

**COMMENTS CONCERNING PROPOSED REGULATIONS UNDER SECTION 355(e)
DEFINING A “PLAN (OR SERIES OF RELATED TRANSACTIONS)”**

The following comments (the “Comments”) constitute the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These Comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation (the “Committee”). Principal responsibility was exercised by Donald P. Hensel and M. Todd Prewett. Substantive contributions were made by Julie A. Divola, Andrew J. Dubroff, Terrill A. Hyde, Dana L. Trier, Gordon E. Warnke, Benjamin G. Wells, and Thomas F. Wessel. The Comments were reviewed by John P. Barrie of the Section’s Committee on Government Submissions and by Joseph M. Pari, Council Director for the Committee on Corporate Tax.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments. Two members of the Committee who have been so engaged have expressed views to the other members listed above, but such members did not participate in decision making with respect to the views adopted and expressed herein.

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These Comments respond to the request for comments regarding the regulations proposed by the Treasury Department (the “Treasury”) and the Internal Revenue Service (the “Service”) in the Federal Register on January 2, 2001 (the “Current Proposed Regulations”),¹ concerning the interpretation of the phrase “plan (or series of related transactions)” for purposes of section 355(e)(2)(A)(ii), (B), and (C) of the Internal Revenue Code of 1986, as amended (the “Code”).² The Current Proposed Regulations replace the proposed regulations that were published in the Federal Register on August 24, 1999 (the “1999 Proposed Regulations”).³ Although most of our comments address technical aspects of the Current Proposed Regulations themselves, these Comments also include some discussion of broader issues.

I. EXECUTIVE SUMMARY

The recommendations in these Comments include the following:

1. Immediate Elective Guidance. Immediate guidance on the “plan” issue is needed, preferably in the form of a notice permitting taxpayers to rely on the Current Proposed Regulations.
2. Step Transaction Principles. We adhere to our prior view that a “plan (or series of related transactions)” should not extend beyond traditional step transaction principles and that, accordingly, a plan should not be found based on the intentions of one party unless that party has the unilateral ability to control all steps necessary to effect its intent.
3. Example 7 and “Similar” Acquisitions. We disagree with the conclusion reached in Example 7 and believe that it should be fixed by replacing the concept of a “similar” acquisition, which is used in the general plan rule of Prop. Reg. § 1.355-7(b)(1) as well as in many of the plan and nonplan factors, with the concept of a “substitute” acquisition.
4. Reasonable Certainty Operating Rule. The reasonable certainty operating rule should be modified so that a “hot market” by itself would not be deemed to reflect a business purpose to facilitate an acquisition. In addition, further guidance on plan factor (ix) relating to debt allocation between Distributing and Controlled should be provided by using the plan factor in an example. Finally, a nonplan factor should be added concerning the lack of the type of leverage described in plan factor (ix).
5. Comments of a More Technical Nature.
 - a. The scope of the term “substantial negotiations” should be clarified. Clarification is also suggested regarding (i) the relevance of discussions between Distributing or Controlled

¹ See REG-107566-00, 66 Fed. Reg. 66 (2001).

² Unless otherwise specified, all “section” references in these Comments are to the Code, and all references to Prop. Reg. § 1.355-7 are to the Current Proposed Regulations.

³ See REG-116733-98, 64 Fed. Reg. 46155 (1999). The 1999 Proposed Regulations were withdrawn in connection with the publication of the Current Proposed Regulations. See Withdrawal of Notice of Proposed Rulemaking, 66 Fed. Reg. 76 (2001).

and a potential acquirer, (ii) what level of internal discussions indicates that the business purpose for a distribution is to facilitate an acquisition, and (iii) the relevance of discussions with investment bankers and outside advisors in transactions which are not public offerings or auctions.

- b. Safe Harbor I should be clarified so that a taxpayer that satisfies the six month rule would have to demonstrate only the existence of a real non-acquisition business purpose sufficient to meet the business purpose requirement of Treas. Reg. § 1.355-2(b). In addition, a business purpose to facilitate an acquisition should be considered under Safe Harbor I only to the extent that it relates to the acquisition in question.
- c. The third prong of Safe Harbor II, limiting safe-harbored acquisitions to those involving no more than 20% of the stock of Distributing or Controlled, should be removed.
- d. For purposes of the public trading safe harbor (Safe Harbor V), the term “5-percent shareholder” should be replaced with “controlling shareholder.”
- e. Safe Harbor VI relating to equity compensation should be expanded to include all transfers of stock for services (except for services rendered by an independent contractor in conjunction with an acquisition which otherwise is part of a section 355(e) plan).
- f. The likelihood of an option’s exercise at the time of the section 355 distribution generally should be deemed irrelevant under Prop. Reg. § 1.355-7(g). Also, customary contingent or escrowed stock arrangements should not be treated as options unless they relate to an acquisition that otherwise is part of a section 355(e) plan.
- g. Additional guidance is requested to clarify the operation of the tolling of time periods under the substantial diminution of risk operating rule.
- h. The last sentence of Prop. Reg. § 1.355-7(b)(1) should be changed from referring to “a distribution” occurring in connection with the acquisition to refer to “the distribution” occurring in connection with the acquisition.

II. BACKGROUND

Section 355 provides generally that if a corporation (“Distributing”) distributes to its shareholders stock of a corporation that it controls immediately before the distribution (“Controlled”) and certain other conditions are satisfied, neither Distributing nor its shareholders will recognize income, gain or loss in connection with the distribution. In an otherwise qualifying section 355 transaction, however, section 355(e) requires Distributing to recognize gain in the distributed stock of Controlled if one or more persons acquire, directly or indirectly, 50% or more (measured by vote or by value) of Distributing or Controlled pursuant to “a plan (or series of related transactions)” that includes the distribution. No adjustment is made to the basis

of the stock or assets of either Distributing or Controlled to reflect the recognition of gain at the corporate level.⁴

The phrase “plan (or series of related transactions)” is not defined in the statute, although the statute does provide that, unless the taxpayer establishes otherwise, such a plan is presumed to exist if a 50% or greater acquisition occurs during the four-year period beginning two years before the date of the distribution.⁵ The Current Proposed Regulations focus on the determination of whether a “plan (or series of related transactions)” exists by requiring an analysis of all relevant facts and circumstances. Nine factors tending to show the existence of a plan (“plan factors”) and seven factors tending to disprove the existence of a plan (“nonplan factors”) guide the facts-and-circumstances test, but other factors may be considered as well.⁶ The flexibility of this facts-and-circumstances test is illustrated not only by the fact that the enumerated plan and nonplan factors are not exclusive but also by statements to the effect that the weight of the factors depends on the particular case and that the existence of a plan should not be determined merely by comparing the number of plan and nonplan factors.⁷ The Current Proposed Regulations supplement the general facts-and-circumstances test with six safe harbors, which are designed to provide taxpayers with a degree of certainty that certain kinds of acquisitions will not be considered part of a section 355(e) plan.⁸ In addition, six operating rules must be considered in applying the safe harbors and the plan and nonplan factors.⁹

The ultimate focus of the safe harbors, the plan and nonplan factors, and the operating rules is to determine the intent of Distributing, Controlled, and their controlling shareholders with respect to whether purportedly separate transactions are related to each other or part of a common plan. In general, an acquisition occurring after a distribution is treated as part of a “plan (or series of related transactions)” if Distributing, Controlled, or any of their respective controlling shareholders intended, on the date of the distribution, that the acquisition (or a similar acquisition) would occur in connection with the distribution.¹⁰ Likewise, in the case of an acquisition occurring before a distribution, a “plan (or series of related transactions)” exists if Distributing, Controlled, or any of their respective controlling shareholders intended, on the date

⁴ Section 355(e)(1), (2)(A). Thus, if section 355(e) applies to a transaction, Distributing is subject to tax on the amount by which the fair market value of the distributed stock of Controlled exceeds Distributing’s adjusted basis in such stock. The shareholders of Distributing will not recognize any income, gain, or loss, and their basis in their Distributing stock will be divided between the Distributing stock they retain (if any) and the Controlled stock they receive.

⁵ Section 355(e)(2)(B).

⁶ Prop. Reg. § 1.355-7(d).

⁷ Prop. Reg. § 1.355-7(d)(1).

⁸ Prop. Reg. § 1.355-7(f).

⁹ Prop. Reg. § 1.355-7(e).

¹⁰ Prop. Reg. § 1.355-7(b)(1).

of the acquisition, that a distribution would occur in connection with the acquisition.¹¹ All acquisitions that are included as part of a “plan (or series of related transactions)” under the Current Proposed Regulations are aggregated to determine whether the 50% threshold has been crossed.¹²

III. DISCUSSION

We believe the Current Proposed Regulations represent a major improvement over the 1999 Proposed Regulations. First, by stating that an acquisition must occur “in connection with” a distribution to be subject to section 355(e), the Current Proposed Regulations state the basic principle under which the technical rules are to be interpreted. Second, the Current Proposed Regulations are significantly more flexible than the 1999 Proposed Regulations, which would have established the exclusive means of overcoming the statutory presumption that arises when an acquisition occurs within the four-year period beginning two years before a distribution. To rebut this statutory presumption, the taxpayer would have had to establish, by clear and convincing evidence, that one of several rebuttal tests set forth in the 1999 Proposed Regulations was met. The 1999 Proposed Regulations, although praised for permitting acquisitions occurring six months (instead of two years) after spin-offs in some instances, were criticized for lacking a facts-and-circumstances alternative to the exclusive methods for rebutting the statutory presumption and for the clear and convincing standard of evidence required to meet the rebuttal tests.¹³

We commend the Treasury and the Service for their responsiveness to the many commentators who weighed in on the 1999 Proposed Regulations. In our view, the flexibility afforded by a facts-and-circumstances approach, with appropriate safe harbors to promote certainty of results, is essential to the administration of a statute that involves inherently ambiguous and fact-driven concepts such as the existence of a “plan” and the “relatedness” of transactions.

With that having been said, however, we believe that section 355(e) is a flawed statute. We discuss our views on the statute in more detail in Section III.A. below to provide background to our comments on the Current Proposed Regulations. We recognize that, unless section 355(e) is changed by legislation, both taxpayers and the Service must continue to live with the statute in its current form. While we believe that the Current Proposed Regulations adopt an overly broad view of what constitutes a “plan (or series of related transactions),” we nevertheless believe, as discussed in Section III.B. below, that a notice permitting taxpayers to rely on the Current Proposed Regulations would be appropriate. (We do not, however, support the adoption of the Current Proposed Regulations as a temporary regulation binding on all taxpayers.) Finally, Section III.C. below contains our specific comments to the Current Proposed Regulations. Some

¹¹ Id.

¹² Prop. Reg. § 1.355-7(c). The Current Proposed Regulations do not provide guidance on how to count whether a 50% ownership change has occurred, however.

¹³ See, e.g., “ABA Members Weigh in on Anti-Morris Trust Regs,” 86 Tax Notes 281 (Jan. 10, 2000); Mark J. Silverman and Lisa M. Zarlenga, “Proposed Section 355(e) Regulations: Broadening the Definition of a Plan,” 87 Tax Notes 117 (Apr. 3, 2000).

of these comments reflect significant policy disagreements with the Current Proposed Regulations (notwithstanding our support of their increased flexibility), and others are more technical in nature.

A. SECTION 355(e): STATUTORY BACKGROUND

Section 355(e) was enacted as part of the Taxpayer Relief Act of 1997.¹⁴ Prior to its enactment, a tax-free spin-off could be combined with a tax-free reorganization, thus enabling a target corporation to tailor itself by disposing of a trade or business unwanted by the acquiring corporation.¹⁵ As part of the 1997 and 1998 budget plans, the Clinton Administration made legislative proposals to impose tax at the corporate level, but not the shareholder level, on certain otherwise qualifying section 355 distributions in which the direct and indirect shareholders of Distributing failed to retain at least 50% of the stock of both Distributing and Controlled for the four-year period beginning two years before the distribution. In testing for a 50% change of ownership under the proposal, certain transactions “unrelated” to the distribution, such as public trading and hostile acquisitions, would have been disregarded.¹⁶

The Clinton Administration’s proposal was enacted in modified form as section 355(e). According to the committee reports:

[S]ection 355 was intended to permit the tax-free division of existing business arrangements among existing shareholders. In cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin-off, the transaction more closely resembles a corporate level disposition of the portion of the business that is acquired.¹⁷

The committee reports do not elaborate on the notion that a Morris Trust-type transaction resulting in a 50% or greater change in ownership of Distributing or Controlled resembles a corporate-level sale. For example, a public offering by Distributing or Controlled hardly resembles a corporate-level sale of a business, yet the committee reports state that “[a] public offering of sufficient size can result in an acquisition that causes gain recognition under the provision.”¹⁸ By requiring corporate-level but not shareholder-level gain recognition, Congress apparently accepted the proposition that such transactions are somehow inconsistent with the repeal of General Utilities in 1986.

¹⁴ Pub. L. No. 105-34 § 1012 (1997).

¹⁵ See Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966).

¹⁶ See Treasury Department, *General Explanation of the Administration’s Revenue Proposals*, March 1996 at 86; Treasury Department, *General Explanation of the Administration’s Revenue Proposals*, April 1997 at 62.

¹⁷ H.R. Rep. No. 105-148 at 462 (1997); S. Rep. No. 105-33 at 139-40 (1997).

¹⁸ Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (JCS-23-97), December 17, 1997, at 199.

We disagree with the underlying premise of section 355(e), i.e., that Morris Trust-type transactions are inherently abusive and contrary to General Utilities repeal. A potential acquirer's desire not to acquire an unwanted business, whether for regulatory or other reasons, has long been recognized as a legitimate corporate business purpose for a section 355 distribution.¹⁹ Indeed, Example 1 of the Current Proposed Regulations confirms that pre-acquisition tailoring of Distributing constitutes a valid corporate business purpose under section 355 and does not result in a tax to Distributing's shareholders.²⁰

The resemblance of a Morris Trust-type transaction to a corporate-level sale is perhaps the strongest where excessive debt, incurred in anticipation of a spin-off, burdens a corporation to such an extent that it cannot survive without being acquired and where the proceeds of the debt are retained by the other corporation. The statute, however, applies to transactions in which the unreasonable manipulation of leverage described in the preceding sentence is absent, and in those cases, section 355(e) may impede legitimate business transactions without serving sound tax policy.²¹ Moreover, even when unreasonable leverage is involved, the alleged avoidance of General Utilities repeal is illusory. The disproportionately leveraged corporation's assets remain in corporate solution with a carryover tax basis, and the debt eventually must be repaid, presumably with after-tax earnings.²²

We point out these flaws in the underpinnings of section 355(e) solely to provide background for these Comments. Given the tenuous foundation of section 355(e), we believe the Current Proposed Regulations should be revised to curtail potentially expansive readings of the statutory language.

B. THE NEED FOR IMMEDIATE GUIDANCE ON THE "PLAN" ISSUE

As long as section 355(e) continues in its current form, both taxpayers and the Service must grapple with the concept of a "plan (or series of related transactions)" as well as other

¹⁹ See Rev. Rul. 68-603, 1968-2 C.B. 148 (agreeing to follow Morris Trust); Rev. Proc. 96-30, Appendix A, sec. 2.07, 1996-1 C.B. 696, 712 (guidelines for IRS ruling requests under section 355).

²⁰ Prop. Reg. § 1.355-7(m), *Example 1*. Otherwise, the example's analysis of section 355(e) would be irrelevant because section 355(e) cannot apply to a distribution to which section 355(a) does not apply.

²¹ Some commentators have pointed out that a Morris Trust transaction not involving debt shifting is economically similar to a taxable transaction in which Distributing transfers a business segment to an acquiring corporation in exchange for the acquiring corporation's stock and then distributes that stock to its shareholders. See, e.g., Michael L. Schler, *The Meaning of a "Plan" Under Section 355(e): Policy Issues*, 85 *Tax Notes* 913, 925 (1999) We do not find the presence of a taxable alternative to a Morris Trust transaction to be a particularly compelling justification for imposing a corporate-level tax.

²² We recognize that sections 337(c) and 355(d) also require corporate-level gain recognition without a corresponding increase in inside asset basis. These provisions were enacted to prevent an acquirer from "busting up" a target corporation without incurring a corporate-level tax by taking advantage of a cost basis in the stock of the subsidiary to be sold. This opportunity to take advantage of a cost basis in stock should normally be absent from a Morris Trust transaction to which section 355(d) does not apply.

difficult issues under section 355(e). In our experience, the uncertain breadth of the phrase “plan (or series of related transactions),” together with the adverse statutory presumption for any transaction occurring within two years on either side of a distribution, has unnecessarily chilled legitimate business transactions. The lack of authoritative guidance on the “plan” issue under section 355(e) is a continuing serious problem for corporations and their advisers, especially due to the extremely high stakes that often are involved.

The Current Proposed Regulations are proposed to apply only to distributions occurring after the publication of final regulations in the Federal Register.²³ We are concerned that the adoption of authoritative regulations on the “plan” issue may be delayed until the resolution of other difficult issues under section 355(e), such as the definition of “acquisition,” the application of the aggregation and attribution rules and the treatment of successors and predecessors. In addition, the technical and policy issues still to be resolved under the “plan” regulations themselves are substantial. As a result, even if the “plan” regulations are adopted before other section 355(e) issues are resolved, significant delay is possible, even with substantial efforts on the part of the Service and the Treasury.

There is a great need for certainty and predictability as to the “plan” concept, and authoritative guidance should be issued as soon as possible, even before the remaining issues are resolved. This need for certainty is exacerbated by what we understand is an evolving new policy of the Service regarding the issuance of private letter rulings on section 355(e) issues. Our understanding is that, as a condition precedent to obtaining a private letter ruling addressing a section 355(e) issue, a taxpayer may be required to establish that the necessary 50% shift in the stock ownership of Distributing or Controlled during the relevant four year period will occur.

While we believe that the Current Proposed Regulations adopt an overly broad concept of a “plan (or series of related transactions),” we assume that the final regulations will not in any event be more restrictive than the Current Proposed Regulations. Therefore, we recommend that the interim guidance on the plan issue take the form of a Notice permitting taxpayers to rely on the Current Proposed Regulations as a reasonable interpretation of section 355(e) until further guidance is issued. In the interest of fairness, the Notice could permit reliance on the Current Proposed Regulations for all distributions to which section 355(e) potentially applies, i.e., all distributions occurring after April 16, 1997. If the Treasury and the Service adopt this approach, we request that the Notice make clear that the regulations are still under consideration and that no inference should be drawn as to the content of final regulations.

Alternatively, the Treasury and the Service could adopt as a Temporary Regulation a version of the Current Proposed Regulations which excludes their most controversial features (e.g., Example 7). Although this approach is intriguing, we see two difficulties. First, the process of identifying the most controversial issues and drafting the edited Temporary Regulation would delay the guidance and take staff time that would be better spent resolving all of the remaining issues. Second, taxpayers may believe that issues that are not reserved in such a Temporary Regulation have actually been resolved, despite the fact that final regulations will not yet have been issued. In other words, this process would result in two classes of issues: reserved

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Prop. Reg. § 1.355-7(n).

issues and issues that taxpayers believe have been resolved by reason of having been included in the Temporary Regulation. For these reasons, we favor the simpler approach of having a Notice issued that permits taxpayers to rely on the entire text of the Current Proposed Regulations as interim guidance.

C. COMMENTS ON THE CURRENT PROPOSED REGULATIONS

By abandoning the exclusive rebuttal tests and the clear and convincing evidence standard in favor of a flexible facts-and-circumstances approach with safe harbors, the Current Proposed Regulations represent a significant improvement to the 1999 Proposed Regulations. Nevertheless, we believe that further modifications, some substantive and some more technical in nature, can and should be made.

Before turning to more specific comments, we would like to make a general observation about the Current Proposed Regulations. Although less so than the 1999 Proposed Regulations, the Current Proposed Regulations continue to reflect an expansive interpretation of the concept of a “plan (or series of related transactions)” that, in some cases, could encompass the unilateral plan of a single party. We reiterate our prior view that a “plan (or series of related transactions)” imports no more than traditional step transaction principles and, therefore, the unilateral plan of a single party should not be covered unless that party has the power to control both steps or to make the second step occur if the first step (which it intends) occurs.²⁴

When an acquisition follows a spin-off, the absence of substantial joint negotiations with the acquirer prior to the distribution normally should prevent the acquisition from being included as part of a plan that includes the distribution. A public offering or auction could be treated as a special situation, assuming the presence of other factors indicating that the distribution and the public offering or auction are part of a common plan (e.g., the public offering or auction is the principal purpose for the distribution and significant steps to accomplish the public offering or auction are taken prior to the decision to effect the distribution). Also, joint negotiations with an acquirer would not necessarily have to occur if one of the corporations involved in a spin-off is burdened with so much debt that its lack of financial viability virtually assures a takeover transaction within a relatively short time after the spin-off. Outside of these limited circumstances, a unilateral plan of one party should not be sufficient to trigger the application of section 355(e). In the remainder of these comments, we offer suggested changes to specific provisions of the Current Proposed Regulations. We note, however, that some of these provisions result from the overly broad concept of a “plan (or series of related transactions)” adopted by the Current Proposed Regulations. If this concept is narrowed as we suggest, many of the issues and ambiguities which we address in the remainder of our comments will disappear.

1. Example 7 and “Similar” Acquisitions

²⁴ See “ABA Comments Concerning Guidance Under 1997 Amendments to Sections 355 and 358,” 98 TNT 93-22 (May 14, 1998); “ABA Members Weigh in on Anti-Morris Trust Regs” 86 Tax Notes 281 (Jan. 10, 2000).

The most troubling aspect of the Current Proposed Regulations is the concept of “a similar acquisition” and the application of that concept in Example 7. We believe that the result in Example 7 is neither correct as a policy matter nor compelled by the statute or its legislative history. Much of our concern with Example 7 results from the concept of a similar acquisition, which is pervasive in the Current Proposed Regulations.

An acquisition that was not intended at the time of a distribution may nevertheless be treated as part of a “plan (or series of related transactions)” under the Current Proposed Regulations if it is “similar” to an acquisition that was so intended. This concept of a “similar” acquisition appears in a number of the plan and nonplan factors,²⁵ as well as in the general rule of Prop. Reg. § 1.355-7(b)(1), which provides that, in the case of an acquisition occurring after a distribution, a plan is considered to exist “if Distributing, Controlled, 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.”²⁶ The Current Proposed Regulations do not define “a similar acquisition” but provide that:

[T]he actual acquisition and the intended acquisition may be similar even though the identity of the person acquiring the stock of Distributing or Controlled (acquirer), the timing of the acquisition or the terms of the actual acquisition are different from the intended acquisition. For example, in the case of a public offering or auction, the actual acquisition and the intended acquisition may be similar even though there are changes in the terms of the stock, the class of stock being offered, the size of the offering, the timing of the offering, the price of the stock, or the participants in the public offering or auction.²⁷

According to the Preamble, “[t]he reference to ‘a similar acquisition’ ensures that changes in the terms of the acquisition intended at the time of the distribution (including, in certain circumstances, a substitution of acquirer) do not prevent the distribution and the acquisition that actually occurs from being considered part of a plan.”

The Current Proposed Regulations do not provide taxpayers with sufficient guidance on the circumstances under which one acquisition will be considered “similar” to another acquisition.²⁸ More troubling than the lack of guidance, however, is the potential for the concept

²⁵ See Prop. Reg. §§ 1.355-7(d)(2)(i), (ii), (v), (vii) (plan factors employing the concept of a “similar” acquisition); 1.355-7(d)(3)(i), (vi), (vii) (nonplan factors that refer to a “similar” acquisition).

²⁶ Prop. Reg. § 1.355-7(b)(1). (Emphasis added.)

²⁷ Prop. Reg. § 1.355-7(b)(2).

²⁸ The result in Example 7, which is discussed in detail in the text, depends on the conclusion that the acquisitions of X, Y, and Z are “similar” to each other, but the example does not sufficiently explain why the acquisitions are similar. See Prop. Reg. § 1.355-7(m), *Example 7*. In addition, Example 4 concludes, without elaboration, that a public offering of Controlled stock before a distribution is not “similar” to a post-distribution issuance of Controlled stock in connection with an acquisition of a target corporation. See Prop. Reg. § 1.355-7(m), *Example 4*. Is an issuance of stock for cash in a public offering inherently different (i.e., not “similar”) than an issuance of stock to acquire a target corporation? Is the conclusion that the transactions are not “similar” affected by the fact that the public offering occurred prior to the spin-off (while Controlled was a subsidiary of Distributing) but

of a “similar” acquisition to lead to inappropriate results. Indeed, Example 7 of the Current Proposed Regulations is a perfect illustration of why the concept of a “similar” acquisition should be modified or eliminated altogether.

In Example 7, Distributing is a public company that wants to expand its business through acquisitions involving the issuance of Distributing stock, but the ownership of Controlled (which is engaged in a different business than Distributing) has impeded Distributing’s acquisition strategy. Therefore, Distributing distributes the stock of Controlled for the sole purpose of facilitating acquisitions using the stock of Distributing. At the time of the distribution, Distributing has no specific goals about how much stock it will use to make acquisitions.

Before the announcement of the distribution, Distributing and its investment banker identify X and Y as potential acquisition targets. After the public announcement of the distribution but before the distribution itself, Distributing negotiates with X but has no contact with Y. One month after the distribution, Distributing consummates the acquisition of X, with X’s sole shareholder receiving 30% of Distributing’s stock in the acquisition. Distributing begins negotiations with Y seven months after the distribution and acquires Y one year after the distribution in exchange for 19% of Distributing’s stock. After the distribution, Distributing’s investment bankers identify Z as another potential target. Eighteen months after the distribution, Distributing acquires Z, with Z’s shareholders receiving 17% of Distributing’s stock.²⁹ On these basic facts, the example concludes that the acquisitions of X, Y and Z are all part of a plan that includes the distribution and that the distribution is subject to tax under section 355(e).³⁰

A determination that the Y and Z acquisitions are similar to the X acquisition is critical to the result in Example 7,³¹ which reaches far beyond even the loosest formulations of the step transaction doctrine. At the time of the spin-off, Distributing had only identified Y without

the acquisition of the target occurred after the spin-off (while Controlled was a stand alone corporation)? Is it relevant to the similarity inquiry that Controlled was “approached unexpectedly” about the acquisition after the initial public offering and the spin-off had already occurred?

²⁹ Prop. Reg. § 1.355-7(m), *Example 7(i)*.

³⁰ Prop. Reg. § 1.355-7(m), *Example 7(ii)(E), (iii)(E), (iv), (v)*.

³¹ By virtue of the conclusion that the acquisitions of Y and Z are similar to the acquisition of X, plan factors (ii) and (vii) apply to both the Y and Z acquisitions, and no nonplan factors apply. Prop. Reg. § 1.355-7(m), *Example 7(iii)(C), (D), (iv)*. Plan factor (ii) applies to the Y acquisition because Distributing and an acquirer, but not the same acquirer, discussed an acquisition (i.e., the X acquisition) before the distribution and a similar acquisition (i.e., the Y acquisition) with a different acquirer occurred. Prop. Reg. § 1.355-7(d)(2)(ii). Plan factor (vii) applies because Distributing had a business purpose to facilitate the Y acquisition or a similar acquisition. Prop. Reg. § 1.355-7(d)(2)(vii). It is not clear whether the reason this plan factor applies to the Y acquisition is that the business purpose was to facilitate the Y acquisition, or the business purpose was to facilitate the X acquisition which is determined to be a similar acquisition to that of Y. If Example 7 is retained, a clarification of its facts would be warranted to make the rationale for the application of plan factor (vii) clear. The analysis of the Z acquisition is the exact same as that of the Y acquisition, even though Distributing had “identified” Y prior to the distribution but had not identified Z as a potential target. Prop. Reg. § 1.355-7(m), *Example 7(iv)*. The example concludes that since there were two plan factors and no nonplan factors in both cases, the Y and Z acquisitions are part of a plan which includes the distribution.

having any discussions with its representatives. The mere identification of Y, without Y's participation, should not be sufficient to include the Y acquisition as part of a plan. Inclusion of the Z acquisition as part of a plan is even more objectionable because Distributing had not even identified Z as a potential target at the time of the distribution. Indeed, Distributing did not know how much stock it ultimately would issue or if any acquisitions (beyond the planned X acquisition) would occur. In our view, a general strategy to grow through acquisitions—even if a spin-off is necessary in order to implement that strategy—should not taint acquisitions that are not the subject of a specific joint plan (of the acquirer and the target) in existence at the time of the spin-off.

To alleviate the problems illustrated by Example 7, the final regulations should replace the concept of a “similar” acquisition with the more narrow concept of a “substitute” acquisition.³² A “substitute” acquisition would be defined to include any acquisition which occurs in lieu of a tainted acquisition but would not include any acquisition which occurs in addition to a tainted acquisition that actually occurs. This change would ensure that an acquisition that takes the place of a tainted acquisition is itself tainted but that additional acquisitions which were not specifically planned at the time of the distribution are not. Therefore, the change to a “substitute” acquisition rule would accomplish all of the goals set out in the Preamble for the concept of a “similar” acquisition but without being so expansive as to lead to inappropriate conclusions such as those reached in Example 7.

The determination of whether an acquisition that actually occurs serves as a substitute for a tainted acquisition that did not occur would depend on the circumstances. We envision a substitute acquisition as a transaction that fulfills the specific intent of Distributing or Controlled that was frustrated by the failure of the intended acquisition to occur. Accordingly, in most cases, an acquisition involving the same acquirer (or a sufficiently related party) would constitute a substitute for the intended acquisition, unless there is a significant passage of time, or the actual acquisition differs from the intended acquisition so much that the transactions cannot be viewed as functionally related (*i.e.*, the acquisition is not “in connection with” the distribution). Similarly, a modification of the terms of a planned public offering would normally cause the actual public offering to be treated as a substitute for the originally intended public offering. Outside of the public offering context, an acquisition involving a different party would usually not constitute a substitute for the intended acquisition absent special circumstances (such as a spin-off resulting in a Distributing or Controlled that is not expected to be economically viable as a stand alone corporation without a takeover).

2. “Reasonable Certainty” Operating Rule

The Current Proposed Regulations appropriately recognize that the lack of discussions with the acquirer prior to the distribution tends to show that the acquisition and the distribution are not connected to each other.³³ If the distribution was motivated by a business purpose to

³² For a similar proposal, see Mark J. Silverman, “Proposal to Modify Section 355(e) Proposed Regulations,” Doc. No. 2001-11823, 2001 TNT 84-19 (May 1, 2001).

³³ Prop. Reg. § 1.355-7(d)(3)(i), (ii).

facilitate the acquisition or a similar acquisition, however, the acquisition may be considered under the Current Proposed Regulations to have been intended to occur in connection with the distribution notwithstanding the lack of discussions.³⁴ For this purpose, evidence of a business purpose to facilitate an acquisition exists if, at the time of the distribution, there was “reasonable certainty” that, within six months after the distribution, an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition. According to the Preamble to the Current Proposed Regulations, this “reasonable certainty” operating rule is necessary to implement section 355(e) because an acquisition that was reasonably certain to occur was likely to have been taken into account in the decision whether to effect a distribution.

Although the “reasonable certainty” operating rule represents a significant improvement over the “reasonable anticipation” standard of the 1999 Proposed Regulations, we believe that further modifications are warranted for the regulations to target more precisely the concerns that motivated Congress to enact section 355(e). In our view, the regulations should make clear that a distribution into a “hot market” should not, by itself, be considered to reflect an intent that an acquisition occur “in connection with” the distribution. Rather, a taxpayer’s “reasonable certainty” with respect to an acquisition should be deemed relevant under section 355(e) only if it results from an awareness that the corporation to be acquired does not have adequate net assets to sustain itself or is otherwise economically burdened so as not to be financially viable without a takeover, public offering, or other capital infusion. In the final regulations, plan factor (ix) (which recognizes that intent for an acquisition to occur in connection with a distribution may be present when the allocation of debt between Distributing and Controlled makes an acquisition of one of the corporations likely in order to service the debt) should take over the role of the “reasonable certainty” operating rule. The facts of Example 5 (the “hot market” example) should be modified by explaining the source of the taxpayer’s reasonable certainty that Controlled will be acquired following the distribution.³⁵ If the reasonable certainty does not relate to Controlled’s economic viability as a stand alone corporation after the distribution, then Distributing should not be deemed to have had a business purpose to facilitate the acquisition of Controlled.

On a related note, we also recommend that the absence of the type of leverage described in plan factor (ix) be included as an additional nonplan factor.

3. Comments of a More Technical Nature

a. “Substantial Negotiations”

³⁴ Prop. Reg. § 1.355-7(d)(2)(vii).

³⁵ Clarification of the facts of Example 5 is warranted even if our suggested changes to the reasonable certainty operating rule are rejected.

The final regulations should provide additional guidance on what “substantial negotiations” are and when “substantial negotiations” will be considered to have commenced.³⁶ Clearly, discussions of a proposed transaction without the knowledge of Distributing, Controlled, or their respective controlling shareholders (such as discussions by investment bankers acting on their own initiative to see whether a deal is possible) should not be taken into account under section 355(e). Discussions between authorized representatives of the parties (such as senior executives or investment bankers having been engaged by Distributing or Controlled) should not constitute “substantial negotiations” if the discussions are preliminary in nature. Nor should the sharing of financial or other corporate information be considered substantial negotiations, if such activities are undertaken merely to enable the parties to determine whether to engage in more serious discussions. In our view, negotiations should not be considered to have become “substantial” until the parties have exchanged at least one specific proposal and counterproposal regarding the price and other material terms of the transaction, either orally or in writing.

In the case of public offerings or auctions, the Current Proposed Regulations provide that “substantial negotiations” can exist “even if the acquirer has not been specifically identified” and “will be based on discussions with an investment banker or other outside adviser.”³⁷ The final regulations should make clear that preliminary discussions of a proposed public offering or an auction with investment bankers or other outside advisers do not constitute “substantial negotiations.” Discussions of a public offering or auction with outside advisers should be considered “preliminary” for this purpose until the issuing corporation is substantially and practically committed to the transaction, as evidenced by a public announcement or the preparation of a prospectus, offering memorandum, or other similar materials.

The final regulations also should provide some relief when “substantial negotiations” concerning a potential transaction break down and do not resume for a significant period of time. As currently drafted, Safe Harbors I, II and II are unavailable if “substantial negotiations” occur at any time prior to the date that is six months after the distribution. We believe that these safe harbors should be available if the negotiations have completely broken off, say, more than six months before the distribution and do not resume until at least six months thereafter.

b. Discussions Not Rising to the Level of “Substantial Negotiations”

Under the facts-and-circumstances test of the Current Proposed Regulations, the existence or lack of discussions between Distributing or Controlled and the acquirer are important factors in determining whether an acquisition is part of a plan.³⁸ The weight to be accorded to the discussions depends on their “nature, timing, and extent.”³⁹ It is unclear, though,

³⁶ Any “substantial negotiations” concerning a second transaction that occur at any time prior to the date that is six months after the first transaction will prevent the application of Safe Harbors I, II, III, and IV. “Substantial negotiations” also are relevant under plan factor (viii) and the “reasonable certainty” operating rule.

³⁷ Prop. Reg. § 1.355-7(k)(1).

³⁸ See Prop. Reg. § 1.355-7(d)(2)(i)-(vi), (3)(i), (ii), (iv).

³⁹ Prop. Reg. § 1.355-7(d)(2)(i)-(vi).

to what level discussions must rise in order to constitute a factor tending to show the existence of a section 355(e) plan or, conversely, to make certain of the nonplan factors unavailable.⁴⁰ Will an unsolicited offer for Controlled or Distributing which is promptly rejected be enough to make the first nonplan factor (as well as Safe Harbor I) unavailable? Would such an exchange be considered a plan factor with respect to a future acquisition (involving the same or a different acquirer) that happens to have terms similar to the terms of the rejected offer? Also, what level in the corporate hierarchy must the participants occupy in order for their discussions to be considered relevant? We think the final regulations should make clear that only discussions between individuals having significant decision making authority in respect of acquisitions (subject, of course, to board approval and shareholder approval where relevant) should be taken into account.

With a facts and circumstances test, additional examples are perhaps the most effective way to clarify the relevance of discussions under section 355(e). In addition, it would be helpful for the final regulations to state (perhaps by way of an example) that discussions concerning a second transaction are given very little weight if they have completely broken off prior to the decision to effect the first transaction.

c. Internal Discussions Operating Rule

The second operating rule states that internal discussions regarding an acquisition could be indicative of an acquisition-related business purpose for the distribution.⁴¹ It is unclear whose discussions are relevant under this rule. Presumably, only discussions involving individuals having the authority to decide whether or not to distribute Controlled are relevant. Internal discussions of lower management which never rise to the level of a corporation's decision makers should not be considered to reflect on the business purpose for undertaking a distribution. In addition, internal discussions that occur after the corporation's decision to effect the distribution should not be indicative of a business purpose for the distribution. The internal discussions operating rule should be clarified in the final regulations because the business purpose for the distribution is an important factor in Safe Harbor I and certain of the plan and nonplan factors.⁴²

⁴⁰ In the case of an acquisition (other than a public offering or auction) occurring after a distribution, the first plan factor requires the absence of discussions between Distributing or Controlled and the acquirer or any potential acquirer (or any of their respective controlling shareholders) about the acquisition or a similar acquisition before the distribution. Prop. Reg. § 1.355-7(d)(3)(i). The wording of this factor puts a large amount of stress on what is considered a similar acquisition. If an acquisition occurring after a distribution is considered "similar" to one that was discussed at any time prior to the distribution, the first nonplan factor might be unavailable, regardless of how long before the distribution the discussions regarding the original acquisition occurred or how long after the distribution the acquisition in question occurred. See, e.g., Prop. Reg. § 1.355-7(m), *Example 2* (discussions before acquisition with different acquirer cause nonplan factor not to be applicable). We hope that the facts-and-circumstances test would lead to the correct result in any case, but we believe this situation provides another illustration of why the concept of a "similar" acquisition should be abandoned.

⁴¹ Prop. Reg. § 1.355-7(e)(2).

⁴² See, e.g., Prop. Reg. § 1.355-7(d)(2)(vii), (d)(3)(vi), (f)(1)(i)(B).

d. Discussions with Investment Bankers

According to Example 7 and several of the plan and nonplan factors, the identification of potential targets by an investment banker is not relevant in determining whether an acquisition is part of a plan. A close reading of Example 7 shows that it was not the identification of X and Y by the investment banker that taints the future acquisitions of Y and Z, but rather the actual discussions between Distributing and X (together with the asserted “similarity” of the X, Y and Z acquisitions). This is a result of the plan and nonplan factors that, except for public offerings and auctions, consider only discussions directly with the acquirer (or its representatives) to be relevant in making a “plan” determination. To ensure that taxpayers do not incorrectly conclude that discussions with one’s own investment bankers could taint a non-public offering or a non-auction acquisition, the references to these discussions should be removed from Example 7 (if the example is retained in its current form).

e. Safe Harbor I -- Multiple Business Purposes for a Distribution

Additional guidance is needed to help taxpayers and the Service apply Safe Harbor I to distributions motivated by both a business purpose to facilitate an acquisition of Distributing or Controlled stock (an “acquisition purpose”) and one or more non-acquisition business purposes. Safe Harbor I applies to an acquisition that occurs more than six months after a distribution if (i) there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is six months after the distribution 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 an acquisition business purpose. Under Safe Harbor I, the presence of an acquisition business purpose is considered “relevant” in determining the extent to which the distribution was motivated by a corporate business purpose (within the meaning of Treas. Reg. § 1.355-2(b)) other than an acquisition business purpose.⁴³ The Preamble to the Current Proposed Regulations states that the analysis of whether there is a substantial non-acquisition business purpose for a distribution in light of an acquisition business purpose is similar to the analysis, under Treas. Reg. §§ 1.355-2(b)(1) and (5), *Example 8*, of whether there is a valid corporate business purpose for a distribution in light of the potential for avoidance of federal taxes, meaning that the non-acquisition business purpose must be “real and substantial even in light of the acquisition business purpose.”⁴⁴

⁴³ Prop. Reg. § 1.355-7(f)(1)(ii). In addition, “reasonable certainty” that an acquisition, agreement, understanding, arrangement, or substantial negotiations concerning an acquisition would occur before a date that is six months after the distribution constitutes evidence of a business purpose to facilitate an acquisition of Distributing or Controlled. See Prop. Reg. § 1.355-7(e)(1)(i).

⁴⁴ The example cited in the Preamble involves a pro rata spin-off motivated by Distributing’s desire to elect Subchapter S status (which is considered to be a tax avoidance purpose) and Controlled’s desire to enable a key employee to acquire a significant amount of Controlled stock. The example states that the potential to avoid federal taxes is a “relevant factor” to take into account in determining whether the issuance of Controlled stock to a key employee actually motivated the spin-off and concludes that the spin-off will meet the corporate business purpose requirement only if the facts and circumstances establish that the spin-off was “substantially motivated” by the need to issue stock to the employee.

We agree that the presence of an acquisition business purpose requires additional scrutiny of the taxpayer's assertion that the distribution was motivated in substantial part by a non-acquisition business purpose. "Substantiality" and "motivation" are vague concepts, however, and it is unclear what must be proven in order for Safe Harbor I to apply. Must the taxpayer show that the distribution would have occurred without regard to the acquisition business purpose? That the distribution would not have occurred but for the existence of the non-acquisition business purpose? That the non-acquisition business purpose outweighed the acquisition business purpose? The final regulations should clarify Safe Harbor I by answering these questions in the negative.

A safe harbor that demands such a subjective and hypothetical analysis fails to serve its purpose of providing reasonable certainty of results. Further, we submit that such an inquiry is unnecessary in light of Safe Harbor I's six month rule, which appropriately recognizes that the absence of any agreement, arrangement, understanding, or substantial negotiations concerning a particular acquisition during the six-month period following the distribution provides strong evidence that there was no intention, on the date of the distribution, that the acquisition would occur "in connection" with the distribution. If no substantial negotiations with respect to an acquisition occur until at least six months after the distribution, we believe that, in virtually all cases, the distribution would have occurred anyway, without regard to the acquisition. With the evidence provided by the passing of six months, and in light of the difficulty of proving subjective motives in a hypothetical situation, the taxpayer should be required to show only that the non-acquisition business purpose was real and would have been sufficient to satisfy the corporate business purpose requirement set forth in Treas. Reg. § 1.355-2(b). This test will make Safe Harbor I simpler and more useful in practice but without inviting abuse.

If our suggested clarification of Safe Harbor I is rejected, and the final regulations require the taxpayer to show that the distribution would have occurred without regard to the acquisition-related business purpose or that the non-acquisition business purpose outweighed the acquisition-related business purpose, we believe that all business purposes that motivated the distribution should be considered, not just non-acquisition business purposes that satisfy the corporate business purpose requirement under Treas. Reg. § 1.355-2(b). For example, the fact that a distribution was motivated in part by a desire to increase shareholder value (which, by itself, is not recognized under Rev. Proc. 96-30, 1996-1 C.B. 696, as a valid corporate business purpose) may indicate less emphasis on a business purpose to facilitate an acquisition, at least to the extent that the desire to increase shareholder value is nonacquisitive in nature -- i.e., not a desire to reflect an acquisition premium but instead a desire to have analysts focus on the value of one of the businesses.⁴⁵ Another example of a business purpose not recognized under Rev. Proc. 96-30, but which could be relevant as a non-acquisition business purpose under Safe Harbor I, would be a "fit and focus" business purpose in the case of a pro rata distribution by a publicly traded corporation that has a significant shareholder.⁴⁶

⁴⁵ In this regard, see Prop. Reg. § 1.355-7(e)(4), which provides that the fact that the distribution makes the stock of Distributing or Controlled trade more actively is not taken into account in determining whether the distribution and an acquisition of Distributing or Controlled stock were part of a plan.

⁴⁶ See Rev. Proc. 96-30, 1996-1 C.B. 696, Appendix A, § 2.05.

In addition, an acquisition-related business purpose should not count against the taxpayer under Safe Harbor I unless the acquisition under review bears some rational relationship to that particular business purpose. As Safe Harbor I is currently drafted, the presence of any acquisition-related business purpose may prevent the taxpayer from satisfying the safe harbor (although Safe Harbor II may still be available). By contrast, under the facts-and-circumstances test, the taxpayer’s business purpose for the distribution constitutes a “plan” factor only if the taxpayer intended to facilitate “the acquisition or a similar acquisition.”⁴⁷ In this regard, Example 4 illustrates that a business purpose to facilitate a public offering of Controlled stock does not count as a plan factor in testing Controlled’s use of its own stock to acquire an unrelated corporation after the distribution.⁴⁸ We suggest that Safe Harbor I’s reference to “a business purpose to facilitate an acquisition of Distributing or Controlled” be replaced with the phrase “a business purpose to facilitate the acquisition of Distributing or Controlled or a similar acquisition.”⁴⁹ This change would ensure that the acquisition in question and the business purpose for the distribution would have to be related before preventing the application of Safe Harbor I.⁵⁰ At a minimum, Safe Harbor I, if otherwise available, should generally protect an acquisition of Controlled if the acquisition-related business purpose for the distribution pertains only to Distributing and vice versa.

f. Safe Harbor II

While Safe Harbor I requires a substantial non-acquisition business purpose, Safe Harbor II does not. Specifically, Safe Harbor II states that a distribution and a later acquisition will not be considered part of a plan if (i) the acquisition occurs more than 6 months after the distribution (and there was no agreement, understanding, arrangement or substantial negotiations concerning the acquisition before the date that is 6 months after the distribution), (ii) the distribution was motivated in whole or in substantial part by a business purpose to facilitate an acquisition or acquisitions of no more than 33% of the stock of Distributing or Controlled, and (iii) no more than 20% of the stock of the corporation (whose stock was acquired in the acquisition or acquisitions that motivated the distribution) was either acquired or the subject of an agreement, understanding, arrangement or substantial negotiations before a date that is 6 months after the distribution.⁵¹

As the only safe harbor available when a distribution is not motivated in whole or substantial part by a non-acquisition business purpose, Safe Harbor II may prove to be a very

⁴⁷ Prop. Reg. § 1.355-7(d)(2)(vii).

⁴⁸ Prop. Reg. § 1.355-7(m), *Example 4*.

⁴⁹ The concept of a “substitute” acquisition could be employed here instead of the concept of a “similar” acquisition.

⁵⁰ We recognize that, if Safe Harbor I were to be modified along these lines, the relevance of Safe Harbor II would be greatly diminished.

⁵¹ Prop. Reg. § 1.355-7(f)(2).

important relief provision. Regardless of its importance, it is unclear why the third prong of the provision exists. If the government wishes to provide a safe harbor for acquisitions following a distribution that was motivated in whole or in substantial part by an acquisition business purpose as long as the amount of stock proposed to be acquired is less than 33% of Distributing or Controlled, why does it not provide relief for an acquisition or series of acquisitions in which no more than 33% of Distributing or Controlled is acquired? We suggest dropping the third prong of the safe harbor (20%) in order to make the safe harbor more workable in practice. Alternatively, the second prong could be dropped and the third prong raised to 33%.

g. Safe Harbor V (Public Trading)

Safe Harbor V provides that an acquisition of Distributing or Controlled stock that is listed on an established market is not part of a plan if the acquisition occurs pursuant to a transfer between shareholders of Distributing or Controlled, neither of whom is a 5-percent shareholder.⁵² Exceptions to the safe harbor apply in the case of certain coordinated acquisitions of stock (pursuant to which the coordinating group would acquire 5% or more of the stock) or with respect to acquisitions by a person if the issuing corporation knows, or has reason to know, that the person (or a coordinating group) intends to become a 5-percent shareholder at any time during the 4-year period beginning 2 years before the distribution.⁵³ The safe harbor defines the term “5-percent shareholder” by reference to Prop. Reg. § 1.355-7(k)(5),⁵⁴ except that the corporation may rely on Schedules 13D or 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its 5-percent shareholders.

We recommend that the first sentence of Safe Harbor V be modified by substituting the term “controlling shareholder” for the term “5-percent shareholder.” For this purpose, the definition of a “controlling shareholder” under the Current Proposed Regulations, *i.e.*, a 5-percent shareholder who actively participates in the management or operation of the corporation, would apply.⁵⁵ The modified safe harbor could be written so that it does not protect (i) an acquisition of stock by a person pursuant to a formal or informal understanding with other persons (the coordinating group) if, at the time of the distribution or at the time of the acquisition by such person, the coordinating group acts as a controlling shareholder and (ii) acquisitions of stock if the issuing corporation knows, or has reason to know, that the person acquiring the stock (or a coordinating group) intends to become a controlling shareholder at any time during the 4-year period beginning 2 years before the distribution.

⁵² Prop. Reg. § 1.355-7(f)(5)(i).

⁵³ See Prop. Reg. § 1.355-7(f)(5)(ii)(B), (C).

⁵⁴ Prop. Reg. § 1.355-7(f)(5)(i). Prop. Reg. § 1.355-7(k)(5) provides that a “5-percent shareholder” is a person who owns, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)) 5 percent or more of any class of stock of the corporation, with all options being treated as exercised for the purpose of determining whether the shareholder is a 5-percent shareholder.

⁵⁵ See Prop. Reg. § 1.355-7(k)(3)(ii).

We believe that these changes to the Current Proposed Regulations are warranted because an acquisition of stock by a shareholder who does not actively participate in the management or operation of the corporation should not be viewed as relevant in determining whether Distributing, Controlled or their respective controlling shareholders intended for the acquisition to occur in connection with the distribution.⁵⁶ In addition, by eliminating the need to track 5-percent shareholders who do not actively participate in the corporation's affairs, compliance with section 355(e) would be made less burdensome in practice.

h. Safe Harbor VI (Equity Compensation)

Safe Harbor VI applies to acquisitions of Distributing or Controlled stock “by an employee or director of Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A), in connection with the performance of services as an employee or director for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) in a transaction to which section 83 applies[.]”⁵⁷ This safe harbor appropriately recognizes that routine equity compensation arrangements should not implicate section 355(e). Safe Harbor VI is narrower than it needs to be, however, and additional compensatory stock transfers should be protected.

First, the protection of the safe harbor should be extended to compensatory transfers of stock to independent contractors, with the exception of stock received by an independent contractor for services rendered in connection with an acquisition that otherwise is treated as part of a “plan (or series of related transactions)” under section 355(e). (For example, if an attorney receives stock in exchange for advising a corporation about an initial public offering that is part of a section 355(e) plan, a transfer of stock to the attorney as compensation should not be treated more favorably than the stock sold to the public in the offering.)

Second, Safe Harbor VI should not be limited to transactions to which section 83 applies but should encompass all transfers of stock in connection with the performance of services. At a minimum, the safe harbor should protect acquisitions of stock governed by section 421(a), which applies to stock acquired upon the exercise of “incentive stock options” within the meaning of section 422 or options granted under an “employee stock purchase plan” qualifying under section 423(b).⁵⁸ We do not believe that there is any meaningful distinction between qualified and nonqualified stock options for purposes of section 355(e).

⁵⁶ In this regard, see Priv. Ltr. Rul. 200125044 (Mar. 22, 2001), which held that various acquisitions and dispositions of Distributing stock, which occurred prior to a distribution, by several different investment advisers that were 5-percent shareholders of Distributing did not constitute part of a section 355(e) plan. The taxpayer represented that none of the investment advisers participated in the management of either Distributing or Controlled and that there was no agreement, understanding, arrangement, or negotiations between Distributing and Controlled and any of the investment advisers concerning the distribution on or before the dates on which the investment advisers acquired or sold any of their Distributing stock.

⁵⁷ Prop. Reg. § 1.355-7(f)(6).

⁵⁸ Section 83 does not apply to these transactions. See I.R.C. § 83(e)(1).

Third, it is unclear whether Safe Harbor VI applies to an acquisition of Controlled stock upon exercise of an option by a Distributing employee whose options to acquire Distributing stock were allocated among Distributing options and Controlled options pursuant to the distribution. Safe Harbor VI should be modified so that it applies in this situation, with a corresponding modification being made to Prop. Reg. § 1.355-7(g)(3)(ii).

Finally, Safe Harbor VI should be modified so that it does not require the person acquiring the stock as compensation to be an employee or director at the time of the acquisition. As written, the safe harbor might not protect an acquisition of stock by a person who acquires compensatory stock options as an employee of Distributing or Controlled but who exercises the options after leaving employment.

i. Options and Similar Instruments

Under certain circumstances, the acquisition of stock upon the exercise of an “option” (including as an “option” for this purpose a call option, a warrant, the conversion feature of convertible debt or stock, a put option, a redemption agreement, including the right to cause the redemption of stock, any other instrument providing for the right or possibility to issue, redeem, or transfer stock, including an option on an option, and any other similar interest) may be treated as having been the subject of an earlier agreement on the date the option was written.⁵⁹ The existence of such an “agreement” to acquire stock could prevent the acquisition to which the agreement relates from satisfying Safe Harbor I, II, or III and also could be treated as a plan factor.⁶⁰ To prevent an option from being treated as an earlier “agreement” to acquire stock, the taxpayer must establish 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.”⁶¹ All relevant facts and circumstances, including control premiums and minority and blockage discounts, are taken into account in determining the fair market value of stock underlying an option and, therefore, the likelihood of exercise.⁶²

These option rules do not apply to the following types of instruments unless written, transferred (directly or indirectly) or listed with a principal purpose of avoiding section 355(e): (i) an option that is part of a security arrangement in a typical lending transaction if the arrangement is subject to customary commercial conditions; (ii) a compensatory option with customary terms and conditions provided to an employee or director of Distributing, Controlled,

⁵⁹ If, however, there was an earlier agreement, understanding, or arrangement to write an option, the option will be treated as having been written on the date of the agreement, understanding, or arrangement. Prop. Reg. § 1.355-7(g)(1)(ii). In addition, if an agreement, understanding, or arrangement to write an option is reached, or an option is written, more than six months but not more than two years after the distribution, and there were substantial negotiations regarding the writing of the option or the acquisition of the stock underlying the option before the end of the six-month period beginning on the date of the distribution, the option will be treated as having been written within six months after the distribution.

⁶⁰ Prop. Reg. § 1.355-7(d)(2)(viii).

⁶¹ Prop. Reg. § 1.355-7(g)(1)(i).

⁶² Prop. Reg. § 1.355-7(g)(1).

or a person related to Distributing or Controlled under section 355(d)(7)(A), that is not excessive by reference to the services performed by such employee or director and that, immediately after the distribution and within six months thereafter, is nontransferable within the meaning of Treas. Reg. § 1.83-3(d) and does not have a “readily ascertainable fair market value” within the meaning of Treas. Reg. § 1.83-7(b); and (iii) any option entered into between shareholders of a corporation (or a shareholder and the corporation) that is exercisable only upon the death, disability or mental incompetence of the shareholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), the shareholder’s separation from service.

Several modifications to these rules are warranted in order to make them more consistent with their function (to determine whether Distributing, Controlled, or their controlling shareholders intended for the option to be exercised “in connection” with the distribution).

First, the likelihood of an option’s exercise on the date of the distribution should not, by itself, be viewed as particularly relevant in testing the existence of a plan. For example, Distributing may have long-outstanding convertible preferred stock or debt that is, by the time of the distribution, more likely than not to be converted into common stock. If the preferred stock or debt has become “in the money” for reasons independent of the distribution, an acquisition of Distributing common stock upon exercise of the conversion rights should not be viewed as part of a section 355(e) plan. If anything, such convertible stock or debt should be treated as “stock” for all section 355(e) purposes -- that is treated as having been converted. The likelihood of an option’s exercise at the time of a distribution should be tested under section 355(e) only when, with the direct involvement of Distributing, Controlled, or their respective controlling shareholders, the option is written, transferred, or modified in a manner that materially increases the likelihood of its exercise,⁶³ or, alternatively, with a principal purpose to avoid the application of section 355(e). Because the distribution of Controlled stock may cause an adjustment to the terms of many kinds of options to acquire Distributing stock (e.g., pursuant to customary anti-dilution features of convertible preferred stock or debt), which should not ordinarily be viewed as having been made with the intent on the part of Distributing or its controlling shareholders to facilitate an acquisition of Distributing stock in connection with the distribution, the modification of an option that does not materially increase the likelihood of its exercise should be ignored under section 355(e).

Second, the list of instruments that generally are not treated as options (in the absence of a principal purpose to avoid section 355(e)) should be broadened to include additional types of routine commercial transactions. Customary post-closing contingent or escrowed stock arrangements (pursuant to which additional stock may be issued to the selling parties depending on the earnings of the acquired business or the absence of indemnification claims against the sellers for breach of representations and warranties) should be excluded from the definition of an

⁶³ A similar standard for testing options applies under Treas. Reg. § 1.355-6(c)(3)(iii).

“option” under Prop. Reg. § 1.355-7(g)(3) if the transaction to which the escrowed or contingent stock relates is not treated as part of a section 355(e) plan.⁶⁴

Finally, if the taxpayer successfully establishes that the option in question was not more likely than not to be exercised, the Current Proposed Regulations provide that an “agreement” to acquire stock will not be deemed to have existed on the date the option was written. The final regulations should make clear that, in addition to the absence of an “agreement,” an “arrangement,” “understanding,” or “substantial negotiations” to acquire the stock underlying the option also will be deemed not to exist.

j. Substantial Diminution of Risk Operating Rule

The sixth operating rule states that the running of any time period prescribed in the Current Proposed Regulations is suspended for any period during which risk of loss is substantially diminished under the principles of section 355(d)(6)(B) (relating to risk diminution through an option, short sale, special class of stock or any other device or transaction).⁶⁵ No example is provided in the Current Proposed Regulations of the operation of this rule in the context of section 355(e), and its intended scope is not clear.

Presumably, the rule is not intended to negate the comfort otherwise provided by the various safe harbors. For example, under Safe Harbor III, if an acquisition occurs more than 2 years after a distribution and there was no agreement, understanding, arrangement or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter, the acquisition and the distribution are not part of a plan.⁶⁶ If there is no agreement, understanding, arrangement or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter, the fact that such activity (for example, the entering into of an acquisition contract or option) occurs more than 6 months but less than 2 years after the distribution presumably does not cause the tolling of the 2 year period so long as the acquisition itself is not consummated until after the end of the 2 year period. Clarification that this is the contemplated result would be helpful.

In addition, given the importance of time periods to the operation of the Current Proposed Regulations, guidance should be provided as to the types of transactions to which the risk diminution operating rule would apply. Absent such guidance, it is difficult to know how the risk diminution operating rule is to be interpreted, which may result in the rule having an unintended chilling effect on transactions.

k. Multiple Distributions

⁶⁴ Instruments not treated as options under Prop. Reg. § 1.355-7(g)(3) should also be excluded from tolling the running of any time period prescribed in section 355(e). See Prop. Reg. § 1.355-7(e)(6) (referring to section 355(d)(6)(B), which tolls 5-year period under section 355(d) when risk of loss is substantially diminished by any device including an option).

⁶⁵ Prop. Reg. § 1.355-7(e)(6).

⁶⁶ Prop. Reg. § 1.355-7(f)(3).

The general rule of the Current Proposed Regulations for a distribution occurring after an acquisition is set forth in the last sentence of Prop. Reg. § 1.355-7(b)(1), which provides as follows:

In general, in the case of an acquisition before a distribution, the acquisition and the 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.

Prop. Reg. § 1.355-7(b)(1) (Emphasis added). This reference to “a distribution” should be modified because it could be misconstrued as referring to any post-acquisition distribution, even one that was not intended at the time of the acquisition. For example, if the stock of a controlled subsidiary (“C1”) is distributed in connection with a third party’s acquisition of Distributing, section 355(e) clearly applies to the planned distribution of C1, but future distributions (of the stock of different controlled subsidiaries) should not forever be tainted if such distributions were not planned at the time of the acquisition. Correcting this unintended anomaly would be consistent with Prop. Reg. § 1.355-7(h), which sensibly provides that, in the case of a section 355 distribution involving more than one controlled corporation, a “planned” acquisition of a 50% or greater interest in one of the controlled corporations will not cause the distributing corporation to recognize gain with respect to the stock of the other controlled corporations.⁶⁷

⁶⁷ Prop. Reg. § 1.355-7(h). Gain with respect to all of the distributed controlled corporations must be recognized, however, if a planned 50% or greater acquisition of the distributing corporation occurs.