COMMENTS ON PROPOSED REGULATIONS UNDER SECTION 355(e)

These comments are the individual views of members* of the Section of Taxation who prepared them and have not been approved by the Section of Taxation, the House of Delegates or the Board of Governors and should not be construed as representing the policy of the Section of Taxation or of the Association.

Section 355(e) applies to a distribution that qualifies under §355(a). It requires the distributing corporation ("distributing") to recognize any appreciation in the distributed stock of the controlled corporation ("controlled"), if the distribution is "part of a plan (or series of related transactions)" pursuant to which an acquisition of a 50% or greater ownership interest in distributing or controlled ("50% acquisition") occurs. The statute presumes such a plan to exist if the 50% acquisition occurs within two years on either side of the distribution. The IRS has appropriately first addressed in REG-116733-98 (August 19, 1999) the application of the term "plan (or series of related transactions)," to be contained in Prop. Reg. §1.355-7. The proposed regulations contain several methods for rebutting the presumption, which methods apparently are intended to be exclusive, and which apply to each acquisition of stock regardless of whether a 50% or greater interest is acquired.

The comments on the proposed regulations are summarized as follows:

Executive Summary

· We applaud the proposed regulations' use of two rebuttals as to post-distribution stock acquisitions, which rebuttals differ in strictness depending on the time lapse (six months) between the §355 distribution and the acquisition. However, we recommend the following changes in the rebuttals:

1. The rebuttal for acquisitions of stock occurring more than six months after a distribution should require a substantial business purpose independent of a purpose to facilitate an acquisition only if there is a purpose to facilitate a 50% acquisition of the corporation whose stock in fact undergoes the 50% acquisition.

2. The "alternative rebuttal" should not require the taxpayer to prove that a 50% acquisition could not be reasonably anticipated. Under this recommendation, a 50% acquisition within 6 months after the distribution would satisfy the alternative rebuttal if either (a) there was no intent for a 50% acquisition, or (b) facilitation of any acquisition was not a substantial motivation for the distribution. The anticipation requirement is beyond the reach of the statute, and is unworkable because it requires the taxpayer to prove a negative, even more so because the negative may relate to the state of mind of numerous individuals.

· The alternative rebuttal for spin-offs that follow acquisitions should be available even if a spin-off was planned at the time of the acquisition, provided the spin-off that occurs is fundamentally different from the spin-off that was planned (i.e., the planned spin-off was abandoned).

· The rebuttals should not be exclusive, but rather should provide safe harbors. This has two aspects:
- Taxpayers should be able to prove no plan under all the facts and circumstances.
- If a taxpayer meets the facts provided in the various "rebuttals," the result should be a determination of "no plan," not just the rebuttal of the presumption of a plan.

- We applaud the per se determination (no plan if an acquisition occurs more than two years after a spin-off). There should be a similar rule for a spin-off that occurs after an acquisition - even if the period is extended to, e.g., three years.
- The requirement that the taxpayer prove the applicability of the rebuttals (which, even as modified above can involve future or inherently ambiguous facts) by clear and convincing evidence does not provide a practically workable basis for planning. The taxpayer should be required only to come forward with evidence that supports the proposition, and to show that alternative interpretations of the evidence are significantly less plausible.

- Options granted before a spin-off in unrelated transactions (or at least unrelated options granted more than a specified period of time before the spin-off, e.g., two years) should not be treated as "agreements" to acquire stock even if they are in-the-money at the time of the spin-off (at least if not in-the-money when issued).
- The IRS should provide rulings in this area under the normal factual standards, either in the form of advance rulings that cover the §355(e) "plan" issue or supplemental rulings related to an acquisition that arises after a distribution.

* These comments were prepared by individual members of the Committee on Corporate Tax of the Section of Taxation. Principal responsibility was exercised by Jasper L. Cumings, Jr. Substantive contributions were made by Don Brosnan, Julie A. Divola, Gary A. Herrmann, Joseph M. Pari, Mark J. Silverman, Dirk Suringa, Benjamin G. Wells, David R. Wheat, William J. Wilkins, and Philip B. Wright. The Comments were reviewed by Robert H. Wellen of the Section’s Committee on Government Submissions and by Terrill A. Hyde, Council Director for the Committee on Corporate Tax.

Although 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.

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BACKGROUND

Anti-Morris Trust Legislation
Before the enactment of section 355(e) as §1012(a) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34 (1997), a tax-free spin-off could be combined with a tax-free reorganization to rid a target corporation of a trade or business unwanted by the acquiror. See Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966). The transaction could be structured to permit the acquisition of the desired trade or business by spinning off the unwanted business, regardless of (1) the relative sizes of the two businesses and (2) the relative size of the target corporation and the acquiring corporation. During 1996 and early 1997, publicity concerning several large transactions suggested that spin-offs could be used to permit parent corporations to dispose of subsidiaries without tax liability, while retaining a substantial portion of the value of the subsidiary in cash or in the form of reduced leverage. These transactions could involve, for example, (a) borrowing by controlled, (b) separation of the cash proceeds of the borrowing from liability for repayment, (c) a spin-off of controlled (the debtor), and (d) the acquisition of a substantial interest in controlled (still encumbered by debt) by a third party through a tax-free reorganization. On a more technical level, there was also concern that an acquisition of distributing was treated more favorably than an acquisition of controlled.

Congress enacted §355(e) to prevent the avoidance of corporate-level gain in transactions that it believed resembled the disposition of a business segment. Specifically, §355(e) provides that distributing must recognize gain on the distribution of controlled stock that otherwise qualifies under §355(a), if one or more persons acquires stock representing a 50% or greater interest in either controlled or distributing pursuant to "a plan or (series of related transactions)" in existence on the date of the distribution. The amount of gain recognized by distributing is the amount that it would have recognized if it had sold the stock of controlled for its fair market value on the date of the distribution. No adjustment to the basis of the stock or assets of either corporation is permitted. The distributee shareholders retain tax-free treatment. Section 355(e)(2)(B) sets forth a statutory presumption that acquisitions occurring within the four-year period beginning two years before the date of the distribution are presumed to have occurred pursuant to a plan or series of related transactions.

Earlier ABA Comments on Guidance Needed Under §355(e)

On April 29, 1998 the ABA Section of Taxation submitted "ABA Comments Concerning Guidance Under 1997 Amendments to §§355 and 358." Relative to the "plan" issue in §355(e), the ABA recommended the adoption of at least two non-exclusive safe harbors: (1) a safe harbor for acquisitions of controlled or distributing after a distribution, where the acquisition has not been negotiated or agreed to at the time of the distribution, and (2) a safe harbor for acquisitions of stock caused by public trading, and by issuance and exercises of employee stock options. The Comments recommended that the first safe harbor exclude from "plan," absent any joint negotiations, arrangements or agreements: (a) the unilateral intention of an unrelated party to make an acquisition, (b) the reasonable anticipation of an acquisition by unrelated parties, and (c) internal analysis of possible stock acquisitions by distributing or controlled.

These suggestions were premised on the view that the statutory reference to "plan (or series of related transactions)" imports the traditional step transaction doctrine, which can cover the plan of a single party only when that party has substantial power to
control (or at least the power to prevent) both steps or to make the second step occur if the first step (which it intends) occurs. Thus, the Comments recommended that "voluntary" stock issuances by distributing or controlled after the distribution (as in a public offering, or acquisitions by distributing or controlled, using its own stock) be tested under the traditional step transaction doctrine. The Comments contained an analysis of legislative history and of the step transaction doctrine to support these recommendations. We continue to believe that this analysis and these recommendations are sound.

Proposed Regulations

On August 24, 1999, the Treasury and the Internal Revenue Service issued proposed regulations defining the scope of the term "a plan (or series of related transactions)" for purposes of §355(e). The proposed regulations deal only with this definition, and do so indirectly by providing rebuttals; they leave for future guidance numerous other issues under §355(e).

The preamble to the proposed regulations indicates that the determination of whether transactions are part of the same "plan (or series of related transactions)" is a subjective test depending upon the intentions and expectations of the relevant parties at certain points in time. Depending upon the precise situation, the relevant factors may include (1) the business purposes for the distribution, (2) the intentions of the parties, (3) the existence of agreements, understandings, arrangements, or substantial negotiations, (4) the timing of the transactions, (5) the likelihood of an acquisition, and (6) the causal connection between the distribution and the acquisition. The proposed regulations make it clear that the existence of a plan (or series of related transactions) does not depend upon whether or not more than one person act in concert. The preamble indicates that the rebuttals provided are to be exclusive: that is, the proposed regulations write the law as to the meaning of "plan" by making the presumption the rule, precluding other avenues of rebuttal, not only before the IRS but also apparently in any court proceeding.

SUMMARY OF PROPOSAL

The proposed regulation undertakes to identify those acquisitions of stock in distributing or controlled that occur within the presumption period (2 years on either side of the §355 distribution) that are not presumed to be part of a plan (or series of related transactions) with the distribution.

The proposed regulations deal primarily with all acquisitions of interest in distributing or controlled (regardless of size), and are not confined to acquisitions of 50% or more. That is, the proposed regulations view the first step of analysis to be the identification of those stock acquisitions that are related to the distribution, to be followed by a determination whether the tainted acquisitions cumulate to 50%.

Exercised options are treated as agreements to acquire stock (and thus as acquisitions) upon the option issuance date unless distributing establishes by clear and convincing evidence that on the later of the option issuance date or the distribution date the option was not more likely than not to be exercised. The option will be deemed to have been issued within 6 months after the distribution if there were substantial negotiations within 6 months and an understanding reached between 6-24 months after the distribution. For
these purposes, the term "option" excludes certain options issued as security, certain compensatory options, certain options exercisable upon events outside the control of the holder and rights of first refusal between shareholders (although the exercise of such an option still is treated as an acquisition).

The proposed regulations provide rebuttals to the statutory presumption of relatedness between the acquisitions and the distribution, which are proposed to be the exclusive means of rebutting the presumption. Separate rebuttals are provided according to whether the acquisition of an interest of any size in controlled or distributing occurs before or after the distribution. In all cases, the standard for taxpayer proof of facts is by "clear and convincing evidence."

Case I: Distribution followed by an acquisition. Because understanding of the proposed regulations is relatively difficult and crucial to our comments, we undertake here to describe the proposed regulations’ treatment of this case in two different ways.

A. Summary of rebuttals based on distributing’s purposes for the distribution. The proposed regulations utilize three types of corporate business purposes for the distribution: a Reg § 1.355-2(b) corporate business purpose other than one of the Bad Purposes, defined below, that motivates the distribution in whole or substantial part ("Good Purpose"); a motivation in whole or substantial part to decrease the likelihood of the acquisition of one or more businesses (apparently by a 50% acquisition) by separating those businesses from others that are likely to be acquired ("Bad Purpose-Avoidance"); a motivation in whole or substantial part to facilitate an acquisition of an interest (of any size) in either distributing or controlled ("Bad Purpose-Facilitative"). The proposed regulations also utilize the concept of a "reasonable anticipation" that a 50% acquisition more likely than not will occur with respect to either distributing or controlled within 2 years ("No Surprise"). Finally, the proposed regulations utilize the concept of lack of intent that a 50% acquisition would occur within 2 years, whether or not the intent is also a purpose motivating the distribution.

These five concepts can be used in a simplified outline of the proposed regulations, assuming in all cases the ability to prove by clear and convincing evidence that there existed no prior agreement or understanding concerning the acquisition (and in some instances no substantial negotiations).

1. Distribution for a Good Purpose only:
   a. Acquisition occurring more than 6 months later is not part of plan.
   b. Acquisition occurring within 6 months is part of plan, unless taxpayer proves it is a Surprise and lack of intent for a 50% acquisition.

2. Distribution at least in part for a Bad Purpose-Avoidance:
   a. Acquisition occurring more than 6 months later is part of plan, unless taxpayer also proves a Good Purpose.
   b. Acquisition occurring within 6 months is part of plan.

3. Distribution at least in part for a Bad Purpose-Facilitative:
a. Acquisition occurring more than 6 months later is part of plan, unless taxpayer proves either (1) a Good Purpose, or (2) Surprise and lack of intent for a 50% acquisition.

b. Acquisition occurring within 6 months is part of plan unless taxpayer proves Surprise and lack of intent for a 50% acquisition.

B. Summary of rebuttals based on timing of acquisition. A more detailed explanation of the proposed regulations as they relate to an acquisition following a distribution can be made through an outline based on the timing of the acquisition. The proposed regulations contain a rebuttal (which we will call the "general rebuttal") and an "alternative rebuttal." They also contain nine examples, which are summarized briefly in connection with the rules to which they relate.

1. Alternative Rebuttal. The acquisition of an interest follows the distribution either (1) by 6 months or less, or (2) by 6-24 months, but there was an "agreement, understanding, arrangement or substantial negotiation concerning the acquisition" at or within 6 months after the distribution:
   a. Base case: The presumption is rebutted under the proposed regulations’ alternative rebuttal if at the time of the distribution both (a) a 50% acquisition is not "reasonably anticipated," and (b) either a 50% acquisition was not intended at the time of the distribution, or the distribution was not motivated "in substantial part" by an intent to facilitate the acquisition of any interest in controlled or distributing. For purposes of the intent test, a pre-distribution acquisition counts against the 50% ceiling, as intended to be acquired within 2 years after the distribution if it is part of a plan including the distribution. Rebuttal in this and other cases must be made by clear and convincing evidence.

Example 1: 50% public offering by distributing. The distribution was to facilitate distributing’s immediate 50% stock offering. Because the 50% acquisition occurred within 6 months, only the alternative rebuttal might be available, and is not satisfied both because the 50% acquisition was intended and the distribution facilitated it.

Example 4: Spin into a hot market. The distribution occurred with the expectation that an acquirer would tender for controlled, which occurred within 6 months. Only the alternative rebuttal is potentially available, but it cannot be satisfied because of the reasonable anticipation of the acquisition.

Example 8: Spin into a hot market, not known at announcement date. The distribution occurred for a good business purpose, but with the expectation of receiving acquisition proposals, and distributing issued an option three months later for 50% of its stock, which option was ultimately exercised. Because the acquisition is deemed to have occurred within 6 months, under the option rule, only the alternative rebuttal is potentially available and it cannot be satisfied because of the reasonable anticipation of a 50% acquisition.

Example 9: Less than 50% acquisition intended or expected. The distribution occurs without the expectation of a 50% acquisition but with the intent for controlled to facilitate a 20% public offering. A surprise acquisition by controlled of another corporation for 40% of the controlled stock occurs within 6 months. The alternative rebuttal is available if the taxpayer can prove lack of both intent for and anticipation of a 50% acquisition, which seems to be the case.
b. **Special case:** In some cases a 50% acquisition is not intended and there is no intent to facilitate the acquisition of any interest, but a 50% acquisition can be reasonably anticipated (because a potential acquirer is known) and does occur. In such cases the presumption can be rebutted if both (a) the distribution is not motivated in substantial part by a desire to avoid both distributing and controlled being acquired by separating them, and (b) the potential acquirer would have in any event acquired 50% or more of distributing in order to get whichever of distributing or controlled it wanted.

**Example 2: Distribution to avoid expected acquisition of both distributing and controlled.** The distribution was made to decrease the likelihood of an acquisition of distributing in order to obtain controlled. Controlled was acquired within 6 months after the distribution, and so only the alternative rebuttal is available. Its requirements are not satisfied because the distribution was intended to decrease the likelihood of the acquisition of distributing, even though an acquisition would have occurred despite the distribution (and thus the "reasonable anticipation" prong is satisfied).

2. **General Rebuttal. Acquisitions between 6-24 months:** The presumption is rebutted under the general rebuttal if there is not an "agreement, understanding, arrangement or substantial negotiation concerning the acquisition" within 6 months after the distribution, and the distribution is motivated in substantial part by a corporate business purpose, other than an intent to facilitate an acquisition or decrease the likelihood of an acquisition. Issuance of an option constitutes an agreement.

**Example 3: Anticipated takeover.** The distribution’s purpose in substantial part was to decrease the likelihood of an acquisition of distributing to obtain controlled; controlled was acquired more than 6 months after the distribution, so the general rebuttal might apply, as well as the alternative rebuttal. But the requirement of the latter cannot be satisfied for the same reason as in Example (2). The general rebuttal is available if the taxpayer can show a co-existing substantial good business motivation that offsets the Bad Purpose of planning to deter the acquisition of distributing.

**Example 5: Distribution to facilitate being acquired.** The distribution was both to maximize the possibility of distributing’s acquisition and to obtain cost savings. Distributing starts the bid process after the 6 month period and the acquisition occurs within 2 years after the distribution. The general rebuttal is potentially available and will be satisfied if distributing can offset the intent to shop itself with proof of the substantial cost saving motivation.

3. **No Rebuttal Needed. Acquisition of any interest in controlled or distributing more than 24 months after the distribution:** No presumption applies unless there was an "agreement, understanding or arrangement" for that acquisition that existed within the 24 months; in such case, the presumption can be rebutted under 1 or 2, above.

**Case II. Acquisition of interest followed by a distribution.**

A. **Distribution follows acquisition of interest within 2 years:** The presumption is rebutted if by clear and convincing evidence the taxpayer proves either that (1) the corporation and its "controlling shareholders" did not immediately after the acquisition intend "a distribution" ("general rebuttal"), or (2) both (a) the distribution would have occurred anyway, and (b) the acquirer did not become a "controlling shareholder" within 2 years.
after the distribution, or later pursuant to an agreement, understanding or arrangement existing within 6 months after the distribution ("alternative rebuttal"). It is important to note that the proposed regulations prevent application of the general rebuttal merely because distributing intended to effectuate a different distribution.

Example 6: Acquisition "unrelated." The stock acquisition occurred before the distribution, but the distribution would have occurred anyway and the stock acquirer did not become a controlling shareholder. Therefore, §355(e) does not apply.

Example 7: Less than 50% acquisition intended. Before the distribution, which had a purpose to facilitate acquisitions by distributing, X was acquired for 30% of distributing’s stock and X’s shareholder A became a controlling shareholder of distributing. Neither the general nor the alternative rebuttal can be satisfied as to the 30% acquisition due to the intent to distribute at the time of the acquisition by A and the fact that A became a controlling shareholder. Later additional issuances of distributing stock, which when added to the pre-distribution acquisition, amount to 50%, may be covered by the alternative rebuttal for post distribution acquisitions if lack of intent to have an additional 20% acquisition can be established.

B. Distribution follows acquisition of an interest by more than 2 years: There is no presumption, but the IRS can prove the acquisition to be part of a plan with the distribution if it shows by clear and convincing evidence that (1) the distribution was intended by distributing or its controlling shareholders immediately after the acquisition, and (2) either (a) the distribution would not otherwise have occurred, or (b) the acquirer became a "controlling shareholder" within 2 years after the distribution.

DISCUSSION

1. Comparison of Proposed Regulations with April 29, 1998 ABA Tax Section Recommendations

The proposed regulations follow the Comments by not treating the unilateral intention of an unrelated party to acquire distributing or controlled as a plan. However, this point is largely nullified as to 50% acquisitions within six months by the "reasonable anticipation" requirement as to likely action by unrelated parties. The proposed regulations also refuse to limit "one party" plans to distributing’s plan for a stock issuance that is so formulated at the time of the distribution as to be integrated with the distribution under traditional step transaction analysis. The proposed regulations view as a possibly disabling purpose any purpose of distributing or controlled to issue its stock in any amount, regardless of whether distributing or controlled can do so without the substantial cooperation of other unrelated persons.

The proposed regulations provide a safe harbor for the issuance of compensatory stock options. The preamble states that it leaves for future guidance the impact of public trading on the determination whether a 50% acquisition has occurred. The proposed regulations also do not address the exercise of employee stock options, stock repurchases under routine stock repurchase programs, issuances of stock under
dividend reinvestment programs and other changes in stock ownership in the ordinary course of business.

Instead of describing safe harbors, the proposed regulations purport to exclusively define the rebuttals available.

2. Overview of Our Recommendation.

We recommend that the Bad-Purpose-Facilitative definition be changed to apply only to a motivation to facilitate a 50% acquisition, (assuming in all cases no agreement, etc. for an acquisition). We recommend that the “reasonable anticipation” test be deleted from the alternative rebuttal. Set forth in the framework used above, the proposal can be summarized as follows:

a. Distribution for a Good Purpose only:
   (1) Acquisition within a 6-to-24-month period is not part of plan, regardless of intent for a 50% acquisition, so long as facilitating that acquisition was not also a substantial purpose motivating the distribution (which must be the case where there is only a Good Purpose).
   (2) Acquisition within 6 months is part of plan only if a 50% acquisition intended.

b. Distribution at least in part for a Bad Purpose-Avoidance:
   (1) Acquisition within a 6-to-24-month period part of plan, unless taxpayer proves Good Purpose.
   (2) Acquisition within 6 months is part of plan.

c. Distribution at least in part for a Bad Purpose-Facilitative:
   (1) Acquisition within a 6-to-24-month period is not part of plan, if taxpayer proves a Good Purpose.
   (2) Acquisition within 6 months is part of plan.

If the test is viewed in this way, our proposed test can be summarized as:

(1) If distribution is for a Good Purpose only, acquisition is not part of a plan unless 50% acquisition is intended and occurs within 6 months.
(2) If distribution is at least in part motivated by a Bad Purpose (either kind) and acquisition occurs within 6 months, acquisition may be part of plan.
(3) If distribution is at least in part motivated by a Bad Purpose, acquisition after 6 months is not part of plan if a Good Purpose is also a substantial motivation for the distribution.

3. Specific Comments on Proposed Regulations.

a. The proposed regulations appropriately create a relaxed test for acquisitions following distributions by a significant period (here, more than six months). We applaud the use of a relaxed rebuttal method in cases where the acquisition occurs after distributing and
controlled have been at the risk of the market for a reasonable period of time, and we agree that six months is such a reasonable period.

We request that the Service clarify in final regulations that the concepts of "agreement, understanding, arrangement or substantial negotiations" refer generally to bilateral contacts, except for situations such as a public offering where no negotiations with the buyer are required to effect an acquisition. As we understand the proposed regulations, distributing or controlled may "plan" a public offering of 50% or more of its stock, if it is willing to wait more than six months before its "plan" crystalizes into an agreement or understanding, so long as there was another substantial business purpose for the distribution.

Because a public offering is largely within the control of the issuer (generally as advised by its investment banker), we believe it would be acceptable in this circumstance to treat as part of a "plan" a certain level of preparation for an offering, including certain dealings with an investment banker in conjunction with other relevant facts, although no ultimate buyer is directly involved. However, prior to public announcement of the offering or other facts that substantially and practically commit the corporation, such contacts should not be viewed as "negotiations."

Contacts with an investment banker raise issues in other scenarios. If an investment banker is acting as an agent of a buyer, negotiations by distributing or controlled with the investment banker could constitute negotiations with the buyer. If the investment banker is acting as the agent of distributing, contacts with the banker should not be viewed as "substantial negotiations" toward any future transaction with a third party that is facilitated by the banker unless the contacts relate to a public offering.

b. The more-than-six-month rebuttal should be changed to require a purpose for a more-than-50% acquisition (as opposed to any acquisition). As proposed, the rebuttal as to an acquisition occurring more than six months after a distribution requires not only that the six-month period pass but also that distributing not have a purpose to facilitate any acquisition as a substantial business purpose for the distribution (or if it does have such a purpose, distributing must establish another substantially motivating corporate business purpose). Thus, for example if a distribution occurs in order to facilitate a 40% public offering of distributing, another 10% acquisition of distributing (or a 50% acquisition of controlled) occurring within the two-year presumption period will void the general rebuttal.

Furthermore, the alternative rebuttal is not available if the 10% acquisition was foreseeable or a substantial motivation for the distribution was to decrease the likelihood of a takeover. The alternative rebuttal can also be unavailable if the distribution is intended to facilitate a much smaller stock issuance, as for example to employees, and the issuance is the only substantial business purpose for the acquisition.

We recommend replacing "an acquisition" in Reg. §1.355-7(a)(2)(ii)(A)(1) and (B) with "acquisition of a 50 percent or greater interest in the corporation as to which such an acquisition occurs." The 50% requirement is in the statute and there is no justification in the statute or the legislative history for applying a mechanical section 382-type of
ownership change test. The effect will be to not require distributing to prove an additional "substantial business purpose" if a substantial business purpose is to facilitate a less than 50% acquisition.

c. The alternative rebuttal for acquisitions on or after a distribution should not require the taxpayer to disprove that a 50% acquisition could be reasonably anticipated. This requirement is beyond the reach of the statute and is unworkable in practice because it requires a taxpayer to prove a negative, even more so because the negative relates to state of mind of many individuals. For these reasons, we believe that the "reasonable anticipation" requirement of Prop. Reg. §1.355-7(a)(2)(iii)(B) should be deleted.

We adhere to our prior view on this point. Where distributing spins off controlled without having had any discussions with others as to a possible acquisition of controlled or distributing, it strains the statutory language, and conflicts with well-established step transaction authority, to treat a subsequent acquisition as part of a "plan (or series of related transactions)" simply because it might have been anticipated. See, e.g., Litton Industries, Inc., 89 T.C. 1086 (1987), acq. in result only, 1988-2 C.B. 1 (presale dividend by subsidiary not integrated with subsequent sale of stock of subsidiary, even though parent had a general intent to make such a sale).

Congress indicated that §355(e) should apply "in cases in which it is intended that new shareholders will acquire ownership of a business in connection with a spin off." S. Rep. No. 105-33, 105th Cong., 1st Sess. 139-40 (1997). We do not see how distributing could "intend" that controlled (or even distributing itself) be acquired when it has had no discussions with anyone. Conversely, where (as described in the proposed regulation's preamble) the circumstances existing at the time of the distribution make a 50% acquisition "virtually assured," the regulations could provide that an intent for a 50% acquisition existed.

As written, the proposed regulations will result in an effective "six month lockup" of distributing and controlled. It is an inappropriate exercise of tax rulemaking powers to effectively preclude business combinations that were not preplanned, when the statute clearly requires a plan. Furthermore, the provisions will discriminate against corporations that are in volatile industries.

The chief consequence of this rule may be to create a new line of business for investment bankers providing opinions concerning the prospects that an acquisition will occur. Such opinions may not be available, or reliable, especially in light of the "clear and convincing" test. The economic utility of such opinions to anyone other than tax professionals and investment bankers is questionable.

As we discussed in our April 28, 1998 comments, there is no evidence that Congress intended the statutory "plan (or series of related transactions)" to embody more than the loosest formulation of the traditional step transaction doctrine, and the phrase should not encompass a step carried out by an unrelated, possibly unknown and unwanted suitor, simply because distributing should have known it would happen.

Deleting the "second prong" of the alternative rebuttal would not leave the rule without teeth. The first prong (Prop. Reg. §1.355-7(a)(1)(iii)(A)) requires a lack of intent for a 50% acquisition or a lack of purpose to facilitate an acquisition. This properly focuses on
distributing's "plan." Thus, while we agree that one taxpayer can have a plan, we believe such a plan should be confined to situations in which the taxpayer controls the accomplishment of all of the major steps in the plan (as in the case of a public offering).

For another extreme example, if distributing causes either distributing or controlled to be set forth as a separated entity that does not have adequate net assets to sustain itself, or is otherwise economically burdened, so as to not be easily viable without a public offering or takeover or other capital infusion, then that fact could indicate an intent for a major change in the ownership of such corporation and a purpose of the distribution to facilitate an acquisition. A characteristic of this case might be the withdrawal of substantial cash funds from one of the corporations and burdening it with debt immediately before the distribution, so that the distribution resembles a sale of the burdened company.

d. The pre-distribution tests should be made less restrictive in several ways. First, the "controlling shareholder's" acquisition should not be treated as part of the distribution if the distribution plan either would have happened anyway, or, at the very least, if the distribution has already been planned by the corporation at the time the person becomes a controlling shareholder. Thus, the proviso to the alternative rebuttal should be deleted or at least limited to a case where the controlling shareholder acquired stock before it was known that the distribution would occur. This recommendation should be consistent with the theory of the proposed regulations, if, as we assume, the "causal connection between the acquisition and the distribution" referred to in the preamble means that the controlling shareholder had some opportunity to influence the distribution (which would not be true if the distribution had been planned before the acquisition occurred).

Second, a distribution that is entirely unrelated to the distribution that was contemplated at the time of the acquisition should not be tainted by that frustrated contemplation.

Third, if the acquisition precedes the spin-off by more than a specified time period (for example, between 2 and 3 years), the IRS should not be allowed to prove a "plan."

e. The preamble indicates (and the examples confirm) that the methods supplied by the proposed regulations to rebut the presumption are exclusive and this is confirmed by the examples; the methods should be safe harbors and not exclusive. Example 8 in the proposed regulations states that §355(e) will apply because the safe harbors do not. The statute and legislative history contain no suggestion that regulations should limit the means of rebutting the statutory presumption to specifically prescribed circumstances that select a limited set or sets from the full range of possibly relevant facts and circumstances. Exclusive rebuttals presumably would preclude a taxpayer from otherwise rebutting the statutory presumption in court. The situations at issue here are not so inherently, and easily identifiable as, abusive as to justify such preclusion. Furthermore, the breadth of the statute and the breadth of possible scenarios means that even the government's most well-meaning efforts to encapsulate the rule and the facts in specific formulations inevitably will fail.

Instead of purporting to establish the exclusive "law" of rebuttals, the regulation's rebuttals should be non-exclusive safe harbors. A taxpayer that is within the
presumption but outside the safe harbors might be required to give notice to the IRS of those facts, if it believes section 355(e) does not apply. We would encourage the IRS to accept other proof in adverse ruling proceedings, but even if it refuses to do so, the taxpayer should not be precluded from making its alternative rebuttal in court. Regulations could introduce a "reasonable anticipation" factor, in describing the facts and circumstances that would be relevant.

Separately, it is not entirely clear whether satisfaction of a rebuttal precludes the proof of a plan by the IRS; we believe it should.

f. The requirement that the taxpayer prove inherently ambiguous facts by clear and convincing evidence is not a practically workable basis for planning to which taxpayers are entitled. We understand that the administration feels a need to give weight to the statutory presumption beyond placing the burden of going forward on the taxpayer, who bears it in any event. However, all proof required of the taxpayer should not be subject to this very high standard.

The statute does not by its terms require it. Such a standard is not typical of analogous regulations. See, for example, Reg. §1.707-4(a)(2) ("clearly establish"). Furthermore, in many cases, it can be practically impossible to prove by clear and convincing evidence that a person did not anticipate future events that are outside the control of the party, or did not have an intent, for example.

The rebuttals, as evidenced by several examples, involve the clash of "substantial purposes" and the need, which is already difficult enough, to prove a good business purpose to be a substantial motivation when an Avoidance Purpose or Facilitative Purpose also is a substantial motivation. Finally, we view it as an inappropriate and unnecessary policy call to exacerbate the difficulty faced by a taxpayer in extricating itself from a rule that is more than arguably harsh, and that potentially applies to cases that are non-abusive.

In the proposed regulations, "clear and convincing evidence" is required to rebut the inference that two actions are so connected as to be part of a "plan." The distribution, and the acquisition, are actions both separate in time and nominally taken by different entities. The question, then, is when does the tax law generally impose such a heavy inference of connectedness on two nominally separate events, to be rebutted by "clear and convincing evidence"? Generally, the mere temporal proximity of two events does not trigger that standard. Rather, there is usually some express legal relationship between the two events, or the two events are entirely within the control of a single actor. Further, in all other cases the rationale for the presumption is either that (i) the penalized act is so noxious that it is justifiable to impose the penalty on those who can prove by a preponderance of the evidence that they are not guilty of the act, or (ii) the cost of failing to rebut the presumption is a relatively minor matter of a small adjustment in the timing of a deduction. The proposed 355(e) regulation deviates from customary practice in all these respects. Moreover, the reference in the statute to a two-year presumption does not compel the unduly limited method of rebutting that presumption currently provided by the proposed regulation, which not only specifies that "clear and convincing evidence" be adduced, but goes much further and limits, without statutory
warrant or rational justification, the set of factors from which that evidence may be drawn.

While we would prefer that no heightened standard of proof be applied, we recommend that any heightened standard be limited to objective facts relating to events that have occurred in the past; here, the existence of any agreement, understanding, arrangement or negotiations, as contrasted with intentions and expectations of future events and business purpose. In no event should proving a negative be subject to such a test.

If the "clear and convincing evidence" standard is to be used, then it should be defined. For example: (a) the taxpayer has to come forward with evidence; (b) the evidence supports the proposition; and (c) alternative interpretations of the evidence or contradictory evidence are significantly less plausible than the argued-for proposition and its supporting evidence. The IRS should outline what types of practically available evidence will be acceptable.

g. There is a need for the availability of rulings in this area, either advance rulings that cover the §355(e) "plan" issue or supplemental rulings related to an acquisition that arises after a distribution. The Service’s ability to issue these rulings presumably will relate to the standard for factual proof, which as stated in the proposed regulations is higher than for general rulings practice. Even if the "clear and convincing" standard is retained, it should not intensify the scrutiny normally applied to rulings in this area. If taxpayers represent that certain facts have occurred (i.e., investment banker contacts on behalf of others), the IRS could rule as to the consequences of those facts for §355(e) purposes.

h. Options. The exclusion for issuance of compensatory options does not eliminate employee stock options from consideration, because their exercise still produces a change of stock ownership at the time of exercise that may be taken into account in determining if there is an acquisition. Also, a convertible debt instrument issued without any connection to the distribution, but which is likely to be exercised at the time of the distribution, and which converts more than 2 years later seems to be treated as an acquisition within 6 months. We believe both of these forms of stock acquisition should be disregarded. Specifically, an option granted separate from the distribution (and two years prior is deemed separate) should be disregarded, regardless of likelihood of exercise at the time of distribution.

i. Effective date. We understand that the IRS is generally reluctant to make regulations of this nature retroactive. However, if reformulated to state non-exclusive safe harbors and to substantially modify the rebuttals, the proposed regulations would seem to be suited for retroactive application. In any event, if finalization is to be delayed, the IRS should consider issuing a Notice setting forth the intended safe harbors, as modified here, or at least exempting routine grants and exercises of compensatory options and public trading, and should issue letter rulings.