

**IRS LIBERALIZES REGULATIONS
DEFINING THE SCOPE OF A PLAN
UNDER SECTION 355(E)**

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On April 26, 2002, the Internal Revenue Service (“IRS”) issued new temporary and proposed regulations that define the scope of a plan under section 355(e) of the Internal Revenue Code of 1986, as amended (the “Code”). The new regulations provide taxpayers with greater flexibility and certainty in assessing whether a change in control transaction is part of a plan related to a spin-off distribution.

BASIC RULES

If a corporation (“Distributing”) distributes to its shareholders the stock of a corporation that it controls immediately before the distribution (“Controlled”), and the requirements of section 355 of the Code are satisfied, neither Distributing nor its shareholders are taxed on the distribution. However, pursuant to section 355(e) of the Code, Distributing will be taxed as if it sold the stock of Controlled for its fair market value if the stock of Controlled is distributed as part of a plan (or series of related transactions) pursuant to which one or more persons acquire, directly or indirectly, stock representing at least a 50-percent interest (by vote or value) in Distributing or Controlled. Under the statute, a plan is presumed to exist if such an acquisition occurs during the four-year period beginning two years before the distribution, unless it is established that the distribution and acquisition are not pursuant to such a plan.

THE NEW REGULATIONS

The General Rule

The most significant and helpful change in the new regulations is a general rule that a distribution and subsequent acquisition will only be treated as part of a plan if at some time during the 2-year period ending on the date of the distribution, there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition.

A “similar acquisition” under the new regulations is generally one involving the same parties or related parties. 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. Substantial negotiations under the new regulations generally require discussions of significant economic terms, e.g., the exchange ratio in a reorganization, by 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, with the acquirer or a person or persons with the implicit or explicit permission of the acquirer. The content of, and the persons engaging in, such discussions are probative in this respect.

In the case of an acquisition involving a public offering by Distributing or Controlled, the existence of an agreement, understanding, arrangement, or substantial negotiations will be based on discussions by 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, with an investment banker.

As a result of the new general rule, in many transactions, Distributing and Controlled should be able to engage in post-spin acquisitions without concern about the application of Section 355(e).

OTHER SAFE HARBORS

For those situations where the general rule does not apply, the regulations provide additional safe harbors pursuant to which a plan will not be deemed to exist if:

- The distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate an acquisition of the acquired corporation, the acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins 1 year before the distribution and ends 6 months thereafter.
- The distribution was not motivated by a business purpose to facilitate the acquisition or a similar acquisition, the acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition during the period that begins 1 year before the distribution and ends 6 months thereafter; and no more than 25 percent of the stock of the acquired corporation was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations during the period that begins 1 year before the distribution and ends 6 months thereafter.

- The acquisition occurs after a distribution, and there was no agreement, understanding or arrangement concerning the acquisition at the time of the distribution, and no agreement, understanding, arrangement, or substantial negotiations concerning the distribution within 1 year after the distribution.
- The distribution occurs more than 2 years after an acquisition, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter.

In addition, the safe harbors provide rules dealing with public trading and compensation-related stock issuances, in particular, increasing the ownership limit for a shareholder from 5 percent to 10 percent, assuming the shareholder does not participate in management.

FACTS AND CIRCUMSTANCES

Where no safe harbor is met, the regulations list certain plan and non-plan facts and circumstances to consider in determining whether a distribution and acquisition are part of a plan. These lists are nonexclusive and the weight to be given any particular factor will depend on the particular situation. Thus, the existence or nonexistence of a plan will not depend merely on the relative number of plan and non-plan factors.

The factors indicating that a distribution and an acquisition are part of a plan include the following:

- In the case of an acquisition (other than involving a public offering) after a distribution, at some time during the 2-year period ending on the date of the distribution, there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition.
- In the case of an acquisition involving a public offering after a distribution, at some time during the 2-year period ending on the date of the distribution, there were discussions by Distributing or Controlled with an investment banker regarding the acquisition or a similar acquisition.
- In the case of an acquisition (other than involving a public offering) before a distribution, at some time during the 2- year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with the acquirer regarding a distribution.
- In the case of an acquisition involving a public offering before a distribution, at some time during the 2-year period ending on the date of the acquisition, there were discussions by Distributing or Controlled with an investment banker regarding a distribution.

- In the case of an acquisition either before or after a distribution, the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition.

The factors indicating that a distribution and an acquisition are not part of a plan include the following:

- In the case of an acquisition involving a public offering after a distribution, during the 2-year period ending on the date of the distribution, there were no discussions by Distributing or Controlled with an investment banker regarding the acquisition or a similar acquisition.
- In the case of an acquisition either before or after a distribution, 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.
- In the case of an acquisition (other than involving a public offering) before a distribution, during the 2-year period ending on the date of the acquisition, there were no discussions by Distributing or Controlled with the acquirer regarding a distribution, unless (i) the acquisition occurred after the date of the public announcement of the planned distribution, or (ii) a person other than Distributing or Controlled intends to cause a distribution and, as a result of the acquisition, can meaningfully participate in the decision regarding whether to make a distribution.
- In the case of an acquisition either before or after a distribution, the distribution 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.
- In the case of an acquisition either before or after a distribution, the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition.

ELIMINATION OF THE
"REASONABLE CERTAINTY" TEST

Under the prior regulations, an acquisition business purpose existed if at the time of the distribution there was a "reasonable certainty" that within 6 months after the distribution an acquisition would occur. The new regulations remove the "reasonable certainty" test to reflect the focus on bilateral agreements at the time of the distribution. Further, the new regulations have removed from the plan factors an acquisition occurring within 6 months before or after the distribution. Thus, a distribution into a "hot market" is no longer a negative factor.

EFFECTIVE DATE

The new regulations are generally effective April 26, 2002. However, taxpayers may apply the new regulations in whole, but not in part, to a distribution occurring after April 16, 1997, and on or before April 26, 2002

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The foregoing is intended only as a general summary. The new regulations are more complex in their entirety. If you have any questions about the new regulations or would like more information regarding specific provisions, please do not hesitate to call Steven Todrys (stodrys@stblaw.com; 212-455-3750), Charlie Rappaport (corappaport@stblaw.com; 212-455-2548), Rob Holo (rholo@stblaw.com; 212-455-2514), Gary Mandel (gmandel@stblaw.com; 212-455-7963), Adam Rosenzweig (arosenzweig@stblaw.com; 212-455-2352) or any other member of our tax department.

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