguably is inconsistent with the basic test set forth in Prop. Treas. Reg. §1.355-7(b), which states "in the case of an acquisition before a distribution, the acquisition and the

(...continued)

Although Examples 5 and 6 suggest this test, it is not clear whether the proposed regulations intended to do so or that the same test should apply whether the acquisition occurs between the announcement date and the distribution or shortly after the distribution. For instance, would it matter to Example 5 if the first contact with the acquiror occurred (as in Example 6) after the announcement date but before the distribution? Would it matter to Example 6 if the acquisition were negotiated between the announcement date and the spin-off date, but completed (as in Example 5) after the distribution rather than before the distribution? The examples provide no guidance to enable the reader to determine the impact on the analysis of these timing points. Indeed, it is possible to read these examples as permitting the distributing corporation to announce a spin-off for a good business reason, negotiate a deal a few days later with an unexpected acquiror, enter into a binding contract for an acquisition to occur immediately prior to or following the spin-off, and then proceed to accomplish a *Morris Trust* spin-off (without triggering Code § 355(e)), at least where it can be established the spin-off would have been effected regardless of the acquisition. If no acquiror appeared, distributing could, of course, change course and decide not to effect the distribution. This possibility raises questions regarding the proper interpretation of these examples, and points to the proof problems associated with showing the absence of a plan where there are negotiations regarding an acquisition shortly before the distribution. Proving or disproving subjective intent is always difficult, and although the burden will be the taxpayer's to prove that a distribution would have occurred in any event, it will be more difficult for the government to contradict the assertion where a distribution actually occurred, and of no consequence where the distribution does not occur.

Effective Date

Since the enactment of Code § 355(e), the Service, taxpayers, and tax practitioners have attempted to interpret a vague standard with respect to which the legislative history is sparse. Final interpretive guidance will provide greater predictability as to the implications of the four-

---

(continued...)

distribution are considered part of a plan if Distributing, Controlled or any of their respective controlling shareholders intended, on the date of the acquisition, that a distribution occur in connection with the acquisition." Reading the phrase "in connection with" as requiring a strong casual link resolves the inconsistency, but may not be what the drafters intended. In any event, this point should be clarified.

year statutory presumption. For this reason, we recommend the final regulations permit taxpayers to rely on the final regulations for distributions that occur prior to the date the final regulations generally become effective.

In addition, unless the final regulations will be published shortly, we urge the Treasury Department and Internal Revenue Service to publish some type of interim guidance upon which taxpayers may rely to analyze the tax consequences of current transactions. For example, interim guidance could state the Code § 355(e) test as articulated in the 2000 Proposed Regulations, confirm that a facts and circumstances analysis applies, and adopt as temporary rules the safe harbors in the 2000 Proposed Regulations (modified as may be necessary to prevent overbreadth).

B. Comments Addressing Other Technical Issues

Safe Harbor V

Safe Harbor V generally applies to acquisitions of stock of publicly-traded corporations if the stock is transferred between shareholders that are not 5-percent shareholders. In general, a person is a 5-percent shareholder if, immediately before or after the transfer, the person owns, directly or indirectly, or together with related persons, 5-percent or more of any class of stock of the corporation.[36] The distributing and controlled corporations generally can rely on the existence or absence of U.S. securities law filings (Schedules 13D and 13G) to determine if a person is a 5-percent shareholder. We recommend the following changes to Safe Harbor V.

First, the regulations should clarify that the mere fact an investment advisor files a Schedule 13D or 13G reporting ownership for U.S. securities law purposes of 5-percent or more of a class of stock does not cause the investment advisor automatically to be considered a 5-percent shareholder.[37] We understand the current Code § 355 private letter ruling practice, at least in some branches, is to treat investment advisors who report a 5-percent or greater interest for 1934 Act purposes as 5-percent shareholders for purposes of the required "no plan or intent to

36. Note that this definition could include shareholders who hold shares representing only a fraction of a percentage of the total voting power or value where there are multiple classes of stock.

37. See Code § 382(k)(7) for the definition of a 5-percent shareholder. See also P.L.R. 9104043 (ruling that the mere filing by an investment corporation of a Schedule 13G with the SEC does not make the filer a 5-percent shareholder).

dispose" representation. If the investment advisor is reporting with respect to shares owned by accounts or funds that individually own less than 5-percent of the class, we do not believe the investment advisor should be considered a 5-percent shareholder for purposes of regulations implementing Code § 355(e).

Second, consideration should be given to expanding Safe Harbor V to cover dispositions of stock by a 5-percent shareholder into the market to persons that are not 5-percent shareholders, at least in cases where the transaction itself is small (*e.g.*, involving less than 10-percent or 5-percent of the stock of the corporation). The focus of Code § 355(e) is on stock "acquisitions" not "dispositions."

"Similar" Acquisitions

The meaning of a "similar" acquisition requires further guidance. The preamble to the 2000 Proposed Regulations states that references to a "similar" acquisition in the regulations (*e.g.*, in the plan and nonplan factors and in Safe Harbor II) are intended to ensure that changes in the terms of the acquisition intended or reasonably anticipated at the time of the distribution (including, in certain circumstances, the substitution of a different acquiror) do not prevent the distribution and the acquisition that actually occurs from being considered part of a plan. While we agree with this concept, we are concerned it may be difficult to apply in practice, absent further explication. We suggest final regulations provide a list of certain terms and conditions that would indicate whether the contemplated and the actual acquisition actually are sufficiently alike to constitute a "similar acquisition." For example, the acquisition of the stock of the distributing corporation should not be considered to be an acquisition similar to an acquisition of the stock of the controlled corporation (and vice versa). Significant differences in critical terms also may reveal sufficient dissimilarity, although a change in price (alone or in combination with a change in the identity of the acquiror) should not cause the acquisition to be treated as dissimilar. Significant differences in the type of acquisition should prevent an unanticipated takeover, for example, from being treated as "similar" to a previously discussed public offering, privately negotiated acquisition of a minority interest, or planned joint venture arrangement. Finally, the suggestion in Example 7 that a series of transactions are "similar" merely because they involve the use of stock as acquisition currency is troubling. While we understand the view that this example describes a plan or series of related transactions intended to be covered by

Code § 355(e), the conclusion that these transactions are "similar" is unexplained and not necessary to reach the result.

Public Offerings or Auctions

Several plan and nonplan factors are drafted to apply only, or not to apply at all, to an acquisition involving "a public offering or auction."[38] These references to "public offering or auction" are unnecessary and confusing and should either be deleted or clarified. First, these terms are not defined and are not easily defined. It is especially unclear as to what is meant by "auction" and whether an "auction" includes a situation where the "plan" is to shop the potential target serially (or to one likely acquiror), rather than to hire a banker to solicit simultaneous bids. Second, looking at the "plan" factors, it appears to us that, although the factors might be weighted differently depending on the particular type of acquisition involved, they are all relevant to the plan inquiry, whether the contemplated transaction is a privately negotiated transaction with a single potential acquiror, a process involving multiple bidders, or a public offering. For example, the nature, extent and timing of pre-distribution discussions with an investment banker should be considered in evaluating whether there is plan to consummate a privately negotiated transaction after the distribution. Accordingly, there is no reason for plan factor (iii) to be drafted to apply only "in the case of an acquisition involving a public offering or auction."[39] Likewise, although plan factors (i) and (ii) usually would not be present in the context of a "public offering or auction," there is no reason to draft these factors to provide anyone a basis to argue, for example, that predistribution discussions with a potential acquiror are not relevant as a plan factor if the acquisition is accomplished by way of an "auction." Third, turning to the nonplan factors, we assume the references to "public offering or auction" in factors (i), (ii) and (iv) are intended to suggest that <u>not</u> having had pre-distribution discussions with an acquiror is <u>not</u> a nonplan factor in a case involving a "unilateral" plan, such as might be the case in a public offering or auction; although in that case, <u>not</u> having had discussions with an

---

38. Prop. Regs. §1.355-7(d)(2)(i)-(iii), (vi) and (d)(3)(i)-(ii), (iv).

39. Prop. Regs. §1.355-7(d)(2)(iii) ("In the case of an acquisition involving a public offering or auction after a distribution, Distributing or Controlled (or any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the distribution. The weight to be accorded to the discussions depends on the nature, extent and timing of the discussions.")

investment banker or outside advisor would be a nonplan factor. It seems to us that not having had discussions with an investment banker or outside advisor should be considered a nonplan factor, whatever kind of acquisition is involved, and that not having had discussions with a potential acquiror should also generally be considered a nonplan factor, except in a case not involving a negotiated sale (*e.g.*, a public offering).

Internal Discussions

The 2000 Proposed Regulations provide that internal discussions within the confines of the distributing corporation or controlled corporation may evidence a purpose to facilitate an acquisition. We believe the regulations should state clearly the weight accorded these discussions depends on the nature, extent, and timing of the relevant discussions. Low level, general or regular strategic planning discussions should be accorded little or no weight.

Nonexclusivity of Plan and Nonplan Factors

As described in the preamble to the 2000 Proposed Regulations, the regulations include a "nonexclusive" lists of facts and circumstances to be considered in determining whether a distribution and an acquisition that are not covered by any safe harbor are part of a plan. We commend the Treasury Department and the Internal Revenue Service for formulating this rule in place of the exclusive general and alternative rebuttals of the 1999 Proposed Regulations. The 2000 Proposed Regulations appropriately state the facts and circumstances to be considered "are not limited to the facts and circumstances specified in paragraphs (d)(2) and (d)(3)."[40] We recommend language be added to the effect that, in specific cases, factors other than the enumerated factors may be highly relevant, and the failure of the regulations to identify a particular factor does not mean it is to be accorded lesser weight in a particular circumstance. This point is particularly relevant in the context of the examples, which as currently written tend to suggest a "factor" analysis limited to the enumerated factors. The final regulations also should state that the absence of a plan factor does not establish the affirmative existence of a nonplan factor, and vice versa.

---

40. Prop. Regs. §1.355-7(d)(1).

Reasonable Certainty of Acquisition

The first operating rule states that evidence of an acquisition business purpose exists if there was a "reasonable certainty" that within 6 months after the distribution an acquisition would occur, or within 6 months after the acquisition the distribution would occur.[41] The preamble to the 2000 Proposed Regulations states that the Service and Treasury believe the rule regarding reasonable certainty is necessary to implement Code § 355(e) because, where a taxpayer is reasonably certain that an acquisition will occur, that acquisition is likely to be taken into account in determining whether to effect the distribution. In this respect, the 2000 Proposed Regulations are an improvement over the "reasonable anticipation" test of the alternative rebuttal of the 1999 proposed regulations, in that the foresight required is (in the language of the preamble) a "strong probability" rather than "reasonable anticipation" and the time frame is reduced to six months from two years. However, we believe further guidance should identify the circumstances intended to be covered by the "reasonable certainty" operating rule.

The "reasonable certainty" operating rule, as currently drafted, is problematic in seeking the "reasonable certainty" determination at the time of the distribution, rather than at the time the distribution is announced. It seems clear these circumstances must have existed at the time the decision to effect the distribution was made (or at least announced) for them fairly to be taken into account in evaluating the "real" motivation for the spin-off. It may be fair to say, however, that an acquisition is "intended" at the time of the distribution if the distributing corporation, the controlled corporation, or their respective controlling shareholders believe there is a near certainty that an acquisition will occur shortly after the distribution. If this is the principle the Service and Treasury feel is necessary to implement Code § 355(e), final regulations should make this point more clearly and expand upon the kind of circumstances where "reasonable certainty" may occur. For example, what are the circumstances, short of an acquiror's communication of an intent to effect an acquisition, that could establish there was a "reasonable certainty" of an acquisition (or an agreement, understanding, or arrangement) within six months after the distribution?

---

41. Prop. Regs. §1.355-7(e)(1)

It may be appropriate to replace this operating rule with additional enumerated "plan" factors that more precisely articulate the government's concern. For example, where the acquisition is initiated by the controlled or distributing corporation, the mere fact the acquisition is consummated within six months following the distribution should be viewed as evidence of a plan. Where the acquisition is initiated by a third party and actually occurs, or is the subject of an agreement, understanding or arrangement within six months after the distribution, evidence of a plan should be deemed to exist if at the time of announcing the distribution, the distributing corporation, the controlled corporation, or their controlling shareholders knew that a particular acquiror with the means to effect an acquisition intended to do so shortly after the distribution. It should also be evidence of a plan if the post-distribution controlled or distributing corporation is not financially viable as a stand-alone company, without regard to whether that circumstance is the result of debt allocation between the distributing and controlled corporations.

If the "reasonable certainty" operating rule is retained, we urge the Service to entertain requests for private rulings that deal with whether and on what basis the reasonable certainty standard is satisfied or not satisfied, the publication of which should allow for the development of meaningful guidance over time.

IV. SUGGESTIONS FOR ADDITIONAL GUIDANCE

In addition to finalizing the "plan" regulations, the remaining provisions of Code § 355(e) require guidance. Some of the principal issues on which guidance in the "nonplan" regulations would be helpful are:

Technical Issues Regarding the Meaning of an "Acquisition"

The scope of "acquisition," as that term is used in Code § 355(e), should be clarified. Questions topic include:

(a) In a non-pro rata redemption by the distributing or controlled corporation, have the shareholders whose ownership percentages increase made an "acquisition"?

(b) Similarly, in a non-pro rata split-off, are shareholders whose percentage ownership of the distributing corporation increased made an "acquisition"? (Presumably, the benign Congressional policy toward split-offs reflected in Code § 355(e)(3)(A)(ii) should prevent an increase in stock ownership percentage attributable to the split-off from being

considered an acquisition that counts toward an ownership change. Regulations should confirm this analysis.)

(c) If the distributing or controlled corporation has multiple classes of stock outstanding, is a shift in the relative values of the stock " without any actual transfer of shares of the corporation " an "acquisition"?

(d) Is a shift in values, coupled with a transfer of shares, an acquisition? If so, how large is the acquisition?

Counting to 50-Percent

Guidance also should provide the methodology to be used in computing the percentage of the distributing or controlled corporation that is acquired in a "planned" transaction, or in a series of planned transactions.

Does it matter in what order planned and unplanned transactions occur? For example, suppose that, as part of a plan, the distributing or controlled corporation has agreed to a stock-for-stock merger with a corporation slightly smaller than it is. Shortly before the merger, there is an unplanned redemption of the distributing or controlled corporation stock (*e.g.*, a redemption resulting from a passive investor's exercise of a redemption right under the terms of preferred stock issued several years earlier), and as a result of the redemption the merger partner is now slightly larger than the distributing or controlled corporation. Alternatively, suppose that a planned acquisition of stock of the distributing or controlled corporation occurs; subsequently, employees exercise compensatory stock options; and a second planned acquisition transaction then occurs. Does it matter whether the parties to a plan anticipated that, for example, employee options would be exercised (by employees not privy to the plan) at approximately a certain rate over a given period? In addressing these issues, the simplest alternative would be in all cases to respect the actual order in which planned and unplanned acquisitions occur. A more complex approach would be to reorder acquisitions in cases where the parties to a plan sought to remain below 50-percent by timing their acquisitions to occur before or after transactions by persons not privy to the parties' plan.

Special "Counting" Problems Where the Distributing or Controlled Corporation is Publicly Traded

Where the distributing or controlled corporation is publicly traded, it presumably will be necessary to identify "public groups" to measure the size of an ownership change that results from, for example, a stock offering, merger or redemption.[42]

Assuming public group identification is to be the order of the day, should it matter whether some of the members of different "public groups" overlap? For example, if the distributing or controlled corporation completes a stock merger with an unrelated corporation as part of a plan, and it is known that certain index funds own stock of both merger parties, should that common ownership make a difference when determining the size of the resulting "acquisition," and the extent to which Code § 355(e)(3)(A)(iv) applies? Should parties be allowed to take affirmative steps to investigate their shareholder base and identify overlaps?

Scope of Ownership Attribution Rules

Code § 355(e)(4)(C)(ii) provides that Code § 318(a)(2) applies[43] "in determining whether a person holds stock or securities in any corporation." Presumably, pursuant to this provision, an increase in the percentage of the distributing or controlled corporation stock that a person owns through one or more tiers of intermediate entities counts as an indirect "acquisition" by that person of the distributing or controlled corporation stock.

In cases involving multiple ownership tiers, it should be clarified how the Code § 355(e)(3)(A) exclusions for certain acquisitions apply, and how these exclusions interact with the attribution rule in Code § 355(e)(4)(C)(ii). If an exclusion in Code § 355(e)(3)(A) applies at one level of ownership, does it apply at all levels? For example, in a split-off of the controlled corporation to a corporate shareholder of the distributing corporation, are the corporate shareholder's owners protected by Code § 355(e)(3)(A)(ii)? Similarly, if an individual owns the distributing or controlled corporation through multiple tiers of intermediate entities, and the

---

42. The regulations under Code § 382 dealing with public groups would provide a frame of reference for such an undertaking. See Treas. Reg. " 1.382-2T(j).

43. Code § 355(e)(4)(C)(ii) modifies the Code § 318(a)(2) attribution rules in one respect. Code § 318(a)(2)(C) provides that shares held by a corporation can be attributed to a shareholder only if the shareholder owns at least 50-percent by value of the corporation. Code § 355(e)(4)(C)(ii) removes this 50-percent restriction.

individual restructures these intermediate entities in a manner that leaves his percentage ownership of the distributing or controlled corporation unchanged, does Code § 355(e)(3)(A)(iv) apply to completely exclude the restructuring from consideration under Code § 355(e) " even though particular intermediate entities may have very different percentages of direct and indirect ownership in the distributing or controlled corporation after the restructuring than those entities did before the restructuring? Presumably, cases like the two just described should be protected by a combination of the rules in Code § 355(e)(3)(A) and the attribution rule in Code § 355(e)(4)(C)(ii). Regulations confirming and clarifying this protection would be welcome.

Joint Ventures and Asset Transfers

Code § 355(e)(4)(D) states that references in Code § 355(e) to the distributing or controlled corporations include "a reference to any predecessor or successor of such corporation." Under Code § 355(e)(3)(B), unless otherwise provided in regulations, the shareholders of a "successor" corporation that acquires assets of a distributing or controlled corporation in a type "A," "C" or "D" reorganization (or any other transaction specified in regulations) are treated as acquiring stock in the transferor. The many interpretive issues that arise out of these provisions include the treatment of joint ventures into which the distributing or controlled corporation enter with third parties.

For example, if the distributing or controlled corporation contributes all its assets to a corporate joint venture entity, and unrelated investors contribute cash, is the joint venture a "successor"? Does the answer change if the unrelated investors contribute business assets, rather than cash? Can there be more than one "successor" (*e.g.*, where all the transferor's assets are contributed to multiple joint venture entities)? Does the answer change if the joint venture entity is not a corporation? Should entering into a joint venture arrangement trigger Code § 355(e) in any event if, at the time of the distribution, the controlled or distributing corporation plans to contribute all its assets to the joint venture in exchange for a less than 50-percent interest in the joint venture?