CLIENT
MEMORANDUM

IRS ISSUES NEW SPIN-OFF REGULATIONS

Responding to widespread criticism of proposed Section 355(e) spin-off regulations issued in 1999, the Internal Revenue Service (the "Service") on December 29, 2000, withdrew those regulations and released a new set of proposed regulations.

Background

A distribution of the stock of a controlled subsidiary ("Controlled") by its parent corporation ("Distributing") to the shareholders of Distributing -- commonly referred to as a "spin-off" -- is tax-free to both Distributing and its shareholders if the requirements of Section 355 of the Internal Revenue Code are met. However, Section 355(e), enacted in 1997, provides that even if the general Section 355 requirements are met, a spin-off will be taxable to Distributing (but not to Distributing shareholders) if the spin-off is part of a "plan (or series of related transactions)" ("Plan") pursuant to which one or more persons acquire 50% or more of the stock of Distributing or Controlled.

Congress adopted Section 355(e) to override partially the prior treatment of "Morris Trust" and "reverse Morris Trust" transactions. In a "Morris Trust" transaction (so-called based on the decision in Commissioner v. Mary Archer W. Morris Trust, 367 F.2d 794 (4th Cir. 1966)), Distributing (1) distributes the stock of Controlled to the shareholders of Distributing, following which (2) a third party acquires Distributing in a tax-free reorganization. A "reverse Morris Trust" involves the second step acquisition of Controlled, rather than Distributing, in a tax-free reorganization. Congress believed that Morris Trust and reverse Morris Trust transactions bore a strong resemblance to taxable asset dispositions. Although debt shifting figured strongly in this resemblance, Section 355(e) does not target spin-offs based on the presence of debt shifting.

The Statute

Section 355(e) treats as taxable at the corporate level any spin-off that is part of a Plan pursuant to which one or more persons acquire stock representing a 50% or greater interest in Distributing or Controlled. If one or more persons acquire stock representing a 50% or greater interest in Distributing or Controlled during the four-year period beginning on the date which is two years before the date of the spin-off, the statute establishes a presumption: the acquisition is treated as pursuant to a Plan unless it is established that the spin-off ahead acquisition are not pursuant to a Plan. If Section 355(e) applies to a spin-off, Distributing must recognize the taxable gain, if any, as if it had sold the stock of Controlled to an unrelated buyer

or its fair market value. Neither Distributing nor Distributing's shareholders are allowed any basis adjustment to compensate for the imposition of this tax

The 1999 Proposed Regulations

Proposed regulations issued in August 1999 ("1999 Proposed Regulations") provided guidance on the meaning of the term "plan (or series of related transactions)." A key element of the 1999 Proposed Regulations was relief from the application of Section 355(e) for an acquisition -- of either Distributing or Controlled -- that occurred more than six months following the spin-off, provided that (1) the spin-off was motivated by a business purpose other than an intent to facilitate an acquisition of stock and (2) there was no agreement, understanding, arrangement or substantial discussions concerning the acquisition at the time of the distribution or within six months thereafter. This relief was labeled a "rebuttal" since it allowed the taxpayer to overcome the statutory presumption of a Plan that resulted from an acquisition within two years following the spin-off. The utility of this rebuttal was materially undermined, however, because any acquisition-related business purpose for the spin-off, even if the acquisition (a) involved only a small amount of equity (such as an intention to issue 20% or less of the stock of Controlled in an IPO) or (b) related to the other company -- i.e., a purpose to facilitate an IPO of Controlled--would prevent use of the rebuttal for an acquisition of Distributing.

Several other features of the 1999 Proposed Regulations were also criticized: First, the rebuttals provided by the regulations purported to provide the sole means to rebut the statutory presumption that an acquisition within two years of the spin-off was pursuant to a Plan; no relief was provided for an acquisition that did not meet the technical requirements of the rebuttals but nevertheless was completely unrelated to the spin-off, such as an unannounced hostile bid. Second, the alternative rebuttal provided by the regulations was unavailable unless it could not be reasonably anticipated that there would be a 50% or greater acquisition of either Distributing or Controlled within a period of two years following the spin-off. Predicting events over a period of two years is obviously very difficult. Third, the 1999 Proposed Regulations required that entitlement to the rebuttals be established by "clear and convincing" evidence, a standard that is higher than that required in virtually all other tax contexts.

The 2000 Proposed Regulations

A. General Background

Reacting to these criticisms, the Internal Revenue Service, in the last days of 2000, withdrew the 1999 Proposed Regulations and issued new proposed regulations in their place (the "2000 Proposed Regulations"). In general, the 2000 Proposed Regulations are significantly more taxpayer-friendly than the 1999 Proposed Regulations; they are also significantly simpler to apply than the 1999 Proposed Regulations, which should result in greater certainty as to the tax treatment of many transactions. At the same time, the subjective issue of whether a spin-off and an acquisition of a 50% or greater interest are linked by a Plan will remain, and will continue to plague taxpayers and their advisors in many cases.

The 2000 Proposed Regulations provide several safe harbors that should prove very useful in a significant number of cases. Other differences between the 1999 Proposed Regulations and the 2000 Proposed Regulations are: (1) The exclusivity of the rebuttals provided in the former regulations has been eliminated; the 2000 Proposed Regulations provide both safe harbors to negate the existence of a Plan, as well as the possibility of proving the non-existence of a Plan by reference to facts and circumstances; (2) The so-called "reasonable anticipation" test concerning the likelihood of an acquisition within a two-year period has been replaced with a much more limited test that creates a presumption of an acquisition-related business purpose for the spin-off if an acquisition or agreement (or understanding, arrangement or substantial negotiations in respect thereof; herein, "agreement, etc.") is reasonably certain to occur within a six-month period following a spin-off; with a similar rule for spin-offs that follow an acquisition. (3) The requirement of the 1999 Proposed Regulations of proof by clear and convincing evidence is absent from the 2000 Proposed Regulations. (4) Finally, a measure of relief is provided for spin-offs motivated by a business purpose to acquire a limited stock interest in either Distributing or Controlled.

The 2000 Proposed Regulations also address an important question unanswered by the statute: whose intentions are relevant to determining the existence of a Plan? The new regulations make clear that in most circumstances, only the intentions of Distributing, Controlled and the "controlling shareholders" of the two companies will be relevant in determining the existence of a Plan.

The 2000 Proposed Regulations do not address numerous other questions that are posed by the Section 355(e) statute, such as aggregation and attribution rules and the treatment of predecessor and successor corporations.

The 2000 Proposed Regulations are proposed to take effect only after they are adopted as final regulations, so they have no current application to transactions.

B. Approach of the 2000 Regulations in General

The 2000 Proposed Regulations provide (1) a statement of (a) the general rule, that whether a spin-off and an acquisition are part of a Plan is determined based on all facts and circumstances and (b) the intent-based standard for determining whether a spin-off and an acquisition are linked by a Plan; (2) a series of factors that tend to show that a spin-off and an acquisition are or are not part of a Plan -- a summary of these factors is set forth on Attachment 1 to this memorandum; (3) a series of so-called "operating rules" for use in applying the regulations -- the most important of which creates a presumption of a purpose to facilitate an acquisition if, at the time of the spin-off, it was "reasonably certain" that, within a period of six months, an acquisition would occur, an agreement, etc., would arise in respect of an acquisition (with a parallel rule for acquisitions that precede spin-offs); (4) a series of six safe harbors from application of the Section 355(e) provisions -- a summary of these safe harbors is set forth on Attachment 2 to this memorandum; and (5) in addition to some special rules for options and transactions treated like options, and other miscellaneous rules, a series of examples that illustrate the operation of the new regulations.

Mechanically, each acquisition of stock of Distributing or Controlled must be analyzed to determine the potential applicability of Section 355(e). The optimal result will be to find a safe harbor for each acquisition; in that event the non-application of Section 355(e) is assured. For acquisitions that do not come within the safe harbors it will be necessary to determine the applicability of the general facts and circumstances test, including by reference to the factors that tend to show or disprove (respectively) the existence of a Plan linked to the spin-off.

C. Detailed Discussion of the New Regulations

1. General facts and circumstances test

If an acquisition follows a spin-off, the two transactions will be considered linked by a Plan if Distributing or Controlled (or any of their respective controlling shareholders) intended, on the date of the spin-off, that the acquisition, or a similar acquisition, occur in connection with the spin-off. In the case of a spin-off that follows an acquisition, the acquisition and the spin-off will be considered linked by a Plan if Distributing, Controlled or any of their respective controlling shareholders intended, on the date of the acquisition, that a spin-off occur in connection with the acquisition. A controlling shareholder is, in the case of a publicly traded corporation, a shareholder who owns 5% or more of the stock and who actively participates in the management or operation of the corporation; in the case of a privately-held corporation, a controlling shareholder is a shareholder who possesses voting power representing a meaningful voice in the governance of the corporation.

2. Pro-Plan factors

The factors tending to indicate the existence or non-existence of a Plan, discussed on Attachment 1, generally represent predictable step-transaction principles. Thus, the discussion prior to the spin-off of an acquisition that would occur thereafter involving Distributing, Controlled or their respective controlling shareholders suggests that the two transactions are linked by a Plan. The existence of an agreement, understanding, arrangement or substantial negotiations at the time of the spin-off "will be given great weight." This factor applies equally to discussions of a different but similar acquisition with the acquirer (Prop. Reg. § 1.355-7(d)(2)(i)). A Plan is also indicated where one acquisition is discussed and a similar acquisition by a different acquirer actually occurs (Prop. Reg. § 1.355-7(d)(2)(ii)). In the case of a public offering or auction following an acquisition, a Plan is indicated by discussions of the acquisition with an investment banker "or other outside advisor" before the spin-off (Prop. Reg. § 1.355-7(d)(2)(iii)). Parallel factors are provided for situations in which an acquisition precedes the spin-off (Prop. Reg. § 1.355-7(d)(2)(iv) - (vi)).

Whether the acquisition precedes or follows the spin-off, the fact that the spin-off was motivated by a business purpose to facilitate the acquisition or a similar acquisition is indicative of a Plan (Prop. Reg. § 1.355-7(d)(2)(vii)). Echoing the six-month hot period provided by the principal safe harbors (see part D., below), an acquisition within six months before or after the spin-off is indicative of a Plan as is an agreement regarding the second transaction within six months of the first (Prop. Reg. § 1.355-7(d)(2)(viii)).

3. Non-Plan factors

The factors that tend to show that a spin-off and an acquisition are not part of a Plan largely mirror the pro-Plan factors. Thus, in the case of an acquisition following a spin-off, the fact that neither Distributing nor Controlled and the acquirer or a potential acquirer (or any of their respective controlling shareholders) discussed the acquisition or a similar acquisition prior to the spin-off is a favorable factor (Prop. Reg. § 1.355-7(d)(3)(i)). The existence of an identifiable, unexpected change in market or business conditions occurring after the spin-off that triggered the acquisition is a non-Plan factor (Prop. Reg. § 1.355-7(d)(3)(iii)). A corporate business purpose for the spin-off other than a purpose to facilitate the acquisition or a similar acquisition is, as one would expect, a non-Plan factor (Prop. Reg. § 1.355- 7(d)(3)(vi)). Importantly, however, an acquisition-related purpose is relevant in determining the extent to which the spin-off is motivated by a non-acquisition business purpose (id.). As discussed in part D.1., below, the requirement to evaluate a non-acquisition business purpose in light of an acquisition-related purpose is one of the principal ambiguities of the regulation -- especially in light of the so-called operating rule that creates an effective presumption of an acquisition business purpose if an acquisition (or agreement, etc.) was reasonably certain to occur within six months of the spin-off.

Finally, a non-Plan factor arises if the spin-off would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition (Prop. Reg. § 1.355-7(d)(3)(vii)).

4. Operating rule: "reasonable certainty" of an acquisition

As mentioned previously, the 2000 Proposed Regulations do in one instance require taxpayers to predict the likelihood of a future acquisition: if at the time of the spin-off it is "reasonably certain" that within six months following a spin-off, an acquisition would occur (or an agreement, understanding or arrangement would exist or substantial negotiations would occur) regarding an acquisition, there is "evidence of a business purpose to facilitate an acquisition . . ." (Prop. Reg. § 1.355-7(e)(1)(i)). A parallel operating rule applies for acquisitions that occur prior to a spin-off (Prop. Reg. § 1.355-7(e)(1)(ii)) .

This operating rule will have importance both in terms of (1) the application of the pro-Plan and non-Plan factors relating to the purpose for the spin-off and (2) the availability of the most significant safe harbors (discussed in D., below)

Obviously, predictions of future acquisition activity are quite difficult. The potential for mischief here may be limited because the bar is set quite high: the presumption of an acquisition-related business purpose comes into play only if the acquisition (or agreement, etc.) is "reasonably certain" to occur within the six-month time frame. One would think that there would have to be an 80-90% likelihood of an acquisition to meet this standard.

D. The Safe Harbors

1. Six-month hot period

Probably the most important safe harbor provided by the new regulations applies if (1) the acquisition occurs more than six months after the distribution and there is no agreement, etc., concerning the acquisition within six months of the acquisition and (2) the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate an acquisition (Prop. Reg. § 1.355-7(f)(1) (Safe Harbor I)). Once again, an acquisition business purpose "is relevant in determining the extent to which the distribution was motivated by a [non-acquisition] business purpose" (Prop. Reg. § 1.355-7(f)(1)(ii)). And again, the operating rule that creates a presumption of an acquisition business purpose if there is "reasonable certainty" of an acquisition (or agreement, etc.) within six months of a spin-off is relevant in the determination of the business purpose for the spin-off.

Three observations regarding this most important safe harbor: (1) There is a significant unanswered question concerning the degree to which a non-acquisition business purpose (e.g., lower cost financing) will be undermined by the existence of an acquisition business purpose, including an acquisition business purpose that is deemed to arise from the operating rule applicable where there is "reasonable certainty" of an acquisition. Further guidance on this subject would seem essential. (2) Because the safe harbor is available only if the spin-off is motivated sufficiently by a non-acquisition business purpose, there will be some number of cases -- potentially a large number -- in which taxpayers will not be able to achieve real comfort as to their entitlement to rely on this safe harbor, since the real purpose for the spin-off may be subject to differing interpretations. (3) The safe harbor will be enormously useful in cases in which (a) the business purpose for the spin-off is relatively clearly not an acquisition purpose, (b) there is no acquisition of Distributing or Controlled within the six-month period following the acquisition, and (c) there are no acquisition-related discussions within the six-month period.

2. Six-month hot period; limited stock acquisition purpose

Responding to the criticism leveled at the 1999 Proposed Regulations that none of the rebuttals were available if there was a stock acquisition business purpose, the Service has devised a safe harbor designed to be of use principally in the case of IPOs. This safe harbor applies if (1) the acquisition occurs more than six months after the distribution and there is no agreement, etc. prior to the close of the six-month period and (2) the distribution was motivated wholly or in substantial part by a purpose to facilitate an acquisition of (a) no more than 33% of the stock of Distributing or Controlled and (b) no more than 20% of the stock of the company whose stock acquisition motivated the spin-off is acquired (or the subject of an agreement, etc.) within six months following the spin-off. The 20% (or less) stock acquisition that motivated the spin-off obviously does not qualify for the safe harbor.

3. Public trading

A safe harbor applies to acquisitions of stock that is listed on an established market if the acquisition is not between 5% shareholders. Schedules 13D and 13G can be relied upon in determining the existence of 5% shareholders (Prop. Reg. § 1.355-7(f)(5) (Safe Harbor V)). Practitioners and the Service have assumed the existence of relief of this nature since the statute came into force. An anti-abuse rule prevents use of the public trading safe harbor for coordinated acquisitions by multiple persons.

4. Compensatory stock arrangements

The acquisition of stock by an employee, director or related person in connection with the performance of services, in a transaction to which Section 83 applies, is protected (Prop. Reg. § 1.355-7(f)(6) (Safe Harbor VI)).

E. Other Rules

1. Options

Generally, if stock of either Distributing or Controlled is acquired pursuant to an option, the option will be treated as an "agreement" to acquire stock unless it is more likely than not that the option will not be exercised, as of the later of (1) the date of the writing of the option or (2) the date of the stock distribution. If the option is treated as an "agreement," then the acquisition of stock pursuant to the exercise of the option may not qualify under a safe harbor that it otherwise would have satisfied.

Whether it is more likely than not that an option will be exercised is determined based upon all the facts and circumstances. Generally, this means that the Service will take into account the fair market value of the option and determine whether it is economically likely to be exercised. In determining the fair market value of the stock underlying the option, the Service will take into account control premiums and minority and blockage discounts.

Compensatory options, however, will not be treated as options (and thus compensatory options will not be deemed "agreements" to acquire stock) if (1) they are granted with customary terms and conditions to an employee or director in connection with the performance of services and (2) immediately after the spin-off and for six months thereafter the option is nontransferable and does not have a readily ascertainable fair market value.

2. Valuation

All shares of stock within a single class are considered to have the same value. This means that control premiums and minority and blockage discounts within a single class are not taken into account. Of course, different classes of stock may have different values for the purposes of these regulations.

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Attachment 1

The following are the factors that the Service will consider in determining whether a spin-off and an acquisition of stock are part of a Plan. The weight of the factors depends on the particular case. The existence of a Plan will not be determined merely by comparing the number of pro-Plan and non-Plan factors.

Pro-Plan Factors

In the case of an acquisition of stock after a spin-off:

- Distributing or Controlled and the acquirer (or any of their respective controlling shareholders) discussed the acquisition or a similar acquisition by the acquirer before the spin-off.
- Distributing or Controlled and a potential acquirer (or any of their respective controlling shareholders) discussed an acquisition before the spin-off and a similar acquisition by a different person occurred after the spin-off.
- In a case involving a public offering or auction, Distributing or Controlled (or any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the spin-off.

In the case of an acquisition of stock before a spin-off:

- Distributing or Controlled and the acquirer (or any of their respective controlling shareholders) discussed a spin-off before the acquisition.
- Distributing or Controlled and a potential acquirer (or any of their respective controlling shareholders) discussed a spin-off before the acquisition and a similar acquisition by a different person occurred before the spin-off.
- In a case involving a public offering or auction, Distributing or Controlled (or any of their respective controlling shareholders) discussed a spin-off with an investment banker or other outside adviser before the acquisition.

In the case of an acquisition of stock either before or after a spin-off:

- The spin-off was motivated by a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled.
- The acquisition and the spin-off occurred within six months of each other or there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction within six months after the first transaction.

- The debt allocation between Distributing and Controlled made an acquisition of Distributing or Controlled likely in order to service the debt.

Non-Plan Factors

In the case of an acquisition of stock after a spin-off:

- Neither Distributing nor Controlled and the acquirer or any potential acquirer (nor any of their respective controlling shareholders) discussed the acquisition or a similar acquisition before the spin-off.

- In the case of a public offering or auction, neither Distributing nor Controlled (nor any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the spin-off.

- There was an identifiable, unexpected change in market or business conditions occurring after the spin-off that resulted in the acquisition that was otherwise unexpected at the time of the spin-off.

In the case of an acquisition of stock before a spin-off:

- Neither Distributing nor Controlled and the acquirer (nor any of their respective controlling shareholders) discussed a spin-off before the acquisition. This factor does not apply if the acquisition occurred after the date of the public announcement of the planned spin-off.

- There was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a spin-off that was otherwise unexpected.

In the case of an acquisition of stock either before or after a spin-off:

- The spin-off was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled.

- The spin-off would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition (including a previously proposed similar acquisition that did not occur).

Attachment 2

An acquisition of stock that is described in one of the following safe harbors will result in the Service finding that a Plan does not exist for the purposes of Section 355(e):

In the case of an acquisition of stock after a spin-off:

- Safe Harbor I
    - The acquisition occurred more than six months after the spin-off and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is six months after the spin-off; and
    - The spin-off was motivated in whole or substantial part by a business purpose other than a business purpose to facilitate an acquisition of Distributing or Controlled.
- Safe Harbor II
    - The acquisition occurred more than six months after the spin-off and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is six months after the spin-off; and
    - The spin-off was motivated in whole or substantial part by a corporate business purpose to facilitate an acquisition or acquisitions of no more than 33% of the stock of Distributing or Controlled, and no more than 20% of the stock of the corporation (whose stock was acquired in the acquisition or acquisitions that motivated the spin-off) was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations before a date that is six months after the spin-off.
- Safe Harbor III
    - The acquisition occurred more than two years after spin-off and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the spin-off or within six months thereafter.

In the case of an acquisition of stock before a spin-off:

- Safe Harbor IV
    - The acquisition occurred more than two years before a spin-off, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the spin-off at the time of the acquisition or within six months thereafter.

In the case of transfers of stock between shareholders and employee stock option holders:

- Safe Harbor V
    - The acquired stock is listed on an established market and the acquisition is a transfer between shareholders neither of whom is a 5% shareholder.
    - This safe harbor does not apply to (1) public offerings or redemptions; (2) acquisitions by a coordinated group that in the aggregate would be a 5% shareholder; or (3) any transfer to or by a person if the corporation the stock of which is being transferred knows, or has reason to know, that the person intends to become a 5% shareholder at any time during the four-year period beginning two years before the spin-off.
- Safe Harbor VI
    - The stock of Distributing or Controlled is acquired by an employee or director of Distributing or Controlled or certain other related parties in connection with the performance of services for the corporation or a person related to it in a transaction to which Section 83 applies.