COMMENTS CONCERNING THE REVISED PROPOSED AND TEMPORARY REGULATIONS PURSUANT TO SECTION 355(e) DEFINING A “PLAN (OR SERIES OF RELATED TRANSACTIONS)”

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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 John P. Barrie, Jasper L. Cummings, Jr., Julie A. Divola, Philip J. Levine, William M. Richardson, Timothy C. Sherck, Thomas F. Wessel, and R. David Wheat. The Comments were reviewed by Robert H. Wellen 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.

Please feel free to contact us to discuss any questions or concerns you may have. Members of the Committee are available to meet, discuss our Comments, and provide specific suggested language changes at your convenience.

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COMMENTS CONCERNING THE REVISED PROPOSED AND TEMPORARY REGULATIONS PURSUANT TO SECTION 355(e) DEFINING A “PLAN (OR SERIES OF RELATED TRANSACTIONS)”

These Comments address the temporary and proposed regulations published by the Treasury Department (the “Treasury”) and the Internal Revenue Service (the “Service”) in the Federal Register on April 26, 2002 (referred to herein as the “Current Temporary Regulations”), concerning the definition of a “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”).

I. EXECUTIVE SUMMARY

1. We commend the Treasury and the Service for their excellent work reflected in the Current Temporary Regulations, which provide improved guidance to taxpayers in many common situations and permit many kinds of legitimate business transactions to go forward without fear of an unwarranted tax liability under section 355(e).

2. In the context of public offerings, additional guidance should be provided, and the scope of a “plan” should be narrowed. First, a general rule should be restored clarifying that a public offering and a distribution are not part of a plan unless the distributing corporation (“Distributing”) or the controlled corporation (“Controlled”), or their respective controlling shareholders, intended the offering to occur in connection with the distribution. Second, the intent to engage in a public offering generally should be evidenced by discussions with an investment banker concerning the type and amount of stock intended to be issued or the amount of proceeds intended to be raised. The purpose of the offering and the intended use of the proceeds also should be relevant. Third, the concept of a “similar” acquisition involving a public offering should be narrowed considerably, perhaps by adding a safe harbor under which an intended public offering that actually occurs (measured by the amount of stock sold and the amount of proceeds raised) is not considered “similar” to a subsequent public offering that fulfills a different purpose. Finally, the term “public offering” should be defined.

3. Several modifications are warranted regarding distributions after acquisitions: (a) a new safe harbor should be created to cover acquisitions of Distributing stock that occur prior to a pro rata distribution of Controlled, (b) Safe Harbor IV should be made less restrictive in cases not covered by the new safe harbor, (c) guidance should be provided on “substantial negotiations” with respect to a distribution, and (d) the third non-plan factor should not be made unavailable automatically when an acquisition occurs after the public announcement of a distribution.

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2 Unless otherwise specified, all “section” references in these Comments are to the Code, and all references to Reg. § 1.355-7T are to the Current Temporary Regulations.
4. The regulations should clarify how to measure the corporate business purpose for a distribution where, in addition to other business purposes, there exists a business purpose to facilitate an acquisition of Distributing or Controlled stock.

5. Safe Harbors V and VII should not be unavailable automatically to acquisitions involving passive investors who are 10-percent shareholders.

6. The vote shifting rule contained in Safe Harbor V should be rephrased as an anti-abuse rule, and the facts of Example 5 should be clarified.

7. In the case of an acquisition of Distributing or Controlled stock by another corporation, the definitions of “substantial negotiations” and “discussions” should be modified to require the involvement of one or more officers, directors, or controlling shareholders of the acquiring corporation, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of the acquiring corporation.

8. The plan and non-plan factors should be modified so that discussions concerning one potential distribution do not taint a subsequent distribution that is not similar to the potential distribution that was discussed.

9. Example 6 should be modified to clarify its rationale.

II. BACKGROUND

In the case of a distribution otherwise qualifying for nonrecognition under section 355(a), section 355(e) generally requires Distributing to recognize gain if one or more persons acquire, directly or indirectly, a 50% or greater interest in the stock of either Distributing or Controlled pursuant to “a plan (or series of related transactions)” that includes the distribution. Under section 355(e)(2)(B), a 50% or greater acquisition of Distributing or Controlled stock that occurs during the four-year period beginning two years before the distribution is deemed to be part of a “plan (or series of related transactions),” unless the taxpayer proves otherwise. Although section 355(e) enumerates specific transactions that are not taken into account, the statutory language

3 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 and securities of Controlled exceeds Distributing’s adjusted basis in such stock and securities. No adjustment is made to the basis of any stock or other property to reflect the recognition of gain at the corporate level.

4 Section 355(e)(2)(C) provides that a plan is disregarded under section 355(e) if, immediately after its completion, Distributing and Controlled are members of the same affiliated group. In addition, section 355(e)(3)(A) provides that, except as provided in regulations, the following acquisitions are not taken into account as part of a plan: acquisitions of Controlled stock by Distributing, acquisitions of Controlled stock by reason of holding stock or securities in Distributing, acquisitions of stock or securities in any successor corporation of Distributing or Controlled by reason of holding stock or securities in Distributing or Controlled, and acquisitions of Distributing or Controlled stock “to the extent that the percentage of stock owned directly or indirectly in such corporation by each person owning stock in such corporation immediately before the acquisition does not decrease.” These four exceptions in section 355(e)(3)(A) are not available to an acquisition of stock, however, if the stock held before such acquisition was acquired pursuant to a “plan (or series of related transactions)” that includes the distribution.
does not shed light on the basic question of when a “plan (or series of related transactions)” is considered to exist. By establishing a broad adverse presumption and failing to explain how to rebut it, the statutory language has deterred taxpayers unnecessarily from legitimate business transactions and created an urgent need for regulatory guidance. The Current Temporary Regulations are very responsive to that need.

Significant improvements have been made to curtail the overbreadth of the temporary regulations issued in August 2001 (the “Prior Temporary Regulations”)\(^5\) and to align the concept of a “plan (or series of related transactions)” more closely with traditional step transaction principles. These positive changes are most evident in the context of acquisitions of Distributing or Controlled stock (other than public offerings) that occur after a spin-off. For example, an operating rule in the Prior Temporary Regulations (sometimes referred to as the “reasonable certainty” operating rule) suggested that an acquisition occurring shortly after a distribution into a “hot market” tended to demonstrate that the acquisition was planned, even if no acquisition was discussed with any potential acquirer prior to the distribution.\(^6\) The Prior Temporary Regulations also adopted a broad definition of a “similar” acquisition under which, in certain circumstances, discussions with one potential acquirer could taint a subsequent acquisition by a completely unrelated acquirer.\(^7\)

By contrast, to support a finding of a “plan” under the Current Temporary Regulations, bilateral negotiations regarding the significant economic terms of the acquisition (or a narrowly defined “similar” acquisition) must have occurred prior to the distribution. The Current Temporary Regulations provide the following new rule (which we refer to as the “Super Safe Harbor”):

In the case of an acquisition (other than involving a public offering) after a distribution, the distribution and the acquisition can be part of a plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition at some time during the 2-year period ending on the date of the distribution.\(^8\)

In applying this Super Safe Harbor, as well as many other aspects of the Current Temporary Regulations, the actual acquisition and the potential acquisition that was the subject of substantial negotiations prior to the spin-off must bear a close relationship in order to be considered “similar” to each other. Similarity exists under the Current Temporary Regulations “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


\(^6\) Prior Reg. § 1.355-7T(e)(1)(i).

\(^7\) Prior Reg. § 1.355-7T(b)(2).

\(^8\) Reg. § 1.355-7T(b)(2).
potential acquisition." Similarity does not exist, however, “if the ultimate owners of the business operations with which Distributing or Controlled is combined in the actual acquisition are substantially different from the ultimate owners of the business operations with which Distributing or Controlled was to be combined in such other acquisition.” Examples 6 and 7 of the Current Temporary Regulations illustrate the revised meaning of a “similar” acquisition.

By focusing on whether bilateral negotiations regarding the significant economic terms of an acquisition (or a closely related “similar” acquisition) occurred prior to a distribution, the Current Temporary Regulations reflect a major change in emphasis. The result is a set of workable and practical rules that, for the most part, allows taxpayers the flexibility to engage in legitimate business transactions without fear of an unwarranted tax liability under section 355(e). We commend the Treasury and the Service for their considerable efforts to respond to taxpayer concerns about the statute and prior sets of proposed and temporary regulations while remaining faithful to the goals of Congress in adopting section 355(e). We offer our comments with the hope that further progress is possible, although much of the hard work has already been done.

III. COMMENTS

A. Public Offerings

Despite significant improvements in the context of other acquisitions after distributions, the Current Temporary Regulations are more stringent than the Prior Temporary Regulations in the context of public offerings. In many cases, it is difficult to apply the safe harbors and other guidance provided by the Current Temporary Regulations to public offerings. The Current Temporary Regulations should be revised to address this problem.

1. Difficulties of Applying the Current Temporary Regulations to Public Offerings

We believe a public offering is no more offensive to the policy of section 355(e) (and perhaps less so) than other types of acquisitions. Accordingly, even taking the legislative history of section 355(e) into account, a “plan (or series of related transactions)” should not be found to exist unless there is a strong link between the public offering and the distribution. Unfortunately, the Current Temporary Regulations make it difficult for taxpayers to establish that a public offering occurring during the four-year statutory presumption period is not part of plan. This aspect of the Current Temporary Regulations merits attention.

9 Reg. § 1.355-7T(h)(8).
10 Id.
11 It is also significant that taxpayers are permitted to rely on the Current Temporary Regulations retroactively, with respect to any distribution occurring on or after the effective date of the statute. See Reg. § 1.355-7T(k) (providing that the Current Temporary Regulations apply to distributions after April 26, 2002, but that taxpayers may apply the Current Temporary Regulations, in whole but not in part, to any distribution after April 16, 1997, and on or before April 26, 2002).
12 See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (JCS-23-97), December 17, 1997 at 199 (“A public offering of sufficient size can result in an acquisition that causes gain recognition under the provision.”).
In the case of an acquisition occurring after a distribution (including a public offering), the Prior Temporary Regulations contained a general rule providing that “the distribution and the acquisition are considered part of a plan 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.” The Current Temporary Regulations contain no such general rule.

In many situations, such an intent-based general rule would be superfluous. Under the Super Safe Harbor, for example, there is no “plan” unless, before the distribution, there were substantial negotiations regarding the significant economic terms of the acquisition. The Super Safe Harbor, however, does not apply to public offerings. In our view, a modified version of the intent-based general rule should apply to public offerings either before or after distributions. Without such a rule, it is difficult to apply the technical provisions of the Current Temporary Regulations because the issue required to be resolved in the analysis is never stated. Thus, the regulations should state that a public offering after a distribution is part of a plan only if, on the date of the distribution, Distributing or Controlled, or any of their respective controlling shareholders, intended that the public offering occur in connection with the distribution.

With such a general rule in place, an important issue would be whether intent to effect a public offering exists at the time of the distribution. In a public offering, the issuer typically does not engage in bilateral negotiations with the actual investors. Rather, the issuer sets the terms of the offering after consultation with investment bankers about market conditions and other factors. Accordingly, to determine whether Distributing or Controlled, or their controlling shareholders, intended a public offering to occur in connection with a distribution, the Current Temporary Regulations appropriately do not rely upon the absence of pre-distribution negotiations with purchasers. The analysis shifts to other factors, such as discussions of the offering with investment bankers and whether there were corporate business purposes for the distribution other than to facilitate the offering.

Unfortunately, there is a great deal of uncertainty in applying these concepts. For example, the Current Temporary Regulations state that “substantial negotiations” with respect to a public offering will be “based on discussions” with an investment banker. No reference is made to the content of those discussions, by contrast to “substantial negotiations” concerning other types of acquisitions (which require discussions with the acquirer regarding the significant economic terms of the proposed acquisition). The language of the Current Temporary Regulations may suggest that even the most general and preliminary discussions with an investment banker about a potential public offering could constitute “substantial negotiations,” thereby making a number of safe harbors unavailable. In our view, “substantial negotiations”

13 Prior Reg. § 1.355-7T(b)(1).

14 A reinstated general rule for all acquisitions of Distributing or Controlled stock (based on the intent of Distributing or Controlled, or their respective controlling shareholders, that the acquisition in question occur “in connection with” a distribution) also would be helpful in other contexts, such as determining whether a distribution (including a public offering) that follows an acquisition is part of a plan or determining whether public trading by a “controlling shareholder” or a “10-percent shareholder” is part of a plan.
with regard to a public offering should be defined more narrowly, to encompass discussions with an investment banker regarding the significant economic terms of the proposed offering. The significant economic terms of a public offering would be defined to include, for example, the amount of cash to be raised in the offering or the type of stock (and the amount of that stock) to be sold in the offering.\footnote{Although a public offering may be discussed internally within a company, the planning for a public offering cannot go very far, in our experience, without the involvement of an outside investment banker. For this reason, the Super Safe Harbor’s exclusion of public offerings should be reconsidered. Even if public offerings continue to be excluded from the Super Safe Harbor, a narrowing of the definition of “substantial negotiations” concerning a public offering would make Safe Harbors I, II and III more useful in the public offering context.}

The concept of a “similar acquisition” in the public offering context is also troubling. For instance, in Example 2, Distributing, in consultation with its investment banker, decides to offer 20 percent of its stock to the public (but without Controlled). One month later, to facilitate the offering, Distributing spins off Controlled, and seven months later, Distributing issues 20 percent of its stock in a public offering. The example concludes that the spin-off and the public offering are part of a plan, since Distributing discussed the offering with its investment banker prior to the distribution and the distribution was motivated solely by a business purpose to facilitate the offering.\footnote{Reg. § 1.355-7T(j), Example 2.}

But suppose that, subsequently, an unexpected opportunity to acquire an unrelated target corporation for cash arises, and Distributing funds the acquisition by selling an additional 30 percent of its common stock 18 months after the spin-off in a second underwritten public offering. Distributing did not intend the second public offering to occur in connection with the distribution, but reaching the conclusion that the second public offering should not be included as part of a “plan” is difficult under the Current Temporary Regulations.\footnote{Reg. § 1.355-7T(h)(8).}

The difficulty arises because the definition of a “similar” acquisition, which was narrowed significantly for all acquisitions other than public offerings, remains wide open in the context of public offerings. The Current Temporary Regulations provide:

\begin{quote}
In the case of a public offering or other stock issuance for cash, an actual acquisition may be similar to another acquisition, even though there are changes in the terms of the stock, the class of stock being offered, the size of the offering, the timing of the offering, the price of the stock, or the participants in the offering.\footnote{Reg. § 1.355-7T(h)(8).}
\end{quote}

This broad statement provides no guidance as to whether the second public offering is “similar” to the public offering that was planned prior to the spin-off. We do not think this uncertainty was intended.
Under the Prior Temporary Regulations, Safe Harbor II would have applied to the second public offering, because that safe harbor became inapplicable only if there were discussions concerning “the acquisition” (with no reference to a “similar acquisition”) during the period ending 6 months after the distribution. In addition, the plan and non-plan factors relating to public offerings referred to discussions concerning “the acquisition” but did not mention a “similar” acquisition. Under the Current Temporary Regulations, however, none of the safe harbors would apply to the second public offering if Distributing cannot establish a lack of similarity to the first public offering. Also, if the first public offering is considered similar to the second public offering, two of the plan factors would apply, and all but one of the non-plan factors would be unavailable, because Distributing discussed a “similar acquisition” with an investment banker prior to the distribution and the distribution was motivated solely by a business purpose to facilitate a “similar acquisition.” The only non-plan factor available would be that “there was an identifiable, unexpected change in market or business conditions occurring after the distribution that resulted in the acquisition that was otherwise unexpected at the time of the distribution,” i.e., the unexpected opportunity to acquire the target corporation and the resulting need for cash. Under the circumstances, Distributing should prevail, but reaching this conclusion under the Current Temporary Regulations is more difficult than it should be.

The regulations should address the uncertainty created by the broad definition of a “similar acquisition” in the context of public offerings, at a minimum by explaining the purpose

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18 Prior Reg. § 1.355-7T(f)(2)(i).

19 See Prior Reg. § 1.355-7T(d)(2)(iii) (plan factor for public offering after a distribution if “Distributing or Controlled (or any of their respective controlling shareholders discussed the acquisition with an investment banker or other outside adviser before the distribution”) (emphasis added); Prior Reg. § 1.355-7T(d)(3)(ii) (non-plan factor for a public offering occurring after a distribution applicable if “neither Distributing nor Controlled (nor any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the distribution”) (emphasis added).

20 Safe Harbor I is unavailable because the distribution was motivated solely by a business purpose to facilitate “an acquisition” of the stock of Distributing. See Reg. § 1.355-7T(d)(1)(i). Safe Harbor II requires, among other things, that the distribution not have been motivated by a business purpose to facilitate “the acquisition or a similar acquisition.” See Reg. § 1.355-7T(d)(2)(i)(A). Safe Harbor III requires, among other things, that there was no agreement, understanding, arrangement, or substantial negotiations concerning “the acquisition or a similar acquisition” within 1 year after the distribution. See Reg. § 1.355-7T(d)(3). None of the other safe harbors are relevant. It is interesting that the Super Safe Harbor under the Current Temporary Regulations would have applied if Distributing had acquired the target corporation by issuing Distributing stock to the target’s shareholders rather than issuing its stock to investors in the second public offering and then paying cash for the target.

21 See Reg. §§ 1.355-7T(b)(3)(ii) (plan factor if a public offering or similar acquisition was discussed with investment banker prior to distribution), 1.355-7T(b)(3)(v) (plan factor if the distribution was motivated by a business purpose to facilitate a similar acquisition), 1.355-7T(b)(4)(i) (non-plan factor available only if there were no discussions prior to the distribution regarding a similar acquisition), 1.355-7T(b)(4)(v) (non-plan factor available only if the distribution was motivated in whole or substantial part by a business purpose other than a business purpose to facilitate a similar acquisition), 1.355-7T(b)(4)(vi) (non-plan factor available only if the distribution would have occurred at approximately the same time and in similar form regardless of a similar acquisition).

22 See Reg. § 1.355-7T(d)(4)(ii).
of the “similar acquisition” rule in the context of public offerings. If the purpose of the rule is to prevent a public offering that was intended at the time of the distribution to avoid being treated as part of a plan merely because some of the terms of the offering are modified, then the second public offering in the example above should not be treated as a “similar” acquisition.

The public offering that was intended actually occurred, and the second public offering fulfills a different purpose that did not exist at the time of the distribution. Thus, the two offerings should not be treated as “similar” to each other even though both transactions are similar on a superficial level in that they involve underwritten public offerings of a significant percentage of Distributing’s common stock.

In determining whether a public offering is “similar” to a prior offering, an important part of the analysis should be whether the originally intended offering has, in fact, been accomplished at the time that the subsequent offering is undertaken. It should be clear, from discussions with underwriters and from securities documents prepared in connection with the offering, what type and amount of stock is expected to be offered and how much cash is intended to be raised. The size of the original offering (by both percentage of stock intended to be sold and amount of cash to be raised) would be a good basis for establishing a safe harbor to distinguish intended offerings from unrelated ones. In cases in which the new safe harbor is unavailable, the purpose of the original offering and the intended use of the proceeds should also be important factors.

Accordingly, if the originally intended offering is fully completed (i.e., the intended amount of stock is sold, and the intended amount of cash is raised), an offering undertaken later should not be considered “similar” to the earlier offering, even if undertaken on similar terms. On the other hand, if all of the shares intended to be issued were not sold or if the company did not raise all the proceeds it intended to raise, a subsequent offering that fills one of these gaps generally would be treated as “similar” to the originally intended offering. Even if the first offering was not fully successful, however, a later offering should not be considered “similar,” if there is a significant change in circumstances, or if, for some other reason, the second offering fulfills a purpose not connected to the purpose of the originally intended offering. For example, if the purpose for the original offering is abandoned, and the second offering is undertaken for a different purpose not in existence at the time of the distribution, the second offering should not be treated as “similar” to the first one.

2. Definition of “Public Offering”

In light of the sharply different rules that apply under the Current Temporary Regulations to privately negotiated acquisitions, on the one hand, and public offerings, on the other hand, the final regulations also should include a definition of a “public offering.” For example, can an issuance by Distributing of its own stock to acquire a target corporation in a tax-free reorganization be considered a “public offering” to the target shareholders? The definition of a

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23 The preamble to the proposed regulations issued in late 2001 stated that “[t]he reference to ‘a similar acquisition’ ensures that changes in the terms of the acquisition intended at the time of the distribution . . . do not prevent the distribution and the acquisition that actually occurs from being considered part of a plan.” See REG-107566-00, 66 F3d. Reg. 66 (2001) (Emphasis added.)
“similar acquisition,” which refers to a “public offering or other stock issuance for cash,” suggests that the answer is no, but this issue should be resolved in the final regulations.

Also, we believe that the term “public offering” should not encompass all issuances of stock for cash. In general, a “public offering” should be limited to a transaction in which stock is sold, through the efforts of one or more investment bankers, to a relatively large group of unidentified buyers. A privately negotiated transaction in which an identified buyer or group of identified buyers negotiates with Distributing or Controlled regarding an investment in stock should be tested under the rules for acquisitions not involving a public offering. The fact that such a transaction is privately negotiated justifies this treatment.

B. Acquisitions Occurring Before a Distribution

1. New Safe Harbor

The Current Temporary Regulations provide the Super Safe Harbor and three other safe harbors, as well as other guidance, for acquisitions occurring after distributions. But the same level of guidance is lacking for acquisitions that occur before distributions. Safe Harbor IV is the only safe harbor specifically directed at pre-distribution acquisitions. For that safe harbor to apply, the acquisition must have occurred more than two years before the distribution, and there cannot have been an agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter. Given that the statutory presumption of section 355(e)(2)(B) applies only to acquisitions occurring within two years of the distribution, Safe Harbor IV verges on superfluous, especially compared with the extensive safe harbors for post-distribution acquisitions.

Treating pre-distribution acquisitions more harshly than post-distribution acquisitions seems inappropriate in light of the policy underlying section 355(e), especially where an acquisition of Distributing stock is followed by a pro rata distribution of Controlled stock. In that case, the shareholders of Distributing (including the acquirer) maintain the same level of interest in both Distributing and Controlled, and the policies motivating the enactment of section 355(e) (i.e., division of business segments among new and old shareholders) are not implicated. For this reason, a new safe harbor would be appropriate to cover any acquisition of Distributing stock that occurs prior to a pro rata distribution, regardless of whether the distribution was publicly announced, discussed or intended by the acquirer prior to the distribution.

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24 See Reg. § 1.355-7T(d)(1), (2) (3).
25 See Reg. § 1.355-7T(d)(4).
26 Id.
27 Of course, in certain cases, the pre-distribution acquisition could cause section 355(d) to apply, thereby producing the same tax consequences as if section 355(e) had applied.
2. **Expansion of Safe Harbor IV**

   For pre-distribution acquisitions not covered by such a new safe harbor (i.e., acquisitions of Controlled stock that precede any kind of distribution and acquisitions of Distributing stock that precede a split-off), Safe Harbor IV should apply if the acquisition occurs more than one year before the distribution, provided there was no agreement, understanding, arrangement or substantial negotiations regarding the distribution at the time of the acquisition or within six months thereafter. A one-year period between the acquisition and the distribution and a six-month period before substantial negotiations are commenced regarding the distribution should ensure that the distribution was not prearranged prior to the acquisition.

   Arguably, by analogy to the Super Safe Harbor for post-distribution acquisitions, there should be no required time period between the acquisition and the distribution as long as there was no agreement, understanding, arrangement or substantial negotiations with respect to the distribution for a certain period prior to the acquisition. We hesitate to suggest such a safe harbor, however, given the administrative difficulty of determining when an agreement, arrangement or the like exists with respect to a distribution, as opposed to an acquisition. In our view, this administrative difficulty argues for some required period between the pre-distribution acquisition and the distribution, at least for a safe harbor to apply.

3. **Definition of “Substantial Negotiations”**

   In addition to the new safe harbor and changes to Safe Harbor IV, additional guidance to define “substantial negotiations” with respect to a distribution would be helpful. Currently, the only guidance on substantial negotiations relates to acquisitions.28 In our view, “substantial negotiations” require discussions concerning the significant economic terms of the distribution, such as which businesses would be separated and whether the distribution would be pro rata or would take the form of a split-off.

4. **Pre-Distribution Acquisition Non-Plan Factor**

   The third non-plan factor states that, in the case of a pre-distribution acquisition (other than a public offering), the fact that there were no discussions by Distributing or Controlled with the acquirer regarding a distribution during the two-year period ending on the date of the acquisition indicates that the acquisition and the distribution are not part of a “plan (or series of related transactions).”29 This non-plan factor is not available, however, if the acquisition occurs after a public announcement of the distribution, or if a person other than Distributing or Controlled intends to cause a distribution and as a result of the acquisition can meaningfully participate in the distribution decision.30

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28 See Reg. § 1.355-7T(h)(1)(ii).

29 Reg. § 1.355-7T(b)(4)(iii).

30 Id. On the other hand, Example 4 indicates that the fact that a distribution was publicly announced prior to an acquisition may suggest, depending on the business purpose for the distribution, that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition. See Reg. § 1.355-7T(j), Example 4.
The unavailability of this non-plan factor if the acquisition occurs after a public announcement of the distribution is too restrictive. The public announcement of a spin-off, as a practical matter, commits Distributing to attempt to consummate the spin-off and thus constitutes strong evidence that the spin-off would have occurred without regard to any acquisition that occurs after the public announcement but before the spin-off. Because section 355(e) focuses on the intent of Distributing, Controlled and their controlling shareholders, an acquirer’s intent should be relevant under section 355(e) only when the acquirer has the ability to participate, and actually does participate, in the distribution decision. In such a situation, the acquirer would have had discussions with Distributing or Controlled regarding the distribution prior to the acquisition, and the non-plan factor would not be available in any case. Thus, an acquirer’s decision to make an acquisition after learning that a distribution will occur should not prevent application of this non-plan factor. Indeed, the absence of discussions with the acquirer about the distribution before it is publicly announced should itself be a separate non-plan factor.31

C. Level of Non-Acquisition Business Purpose

The business purpose motivating a distribution is important in determining the applicability of certain safe harbors and non-plan factors. For instance, Safe Harbor I applies only if “[t]he distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355-2(b)), other than a business purpose to facilitate an acquisition of the acquired corporation (Distributing or Controlled).”32 Similarly, non-plan factor (v) applies only if “[t]he distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition.”33

In the Prior Temporary Regulations, a similar safe harbor and non-plan factor both were accompanied by the following statement:

The presence of a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled is relevant in determining the extent to which the distribution was motivated by a corporate business purpose (within the meaning of § 1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled.34

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31 We acknowledge that the public announcement of a distribution may make a subsequent acquisition more likely to occur, but this fact should be deemed irrelevant under an approach similar to the approach taken by the Current Temporary Regulations with respect to post-distribution acquisitions (i.e., the focus on specific bilateral negotiations, the deletion of the “reasonable certainty” operating rule, etc.).

32 See Reg. § 1.355-7T(d)(1)(i).

33 See Reg. § 1.355-7T(b)(4)(v).

This statement, which was derived from the regulation governing business purpose under section 355 in general when a potential motive to avoid federal taxes also exists, was dropped without explanation. This omission could suggest that the required showing of a non-acquisitive business purpose under section 355(e), measured in light of an acquisition-related business purpose, may be different from (and perhaps is less stringent than) the requirement for business purpose measured in light of a potential tax avoidance purpose. If such a distinction was intended, it should be explained, at least in the preamble to the final regulations. If not, the absence of a difference should be made clear.

As we suggested in our comments to the proposed regulations that preceded the Prior Temporary Regulations, the non-acquisitive business purpose requirement is too vague to provide taxpayers with guidance as to when the safe harbor or the non-plan factor apply. It is unclear whether a taxpayer must show that the distribution would not have occurred but for the non-acquisitive business purpose or that the non-acquisitive business purpose outweighed in importance the acquisition-related business purpose. We believe either of these tests is too stringent and that the regulations should require only that the non-acquisitive business purpose be sufficient to meet the requirements of Reg. § 1.355-2(b). Regardless of what standard is applied, however, clarification of the Current Temporary Regulations would be helpful.

D. 10-Percent Shareholders and Safe Harbors V and VII

Under Safe Harbor V, acquisitions of stock involving public trading between shareholders generally are not treated as part of a plan, unless the transferor or the transferee is a 10-percent shareholder or a controlling shareholder of the corporation whose stock is acquired. A 10-percent shareholder of a publicly traded corporation is a person who owns, immediately before or after the acquisition, actually or constructively under section 318, 10 percent or more of any class of stock of the corporation whose stock is transferred. A controlling shareholder of a publicly traded corporation is a 5-percent shareholder who actively participates in the management or operation of the corporation.

It is unclear why public trading by a 10-percent shareholder who is not a controlling shareholder (for example, a passive investor such as a mutual fund or retirement plan) should not be covered by Safe Harbor V. Presumably, public trading in general is exempted because the trading shareholders are not involved in the decision to make a distribution. If, in the context of a post-distribution acquisition, the trading shareholder could not and did not influence the

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35 See Reg. § 1.355-2(b)(1) (“The potential for the avoidance of Federal taxes by the distributing or controlled corporations (or a corporation controlled by either) is relevant in determining the extent to which an existing corporate business purpose motivated the distribution.”).

36 For our prior comments, see 2001 TNT 149-26 (July 23, 2001).

37 Reg. § 1.355-7T(d)(5)

38 Reg. § 1.355-7T(h)(9).

39 Reg. § 1.355-7T(h)(3).
decision to distribute the stock of Controlled, there is no reason to conclude that the subsequent public trade and the distribution were part of a plan. Likewise, if a shareholder trading stock had no intent at the time of a pre-distribution acquisition to cause a distribution (which would necessarily require an intent to be in a position to cause the distribution, i.e., an intent to become a controlling shareholder), then the pre-distribution trade cannot be part of a plan that includes the distribution. Therefore, regardless of whether the trading shareholder is a 10-percent shareholder immediately before or after the acquisition, public trading by such shareholder should be exempted unless such shareholder is, or intends to become, a controlling shareholder.

For the same reason, the 10 percent limit should be removed from Safe Harbor VII and a “controlling shareholder” limitation substituted in its place. Under Safe Harbor VII, acquisitions of Distributing or Controlled stock by certain qualified retirement plans generally are not treated as part of a section 355(e) plan. This safe harbor is not available, however, to the extent the stock acquired by all the qualified plans of the employer (and any other persons treated as the same employer), during the 4-year period beginning 2 years before the distribution, in the aggregate, represents 10-percent-or-more of the Distributing or Controlled stock, either by vote or by value.40 If the retirement plan is a passive investor not involved in the management of Distributing or Controlled, its acquisition of stock should be covered by a safe harbor, even if its stock ownership exceeds 10 percent.41

E. Vote-Shifting Transactions and Example 5

Safe Harbor V (on public trading) contains a rule to deal with “vote shifting” mechanisms built into publicly traded stock. This rule applies if Safe Harbor V protects a transfer of stock through public trading, but the transfer results immediately, or upon a subsequent event or the passage of time, in an “indirect acquisition” of voting power by a person other than the transferee. Under these circumstances, Safe Harbor V does not prevent such other person’s prior acquisition of stock (with the voting power such stock represents after the transfer to which Safe Harbor V applies) from being treated as part of a plan.42

Example 5 of the Current Temporary Regulations illustrates the vote shifting rule. The facts of the example, however, are confusing (and perhaps flawed), and the scope of the rule is uncertain. In the example, Distributing wants to merge with a closely held corporation engaged in the same line of business as Distributing, but the shareholders of the target do not want to acquire an interest in Controlled’s business. To facilitate the acquisition, Distributing agrees to spin off Controlled. One month after the merger agreement is signed, Distributing spins off Controlled. The merger is consummated on the day after the spin-off, and the former

40 Reg. § 1.355-7T(d)(7)(i), (ii).

41 Some of the members who participated in preparing these Comments were not troubled by preventing a 10 percent shareholder from qualifying for Safe Harbors V and VII, given that the facts-and-circumstances test generally would be available to show the absence of a plan. In any case, it would be helpful to restore the general intent-based rule so that the issue to be resolved under the facts-and-circumstances test is stated explicitly. See supra note 14.

42 See Reg. § 1.355-7T(d)(5)(ii)(B).
shareholders of the target exchange their target stock for Distributing stock. The example concludes that the acquisition of Distributing stock by the former shareholders of the target pursuant to the merger is part of a plan under section 355(e), although it appears (as discussed below) that the merger alone did not result in an acquisition of a 50 percent or greater interest in Distributing.

The second part of the example illustrates the vote shifting rule. The merger agreement between Distributing and the target required Distributing to amend its charter to provide for two classes of stock. The “Class A” stock, which the target shareholders received in the merger, carried 10 votes per share under all circumstances. The “Class B” stock, which Distributing’s historic shareholders received in a recapitalization of Distributing occurring immediately after the spin-off but immediately before the merger, initially carried 10 votes per share, but a disposition of a Class B share by its original holder would result in such share being entitled to only one vote.

According to the example, the Class A stock received in the merger by the former shareholders of the target represented, immediately after the merger, 49 percent of the total combined voting power of all classes of Distributing stock entitled to vote. During the 30-day period following the merger, however, transfers of the Class B stock through public trading on an established market caused the Class A stock held by the former shareholders of the target to experience an increase in voting power to 52 percent. None of the former shareholders of the target transferred their Class A stock during the 30-day period following the merger.

The example concludes that the acquisitions of the Class B stock through public trading are covered by Safe Harbor V (assuming that the transferors and transferees are not “controlling shareholders” or otherwise excluded from Safe Harbor V) and will not be treated as part of a plan. However, to the extent that the public trading of the Class B stock resulted in an “indirect acquisition” of voting power by the former shareholders of the target, the acquisition by the target shareholders of the Distributing Class A stock in the merger (taking into account the increased voting power represented by the Class A stock as a result of the trading of the Class B stock) is not protected by Safe Harbor V. Accordingly, the example concludes that “[t]o the extent that the transfer of the Class B shares causes the voting power of [Distributing] to shift to the Class A stock acquired by the former [target] shareholders, such shifted voting power will be treated as attributable to the stock acquired by the former [target] shareholders as part of the plan that includes the distribution and the [target] acquisition.”

The facts of Example 5 are confusing. At the beginning of the example, the target corporation is described as being “larger” than Distributing, even before Distributing becomes smaller still by shedding its interest in Controlled. If Distributing really is the smaller corporation, then presumably it would have been required to issue more than 50 percent of the value of its stock in the merger (or additional consideration other than stock) to acquire the “larger” target corporation. The example does not indicate, however, that the former shareholders of the target received any consideration other than Distributing Class A stock in the merger, nor does it indicate whether the Class A stock was relatively more or less valuable than

43  Reg. § 1.355-7T(j), Example 5(iii)(B).
the Class B stock. If the Class A stock received by the former target shareholders represented 50 percent or more of the value of Distributing’s outstanding stock, the merger itself would have triggered section 355(e) without the shift in voting power. The facts of Example 5, however, suggest that the vote shifting mechanism was structured for the purpose of avoiding section 355(e), which would indicate that the aggregate value of the Class A stock was less than the aggregate value of the Class B stock. If so, it is unclear from the facts of the example why the shareholders of the “larger” corporation ended up with less than 50 percent of the value of the Distributing stock and yet ultimately acquired more than 50 percent of the voting power.

Regardless of how the factual problems in Example 5 are resolved, we believe the vote shifting rule should be limited to situations in which the vote shifting mechanism has a principal purpose to avoid section 355(e). In Example 5, it appears that the vote shifting mechanism had such a purpose. Accordingly, the shift in voting power within 30 days after the acquisition is appropriately treated as occurring at the time of the original acquisition, resulting in application of section 355(e) to the spin-off.

A corporation may have different classes of stock with voting rights that shift for reasons unrelated to the avoidance of section 355(e), however. In these circumstances, a shift in voting power caused by public trading or other events should not be treated as an “indirect acquisition” of stock for purposes of section 355(e). Further, we believe a broad concept of an “indirect acquisition” was not intended by the vote shifting rule. This should be clarified in the final regulations. In the interest of avoiding undue complexity and uncertainty, the concept of an “indirect” acquisition of stock should be resisted, at least in the absence of a purpose to circumvent section 355(e).

F. “Substantial Negotiations” and “Discussions” with an Acquirer

In defining “substantial negotiations” and “discussions” concerning an acquisition, the Current Temporary Regulations make clear that the participants on Distributing’s or Controlled’s side of the transaction must include “one or more officers, directors, or controlling shareholders of Distributing or Controlled, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of Distributing or Controlled.” On the other side of the transaction, however, the Current Temporary Regulations merely refer to “the acquirer or a person or persons with the implicit or explicit permission of the

44 A broad concept of an “indirect acquisition” could include increases in a shareholder’s percentage ownership of stock occurring, for example, when the values of different classes of stock fluctuate or when stock owned by other shareholders is redeemed pursuant to a corporation’s stock redemption program. Treating these kinds of events as resulting in “indirect acquisitions” would create unnecessary complexity without furthering the purposes of section 355(e). A split-off is another example of a potential indirect acquisition of stock by those shareholders of Distributing whose percentage ownership of Distributing stock increases because they do not exchange their Distributing stock for Controlled stock. Treating a split-off as an “indirect acquisition” of Distributing stock is troubling because section 355(e)(3)(A)(ii) protects the direct acquisition of Controlled stock in the split-off from being considered part of a “plan,” but no such rule would protect an “indirect acquisition” of Distributing stock.

45 See Reg. §§ 1.355-7T(h)(1)(ii) (definition of “substantial negotiations”), 1.355-7T(h)(5) (definition of “discussions”).
acquirer,” perhaps because an “acquirer” (unlike Distributing and Controlled) may be an individual, partnership or other non-corporate entity without officers, directors or controlling shareholders.

In the common situation in which the acquirer is a corporation, however, we presume a different standard was not intended. The final regulations should clarify that, in an acquisition of Distributing or Controlled stock by another corporation, “substantial negotiations” and “discussions” must involve one or more officers, directors, or controlling shareholders of the acquiring corporation, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of the acquiring corporation.

G. Use of the Phrase “A” Distribution in Plan and Non-Plan Factors

Plan factors (iii) and (iv), as well as non-plan factor (iii), depend on whether there have been certain discussions regarding “a” distribution before the acquisition in question. The use of the phrase “a” distribution suggests that these plan factors will apply as long as there was a discussion of any distribution, even if the actual distribution is completely different from the potential distribution discussed. Similarly, non-plan factor (iii) is inapplicable if there is any discussion regarding “a” distribution during the two-year period prior to the acquisition, even if the distribution which occurs is different from the potential distribution discussed.

Presumably, little weight will be accorded to the discussions if the distribution that was discussed bears little resemblance to the distribution that occurs. It is our view, however, that plan factors (iii) and (iv) should not apply at all, and that non-plan factor (iii) should be available, unless the distribution that is discussed actually occurs or is closely related to the distribution that occurs. To make this change, the phrase “regarding a distribution” in each of the factors could be replaced by the phrase “regarding the distribution or a similar distribution.” The term “similar distribution” could be defined like the term “similar acquisition.” Specifically, a “similar distribution” would be one in which the assets of Distributing and Controlled are separated in similar ways, regardless of whether the assets end up in Distributing or Controlled. Thus, if Distributing had three businesses (A, B and C), a distribution of A and a retention of B and C would be similar to a distribution of B and C and a retention of A. On the other hand, a distribution of B alone generally would not be “similar” to a distribution of B and C, assuming that C is a significant business.

H. Similar Acquisition - Rationale of Example 6

The Current Temporary Regulations state that an actual acquisition (other than a public offering) is similar to a proposed acquisition, if the actual acquisition effects a direct or indirect

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46 See id.

47 Reg. § 1.355-7T(b)(3)(iii), (3)(iv), (4)(iii).

48 See Reg. § 1.355-7T(b)(3)(iii), (iv) (noting that the weight accorded to the discussions about the distribution depends on their nature, extent and timing).
combination of all or a significant portion of the same business operations as would have been
effected by the proposed acquisition.\textsuperscript{49} Additional guidance on the definition of a similar
acquisition is provided in Example 6.\textsuperscript{50} In the example, Distributing engages in substantial
negotiations with an unrelated public company (“X”) to acquire Distributing’s publicly traded
stock. Distributing and X cannot reach an agreement concerning the acquisition, however.
Three months after the negotiations between Distributing and X began, Distributing distributes
the stock of Controlled pro rata to its shareholders. Three months after the distribution, another
unrelated public company (“Y”) acquires the stock of Distributing in exchange for Y stock.
Distributing, X, and Y are all engaged in the manufacture and sale of trucks, while Controlled is
engaged in the manufacture and sale of buses. The example concludes that, while X and Y are
both engaged in the manufacture and sale of trucks, their businesses are not the same. Therefore,
the acquisition by Y does not effect a combination of all or a significant portion of the same
business operations as the acquisition by X.

The stated rationale for Example 6 produces inconsistent results when applied to actual
and proposed acquisitions by related companies. If X was a wholly owned subsidiary of Y, the
stated rationale of Example 6 indicates that the acquisition by Y would be treated as dissimilar to
the proposed acquisition by X, because X’s and Y’s businesses are different. This conclusion is
contrary to the express statement in the definition that an acquisition by merger into a subsidiary
of an acquirer is considered similar to a proposed acquisition by merger into the acquiring
corporation itself.\textsuperscript{51} A more appropriate explanation of the conclusion of Example 6 is that the
ultimate owners of X and Y are substantially different.

\textsuperscript{49} Reg. § 1.355-7T(h)(8).

\textsuperscript{50} Reg. § 1.355-7T(j), Example 6.

\textsuperscript{51} See Reg. § 1.355-7T(h)(8).