New York State Bar Association

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October 28, 2002

The Honorable Pamela F. Olson
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 1334 MT
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, DC 20224

Ladies and Gentlemen:

This letter[1] comments on the Treasury Department's Temporary Regulations issued April 26, 2002, identifying a "plan (or series of related transactions)" for purposes of Internal Revenue Code ("Code") § 355(e)(2)(A)(ii), (B) and (C) (the "2002 Temporary Regulations"). The 2002 Temporary Regulations revise the temporary regulations, published August 3, 2001 (the "2001 Temporary Regulations"), that made temporary the proposed regulations published January 2, 2001 (the "2001 Proposed Regulations"). The 2001 Proposed Regulations replaced earlier proposed regulations, published August 19, 1999 (the "1999 Proposed Regulations"), which were withdrawn on January 2, 2001.

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[1] The principal authors of this letter are Andrew Berg, Dale Ponikvar and Russell Kestenbaum. Helpful comments were received from numerous members of the Executive Committee of the Tax Section of the New York State Bar Association.

Code § 355(e) generally imposes tax on the distributing corporation in a 355 transaction in circumstances where, pursuant to a plan, "1 or more persons acquire . . . a 50% or greater interest in the distributing corporation or any controlled corporation." Code § 355(e)(2)(B) establishes a presumption that a distribution and acquisition of a corporation are part of a plan if "1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation during the 4-year period beginning on the date which is 2 years before the date of the distribution." The 1999 Proposed Regulations provided the Code § 355(e)(2)(B) presumption could be overcome only by demonstrating that each element of one of several enumerated rebuttal tests was satisfied.

The 2001 Proposed Regulations responded to comments criticizing the presumption and rebuttal test set forth in the 1999 Proposed Regulations. The 2001 Proposed Regulations eliminated the presumption and rebuttal tests and instead adopted a general test to determine whether a distribution and acquisition are part of a plan (or series of related transactions) based on the intent of the relevant parties, determined on the basis of all the "facts and circumstances." The 2001 Proposed Regulations provided lists of nonexclusive factors indicating the presence or absence of a "plan." As an additional change to the 1999 Proposed Regulations, the 2001 Proposed Regulations established six safe harbors to provide taxpayers greater certainty that in prescribed circumstances a distribution and acquisition of a corporation would not be considered part of a "plan."

In our April 10, 2001 report on the 2001 Proposed Regulations (the "Report")[2] we noted that a "facts and circumstances" test more appropriately interprets Code § 355(e) than did the "rebuttable presumption" test of the 1999 Proposed Regulations. The 2002 Temporary Regulations reflect many of the changes we and other commentators suggested, including a number of comments that significantly limit the "plan" concept. In general, we believe these changes appropriately refine the "plan" concept and are a substantial improvement over the prior set of regulations because they provide taxpayers and the IRS with a more objective and clearly defined set of rules for determining when a distribution and acquisition are properly considered part of a "plan". We note, however, that because the new regulations rely largely on objective tests, they are somewhat less consistent with the statutory

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[2] See NYSBA Tax Section Report #991, Report on Proposed Section 355(e) "Plan" Regulations, reprinted at 2001 TNT 72-17 (April 13, 2001).

language and legislative history of Code § 355(e), which seem more focused on the subjective intent of the distributing corporation.

While Treasury no doubt has the authority to take a more objective approach than is indicated in the legislative history, and while a majority of our members support this approach, this report considers how the revised approach, and in particular the new safe-harbors, may apply in specific cases. We think there may be circumstances where the proposed safe harbors may go too far. We in any case commend the IRS and the Treasury for taking the time and making the effort to address these important issues, for being so responsive to taxpayer commentary, and for making an effort to provide clear, workable and objective administrative rules.

Changes Made by the 2002 Temporary Regulations

Factors and Definitions

The 2001 Temporary Regulations provided in general that as part of the facts and circumstances test, a distribution and an acquisition would be considered part of a plan if, at the time of the first transaction, Distributing, Controlled, or any controlling shareholder of either, *intended* for the second transaction to occur in connection with the first transaction. The 2002 Temporary Regulations eliminate the specific language of the 2001 Temporary Regulations regarding intent, but continue to focus on whether there was an agreement, understanding, arrangement or substantial negotiations regarding the second transaction at or prior to the time the first transaction was consummated.

The 2001 Temporary Regulations provided a list of factors indicating the presence or non-presence of a "plan" to divest control of either the controlled or distributing corporation. Several of these factors suggested that in the case of an acquisition after a distribution, pre-distribution discussions between the distributing or controlled corporation and the acquirer regarding the acquisition or a similar acquisition could establish the presence of a plan regardless of the proximity in time between the discussions and the distribution. Commentators suggested that certain bilateral discussions, or even agreements or understandings, between the parties should have occurred within a specified time period before the distribution for a post-distribution acquisition and distribution to be considered part of "a plan." The 2002 Temporary Regulations reflect these comments, providing that with respect to an acquisition following a distribution, a plan can exist only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some point during the two-year period preceding the distribution.[3] Although the facts and circumstances based definition of an agreement, understanding or arrangement and the newly provided definition of substantial negotiations (discussed below) do not allow this new rule to provide certainty to taxpayers engaged in certain discussions during the prohibited two year time frame, we believe this change to be salutary as it provides taxpayers certainty that an acquisition following a distribution will not be part of a plan including the distribution if *no* discussions occurred during the two years preceding the distribution.

The list of factors in the 2001 Temporary Regulations indicating the presence or absence of a plan distinguished in a confusing way between acquisitions involving a public offering or auction and those not involving a public offering or auction. Certain factors, such as the presence or absence of discussions with an investment banker, were listed as applicable only with respect to acquisitions involving a public offering or auction. Noting these issues, we suggested that the rules distinguishing public offerings and auctions from other types of acquisitions should be either deleted or clarified. Noting the difficulty in defining the term "auction" for purposes of determining whether a plan is present, the 2002 Temporary Regulations eliminate the distinction between acquisitions occurring pursuant to an auction and acquisitions not occurring pursuant to an auction. We support this change. However, the 2002 Temporary Regulations continue to provide different rules for analyzing acquisitions that occur pursuant to a public offering from acquisitions that do not involve a public offering.

Definition of "Similar Acquisition"

The 2001 Temporary Regulations provided that in the case of an acquisition following a distribution, the determination of whether a plan is present will depend upon whether there were pre-distribution discussions regarding the acquisition or a "similar acquisition." Regulations issued prior to the 2002 Temporary Regulations did not provide a definition of "similar acquisition." Example 7 of the 2001 Proposed Regulations, however, treated as similar (a) acquisitions where the target was identified and contacted prior

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[3] Although this rule applies only to acquisitions following a distribution, its concept remains a factor in determining whether an acquisition and a post-acquisition distribution are part of a plan.

to the distribution and (b) acquisitions where the target was identified prior to the distribution but not contacted, or was not identified at all. The 2001 Temporary Regulations eliminated Example 7 and narrowed the "similar acquisition" concept.

In our comments responding to the 2001 Proposed Regulations (drafted prior to the elimination of Example 7), we suggested providing lists of terms and conditions that must be similar before an actual and intended acquisition would be considered similar. We suggested that an acquisition of Distributing stock should not be considered similar to an acquisition of Controlled stock.[4] The 2002 Temporary Regulations now provide that "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."[5] As an example of the application of the term "similar acquisition," the 2002 Temporary Regulations provide that a planned merger of an acquirer into a distributing corporation will be considered similar to a merger of the distributing corporation into the same acquirer or a subsidiary of the acquirer but a planned merger of a distributing corporation and an acquiring corporation would not be similar to an actual merger of the distributing corporation and an acquiring corporation with different owners.[6]

The regulations now provide greater certainty, with a narrow definition of "similar acquisition,". As is often the case with bright line tests, issues of under or over inclusiveness arise. In this case we note that the rule may be under inclusive and exclude from the operation of Code § 355(e) transactions that arguably should be covered. In particular, it would seem that if pre-distribution discussions between Distributing and a potential buyer of Distributing (or Controlled) regarding a post-distribution acquisition of Distributing (or Controlled) would render their acquisition part of a plan if consummated, there may be circumstances under which a post-distribution acquisition of Distributing (or Controlled) by a completely unrelated acquirer made on substantially similar terms should be considered part of the plan as

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[4] Report at 23.

[5] 2002 Temp. Treas. Reg. § 1.355-7T(h)(8).

[6] 2002 Temp. Treas. Reg. § 1.355-7T(h)(8) and 2002 Temp. Treas. Reg. § 1.355-7T(j) Example 6.

well. For example, assume that Acquirer I and Target agree on terms of a merger planned to occur immediately after Target spins off its subsidiary (Controlled). As planned, the spinoff is consummated. Promptly thereafter Acquirer II submits a bid to merge with Target for consideration greater than the consideration previously offered by Acquirer I.[7] Acquirer II and Target subsequently merge. We think Acquirer II's acquisition of Target should be considered similar to Target and Acquirer I's intended merger. On the other hand, we believe that an Acquirer II acquisition would not be similar to an Acquirer I merger proposal which was the subject of pre-spin substantial negotiations that did not result in an agreement regarding a post-spin acquisition. In this case, the rationale for denying safe-harbor treatment to the Acquirer I transaction (the risk that substantial negotiations were only interrupted to permit the spin to occur) does not implicate a transaction with Acquirer II, which may not even have had knowledge of these substantial negotiations.

Definition of "substantial negotiations"

The 2001 Temporary Regulations included several factors and safe harbors indicating the presence of a plan. One significant factor was whether "substantial negotiations" had occurred prior to or after a spinoff. However, the 2001 Temporary Regulations did not define the term "substantial negotiations." The 2002 Temporary Regulations provide a definition to the effect that substantial negotiations generally require discussions of "significant economic terms" by a person authorized to act for the acquirer with a person authorized to act for either the distributing or controlled corporation.[8] We are concerned that this definition is too vague and vulnerable to being interpreted too aggressively in the taxpayer's favor. The only example of a significant economic term mentioned in the 2002 Temporary Regulations is the exchange ratio in a reorganization. It would be helpful to include other examples regarding the meaning of the term

[7] Arguably Acquirer II does not even have to top Acquirer I's bid if Acquirer II's acquisition avoids § 355(e).

[8] See 2002 Temp. Treas. Reg. § 1.355-7T(h)(1)(ii), which provides that officers, directors, controlling shareholders or any other person with implicit or explicit permission of an officer, director or controlling shareholder are persons authorized to act on behalf of a corporation.

"substantial negotiations" in light of the new definition. Following are a few suggested examples:

Example 1: A senior officer of Acquirer requests a meeting with officers and directors of Distributing to discuss a potential acquisition of Controlled. During the meeting, Acquirer mentions a purchase price for Controlled. The representatives of Distributing reject the price as inadequate and the meeting ends shortly thereafter. The meeting should not be considered a "substantial negotiation," because although the meeting concerned a significant economic term (price) there was no real substantial negotiation of price between the parties.

Example 2: Same facts as Example 1 except that the parties discuss purchase price for several days. After a few days the parties do not agree to a price but the difference between them has been significantly narrowed. At that time, no other significant discussions have occurred. The discussions among the management of Distributing and Acquirer should be considered substantial negotiations because the discussions were more than preliminary in nature and concerned significant economic terms.

We also note that the focus on discussions concerning significant economic terms may result in a plan not being deemed to exist where lengthy negotiations concerning issues other than price occur but where there is arguably no "agreement, understanding or arrangement" concerning a distribution and an acquisition. For example, assume senior officers of Acquirer request a meeting with officers and directors of Distributing to discuss a potential acquisition of Controlled. During several meetings involving the parties, many material terms regarding a potential acquisition (including the potential form for the transaction and whether officers of Controlled will have a significant role in the combined operation) are discussed, but, perhaps on the advice of counsel, price is not mentioned. Assuming the meetings are not deemed to result in an agreement, understanding or arrangement concerning the acquisition, a post-distribution acquisition of Controlled by Acquirer might not be considered part of a plan because the definition of substantial negotiations generally would require a discussion of significant economic terms. We believe that discussions of the magnitude mentioned in our example probably should rise to the level of substantial negotiations.[9] We also think that the new definition of substantial

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[9] In point of fact, we think this example more theoretical than real world. While perhaps negotiations of this sort of magnitude could occur without an "agreement" on price (...continued)

negotiations can and should be interpreted to treat these discussions as substantial negotiations because although the definition notes that substantial negotiations "generally" require the discussion of significant economic terms, those discussions should not necessarily be required in all cases. As a further point, we believe reliance on the word "generally" by the government should be sparing, addressed only to the most egregious cases. Otherwise the objective focus of the regulations would be significantly undermined.

Finally, while we generally support the regulations' emphasis on the existence of bilateral negotiations, we can conceive of carefully orchestrated transactions designed to take advantage of this approach. For example, assume Distributing announces a spinoff of Controlled for a valid business purpose other than to facilitate an acquisition of Controlled. Distributing nonetheless announces that it is interested in receiving indications of interest from prospective purchasers of Controlled. Distributing sets up a data room for the purpose of permitting potential acquirers to perform due diligence on Controlled. Several potential acquirers submit offers to Acquirer for Controlled. Acquirer does not respond to these offers and neither Distributing nor Controlled engage in bilateral negotiations with any of the potential acquirers.

Distributing then distributes Controlled which is shortly thereafter acquired by one of the interested parties. We are troubled by this example and raise it as another possible area where the Temporary Regulations are susceptible to expansive interpretation by aggressive taxpayers.

Safe Harbors

Under the 2001 Temporary Regulations, Safe Harbors I and II were available only if, among other things, the acquisition occurred more than six months after the distribution *and* there was no agreement, understanding, arrangement, or substantial negotiations regarding the acquisition at any time prior to the six month anniversary following the distribution. Commentators

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(continued...)

or exchange ratio we think it unlikely that the parties would get that far in the negotiation process without some implicit understanding of a price range, *e.g.*, whether there would be an acquisition premium and some other direct or indirect understanding of price magnitude. In any case, modifying the regulation so that the IRS is relieved of the burden of proving such an agreement in litigation is, in our view, advisable.

suggested that negotiations that occur some period of time prior to a distribution, but that break off sometime before the distribution, should not render Safe Harbors I and II inapplicable. Responding to these comments, the 2002 Temporary Regulations revise Safe Harbors I and II to make the safe harbors inapplicable only if the agreement, understanding, arrangement or substantial negotiations occurred during the period that begins one year before the distribution and ends six months after the distribution. We believe this is a salutary change as it will help ensure that discussions occurring long before a distribution and a subsequent acquisition are not deemed to be in connection with the acquisition.

Under the 2001 Temporary Regulations, Safe Harbors I and II would be operative if an acquisition occurs more than six months after a distribution and there was no agreement, understanding, arrangement or substantial negotiations regarding *the* acquisition during the period ending six months after the distribution. These safe harbors appeared to permit negotiations regarding an acquisition during the prohibited period so long as a "substitute" acquisition, and not the acquisition that actually was discussed, was consummated more than six months after the distribution. The 2002 Temporary Regulations now make Safe Harbors I and II unavailable to both acquisitions *and* substitute acquisitions that occur after a distribution if the acquisition or an acquisition similar to the substitute acquisition had been discussed during the prohibited pre-acquisition period. We support this change.

Safe Harbor II under the 2001 Temporary Regulations applied only if the amount of stock of the corporation subject to the post-distribution acquisition did not exceed 33 percent of the acquired corporation's stock *and* before the date that is six months after the distribution, not more than 20 percent of the acquired corporation's stock actually is acquired or the subject of an agreement, understanding, arrangement or substantial negotiations regarding its acquisition. This two-prong numerical test was confusing and now Safe Harbor II unifies it into a single 25 percent test. We find this change simplifying and helpful. It would also be helpful if final regulations included an example in which Safe Harbor II would prevent a distribution and acquisition from being considered part of a plan. We suggest the following example:

Example. During the period beginning two years before and ending one year before a distribution of Controlled, Acquirer and Distributing engage in substantial negotiations regarding Acquirer's planned acquisition of 20 percent of Controlled. During the six month period following the distribution of Controlled to Distributing shareholders, Acquirer purchases 20 percent of Controlled from Controlled. More than six months after the distribution of Controlled, Acquirer and Controlled enter into negotiations regarding Acquirer's purchase of an additional 35 percent of Controlled, after which Acquirer actually acquires an additional 35 percent of Controlled from Controlled. Assuming the distribution was not motivated by a business purpose to facilitate Acquirer's acquisition of Controlled, Safe Harbor II should apply to the 35 percent acquisition because (i) the 35 percent acquisition occurred more than 6 months after the distribution, (ii) there was no agreement, understanding, arrangement or substantial negotiations regarding the 35 percent acquisition during the period beginning one year before and ending six months after the distribution and (iii) less than 25 percent of Controlled corporation stock was acquired during the period referred to in (ii).[10] In cases such as this, however, the determination there was no agreement, understanding or arrangement regarding the second acquisition should be made by closely scrutinizing all arrangements among Distributing, Acquirer and Controlled (*e.g.,* standstill or other agreements) from which a plan might be inferred.

Operating Rules

Both the 2001 Temporary Regulations and the 2002 Temporary Regulations provide that it is evidence of a plan if the distribution is motivated by a business purpose to facilitate the acquisition or a similar acquisition.[11] The 2001 Temporary Regulations included an operating rule that provided it would be evidence of a business purpose to facilitate an acquisition if, at the time of the first transaction (either the distribution or the acquisition), it was "reasonably certain" that within six months after the first transaction the second transaction (either the distribution or acquisition) would occur, or an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding the second transaction.[12] In

[10] We note that although this example appears correct under the 2002 Temporary Regulations and is in accord with the overall views of the Committee, several Committee members expressed the view that it was an inappropriate result.

[11] 2001 Temp. Treas. Reg. § 1.355-7T(d)(1)(vii) and 2002 Temp. Treas. Reg. § 1.355-7T(b)(3)(v).

[12] 2001 Temp. Treas. Reg. § 1.355-7T(e)(1).

our Report, we raised several issues with the "reasonable certainty" operating rule, noting that if the reasonable certainty operating rule is retained, it should apply only if the reasonable certainty existed at the time the decision to effect the distribution (or acquisition, if earlier) was made and not at the time the distribution (or acquisition) actually occurred. The 2002 Temporary Regulations delete the "reasonable certainty" operating rule, citing the added significance that the 2002 Temporary Regulations place on discussions or an agreement, understanding, arrangement or substantial negotiations when determining the presence or absence of a Code § 355(e) plan. We agree with this approach.

Other Comments

Plan factors (iii) and (iv) of the 2002 Temporary Regulations provide that in the case of an acquisition occurring before a distribution, evidence of a plan exists if prior to the acquisition (or, with respect to plan factor (iv), prior to the public offering) discussions occur between Acquirer (or, with respect to plan factor (iv), an investment banker) and Distributing or Controlled regarding *a* distribution.[13] We question whether discussions regarding a distribution of an identified Distributing subsidiary should result in the finding of a plan with respect to a post-acquisition distribution of a different Distributing subsidiary. We therefore suggest that the references in plan factors (iii) and (iv) to "a distribution" be revised to encompass only "the distribution."

During Committee discussions some confusion was apparent concerning the scope of the parenthetical clause "other than involving a public offering" in the first sentence of 2002 Temporary Regulations § 1.355-7T(b)(2). Questions arose whether the phrase "public offering" referred only to public offerings by Distributing or Controlled or whether it could involve an offering by another company. It was also unclear whether the parenthetical was intended to apply only to public offerings for cash, as opposed to public offerings of securities as acquisition currency. We believe these issues should be clarified in the Final Regulation.

The 2002 Temporary Regulations provide that an unexpected change in market or business conditions occurring after a distribution that *results in*

[13] 2002 Temp. Treas. Reg. § 1.355-7T(b)(3)(iii) and (iv).

an acquisition (or in the case of a post-acquisition distribution, a change occurring after the acquisition) and that was unexpected at the time of the distribution (or in the case of a post-acquisition distribution, that was unexpected at the time of the acquisition), is evidence the distribution and acquisition are not part of a plan.[14] We believe that the "results in" standard will be difficult to prove, and therefore of limited application. We suggest changing the words to "substantially contributes to the occurrence of."

The 2002 Temporary Regulations contain a new rule governing the treatment of stock acquired pursuant to the exercise of options. The rule provides that stock acquired pursuant to an option exercise will be treated as having been acquired pursuant to an agreement, understanding, or arrangement to acquire the underlying stock on the earliest of (i) the date the option is written, if at that time the option was more likely than not to be exercised, (ii) the date the option is transferred, if at that time the option was more likely than not to be exercised by the transferee, and (iii) the date the option is modified in a manner that materially increases the likelihood of exercise, if at that date the option was more likely than not to be exercised.[15] To prevent potential abuse associated with these revisions, the 2002 Temporary Regulations provide that if a principal purpose of the writing, transfer or modification of an option is the avoidance of Code § 355(e), the option will be treated as an agreement, understanding, arrangement, or substantial negotiations to acquire the underlying stock on the date of a distribution. We agree with these changes.

Respectfully submitted,

Samuel J. Dimon
Chair

cc: Eric Solomon
Helen M. Hubbard
The Honorable B. John Williams, Jr.
Gary B. Wilcox

[14] 2002 Temp. Treas. Reg. § 1.355-7T(b)(4)(ii) and (iv).

[15] 2002 Temp. Treas. Reg. § 1.355-7T(e)(i).