NEW REGULATIONS UNDER I.R.C. § 355(e)

On April 24, 2002, the Treasury Department issued new temporary and proposed regulations under Section 355(e) of the Internal Revenue Code of 1986, as amended (the "Code"). The new regulations represent a substantial liberalization of the regime of the prior regulations.

Section 355(e) of the Code imposes tax on a spin-off distribution that qualifies under section 355 if the spin-off is linked to a 50-percent-or-greater acquisition of either the spinning corporation or the spun corporation. Under the statute, the required linkage is presumed to exist whenever such an acquisition occurs within two years preceding or following the spin-off.

The new regulations are effective for distributions after April 26, 2002. Taxpayers may apply the new regulations in whole, but not in part, to any distribution occurring since the effective date of section 355(e), April 16, 1997.

I. Background

Section 355(e) imposes corporate level tax upon an otherwise tax-free spin-off distribution if pursuant to a "plan (or series of related transactions)" (herein, "Plan"), there is a 50-percent-or-greater acquisition of the stock of either the spinning corporation or the spun corporation. The new regulations follow the format of the prior, January 2001, regulations (the "2001 regulations"): First, the new regulations provide guidance on what constitutes a Plan by setting forth a facts-and-circumstances test elucidated by five nonexclusive factors that tend to show the existence of a Plan, and six nonexclusive factors that tend to negate the existence of a Plan. Factors tending to indicate the existence of a Plan include, most importantly, the existence of an agreement, understanding or arrangement, or substantial negotiations, regarding an acquisition. Second, the regulations provide seven safe harbors, thereby affording the possibility of achieving a high degree of comfort as to the nonapplication of section 355(e) in many cases. Third, the regulations contain five operating rules to be employed in applying the Plan factors and safe-harbor rules.

II. New Regulations Significantly Improve Taxpayers' Ability to Plan Transactions

The new regulations represent the Bush Administration's first attempt to grapple with the rigors of section 355(e). Many -- if not most -- corporate tax practitioners regard section 355(e) as flawed from a policy perspective in treating virtually all spin-merge transactions as the equivalent of a taxable sale. While it cannot be denied that certain spin-offs that involved placement of substantial debt on the spun company raised difficult tax policy concerns, the scope of section 355(e) goes well beyond such cases.

The 2001 regulations made a substantial effort to limit the scope of section 355(e), but left a number of difficult questions unanswered, or not answered satisfactorily.[1]

The new regulations take a significant step in the direction of allowing taxpayers to engage in section 355 spin-off distributions and at the same time take commercially prudent steps to evaluate and plan acquisitions without undue concern that those steps will alter the tax consequences of the distribution. This is not to say that section 355(e) has been rendered toothless, only that its contours have been made more definite, thereby placing taxpayers and their advisors in a position in which firm conclusions regarding the application of section 355(e) can be reached in many more situations.

III. Significant Changes in the New Regulations

The new regulations are, like their predecessors, complex. Moreover, in many cases the conclusions to be drawn regarding the application of section 355(e) will turn on the interpretation of the facts of the particular situation. Nonetheless, the new rules are significantly more taxpayer-friendly than the prior regulations. The principal changes from the prior regulations are the following:

1. Emphasis on bilateral conduct, rather than corporate "intentions"

The new regulations limit the definition of Plan by stating that an acquisition of the spinning or spun company after a spin-off will be part of a Plan with the distribution "<u>only</u> 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."[2] The narrowness of this rule becomes clear from the definition of the terms employed:

- An "agreement, understanding or arrangement", while dependent on the facts and circumstances of each case, will generally be considered to exist only if a common understanding exists between the spinning (or spun) company and the acquirer as to most of the significant economic terms of the transaction.

- "Substantial negotiations" will be considered to exist only if the significant economic terms of an acquisition have been discussed between the officers, directors or controlling shareholders (or any of their representatives) of the spinning or spun companies, on the one hand, and the acquirer, on the other.

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[1] Proposed section 355(e) regulations issued in 1999 were generally regarded as unworkable.

[2] Reg. § 1.355-7T(b)(2) (emphasis added). The quoted rule does not apply to a public offering.

- In a stock-for-stock transaction, the exchange ratio to be employed is a significant economic term.

Given the regulations' focus on bilateral discussions that have -- at a minimum -- arrived at a fairly advanced stage, it is apparent that in contrast to the regime under the 2001 regulations, preliminary discussions, the exchange of information, and the like, can now proceed without undue concern for the application of section 355(e) to a proximate spin-off distribution.

2. Scope of "similar acquisition" concept reduced

The 2001 regulations were vague in describing the circumstances under which an actual acquisition would be viewed as "similar" to a previously contemplated acquisition. The effect of this uncertainty rippled through the prior regulations, making it difficult in many cases to know whether acquisition-related discussions with one party would taint a later acquisition involving a different, unrelated party. In some cases, this uncertainty undermined a taxpayer's ability to rely on the regulatory safe-harbors. For example, a spinning company's acquisition discussions with X might terminate and then be followed by a spin-off. After a year's time, unrelated Y might make an initial approach to the spinning company resulting in Y's acquisition of the spinning company. If the X and Y acquisitions were regarded as similar, a strong inference as to the existence of a Plan would result. The new regulations largely eliminate the uncertainty on this point by defining acquisitions as "similar" only in narrowly circumscribed circumstances.

In general, an actual acquisition (not involving a public offering) will be similar to another, potential acquisition if the result is a combination of "all or a significant portion of <u>the same</u> business operations."[3] The fact that the potential acquisition counterparty is different from (and not related to) the actual acquisition counterparty is sufficient to defeat "similarity" even though the nature of the business assets is the same.[4]

The definite contours of the "similar acquisition" concept will plainly enhance taxpayers' ability to plan transactions in circumstances involving a prior history of acquisition negotiations with a particular party.

3. "Hot market" concept eliminated

The 2001 regulations contained an "operating rule" with broad effect: if, at the time of a spin-off distribution, it was "reasonably certain" that within six months following the distribution, an acquisition of the spinning or spun company would occur, or an agreement, arrangement or understanding concerning such an acquisition would exist or substantial negotiations to the same

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[3] Reg. § 1.355-7T (h) (8) (emphasis added).

[4] Reg. § 1.355-7T (j), Example 6.

effect would occur, that fact was regarded as evidence that the business purpose for the spin-off was to facilitate an acquisition.[5]

Again, the impact of this operating rule rippled through the regulations, with the effect, for example, that a basic safe harbor (Safe Harbor I) was unavailable if there was a risk that an acquisition, agreement, arrangement, understanding or substantial discussions would be seen to occur or exist within six months of the distribution.[6] The result was considerable uncertainty on the part of taxpayers and their advisors, especially in situations in which contractions within a particular industry were expected. The new regulations eliminate this operating rule in light of their emphasis on bilateral conduct.

4. Continuing impact of prior negotiations

The prior regulations created significant doubt about the application of section 355(e) in the not-uncommon situation in which (1) substantial negotiations regarding the acquisition of a company occurred, (2) the negotiations terminated, and (3) thereafter a party to the acquisition discussions spun off a subsidiary. At a later point in time -- possibly much later -- the spinning (or spun) company and the acquirer might wish to recommence discussions. Under the prior regulations, it was difficult to fix a point in time when the original negotiations would no longer be treated as part of a Plan with the distribution. The effect was that the spinning (or spun) company faced real risk under section 355(e) if it were acquired by the original acquirer.

The new regulations properly recognize that the pool of likely acquisition partners is often quite small, and that a negotiation that is terminated ought to be regarded as over for tax purposes too at some point in time. Under the new regulations, a waiting period of 18 months -- possibly 12 in some cases -- will suffice.[7]

IV. Other Changes

It is impractical to list all the liberalizing features of the new regulations in this memorandum. Aside from the changes described above, the following merit brief mention:

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[5] Prior reg. § 1.355-7T(e)(1).

[6] Safe Harbor I generally was (and is) available if (1) the main purpose of the spin-off was not to facilitate an acquisition, (2) the acquisition occurs more than six months after the distribution and (3) there was no agreement/understanding or substantial negotiations regarding the acquisition during the period beginning one year prior to the distribution and ending six months following the distribution.

[7] The combined effect of the change described in the text and the narrowed concept of "similar" acquisition, discussed above, will in some cases yield a curious (if not perverse) result in the case in which the spinning company negotiates an acquisition with X, calls off those negotiations and then spins off a subsidiary. In such a case, it will be possible for the spinning company to combine with X's competitor, Y, after a waiting period of only six months without concern for the application of section 355(e) while a waiting period of 12-18 months would be required for a combination with X.

- Public trading safe-harbor expanded. Previously, Safe Harbor V protected acquisitions and dispositions of stock by persons holding less than five percent of the spinning or spun company. The new regulations increase the permitted ownership from five percent to 10 percent, provided the 10 percent shareholder does not participate in management.

- Compensatory stock. Safe Harbor VI previously protected compensatory stock acquisitions by employees and directors of the spinning and spun companies. The new regulations extend this relief to independent contractors who are not 10-percent-or-greater shareholders or controlling shareholders.

- Stock acquisitions by pension plans. New Safe Harbor VII protects acquisitions of the stock of the spinning or spun companies by pension and profit sharing plans, limited, however, to acquisitions of 10 percent of the stock of the company within the four-year period bracketing the spin-off.

- Options. Under the prior regulations, the acquisition of stock upon the exercise of an option would be considered an acquisition pursuant to an agreement to acquire stock made on the date the option was written, unless the spinning corporation could establish that the option was not more likely than not to be exercised on the later of the date the option was written, or the date of the spin-off. In general, and subject to an exception for tax avoidance transactions, the new regulations provide that only the date the option is written, transferred, or materially modified is considered in determining whether the option is more likely than not to be exercised.

- Auctions. The prior regulations contained a special set of rules regarding the facts and circumstances tending to show a Plan if the acquisition resulted from an auction or a public offering. The new regulations eliminate the distinction between an acquisition resulting from an auction and other acquisitions (other than those involving public offerings). Thus under the new regulations auctions are analyzed under the general facts-and-circumstances test, and the unilateral intention of the spinning or spun corporation are no longer sufficient to find the existence of a Plan in the context of an auction.

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This memorandum is a general summary of the new regulations intended only to highlight certain aspects of the regulations. The rules governing tax-free spin-offs and section 355(e) are complex and the advice of a professional tax advisor should be obtained in connection with any particular fact pattern. This memorandum is not intended as legal advice.

The new regulations may present planning opportunities in a variety of structural contexts. Questions regarding this memorandum can be addressed to Richard L. Reinhold at (212) 728-8292, Andrew W. Needham at (212) 728-8728, Devorah Pomerantz at (212) 728-8121, or Ruth Mason at (212) 728-8127.

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