

**RECENT PROPOSED REGULATIONS
DEFINING THE SCOPE OF A PLAN UNDER
SECTION 355(e)**

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The Internal Revenue Service (“IRS”) recently issued new proposed regulations that define the scope of a “plan” under section 355(e) of the Internal Revenue Code of 1986, as amended (the “Code”). These proposed regulations replace earlier proposed regulations that, after consideration of public comments, have been withdrawn by the IRS and Treasury.

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. A plan is presumed to exist if such an acquisition occurs during the four-year period beginning two years before the distribution, unless the taxpayer establishes that the distribution and acquisition are not pursuant to such a plan.

Facts and Circumstances

The newly issued proposed regulations provide guidance regarding interpretation of the phrase “plan (or series of related transactions)” contained in section 355(e) of the Code. The determination of whether or not a plan exists is based on all of the facts and circumstances. In general, the regulations provide that a distribution and acquisition will be considered part of a plan if Distributing, Controlled or any of their respective “controlling shareholders”^{*} intended, on the date of the first transaction, that the second transaction occur in connection with the first transaction. In addition, all acquisitions determined to be part of a plan with a distribution will be aggregated for purposes of the 50-percent test.

* The proposed regulations define “controlling shareholder” as follows: (i) a controlling shareholder of a corporation the stock of which is not listed on an established market is any person who, directly or indirectly, or together with related persons (within the meaning of sections 267(b) and 707(b) of the Code), possesses voting power in Distributing or Controlled representing a meaningful voice in the corporation’s governance, and (ii) a controlling shareholder of a corporation the stock of which is listed on an established market is a 5-percent shareholder who actively participates in the management or operation of the corporation.

The proposed regulations list certain plan and nonplan facts and circumstances to consider in determining whether a distribution and acquisition are part of a plan. These lists are nonexclusive and the weight given any particular factor will depend on the particular situation. Thus, the existence of a plan will not depend merely on the relative number of plan and nonplan factors. The proposed regulations include examples that apply the facts and circumstances approach by analyzing the plan and nonplan factors in the context of certain hypothetical situations.

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

- Where an acquisition (not involving a public offering or auction) follows a distribution, (i) Distributing or Controlled and the acquirer (or any of their respective controlling shareholders) discussed the acquisition or a similar acquisition by the acquirer prior to the distribution, or (ii) Distributing or Controlled and a potential acquirer (or any of their respective controlling shareholders) discussed an acquisition prior to the distribution and a similar acquisition by a different person occurred after the distribution.
- Where the acquisition involves a public offering or auction and regardless of the order of the transactions, Distributing or Controlled (or any of their respective controlling shareholders) discussed the second transaction with an investment banker or other outside adviser before the first transaction.
- Where a distribution follows an acquisition, (i) Distributing or Controlled and the acquirer (or any of their respective controlling shareholders) discussed a distribution prior to the acquisition, or (ii) Distributing or Controlled and a potential acquirer (or any of their respective controlling shareholders) discussed a distribution before the acquisition and a similar acquisition by a different person occurred before the distribution.
- Regardless of the order of the transactions, the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled.
- Regardless of the order of the transactions, the transactions occurred within six months of each other or there was an agreement, understanding, arrangement or substantial negotiations regarding the second transaction (or, where an acquisition follows a distribution, a similar acquisition) within six months after the first transaction.
- Regardless of the order of the transactions, the debt allocation between Distributing and Controlled made an acquisition likely in order to service the debt.

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

- Where an acquisition (not involving a public offering or auction) follows a distribution, 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 distribution.
- Where an acquisition (involving a public offering or auction) follows a distribution, neither Distributing nor Controlled (nor any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the distribution.
- Regardless of the order of the transactions, there was an identifiable, unexpected change in market or business conditions occurring after the first transaction that resulted in the second transaction that was otherwise unexpected.
- Where a distribution follows an acquisition (not involving a public offering or auction), neither Distributing nor Controlled and the acquirer (nor any of their respective controlling shareholders) discussed a distribution before the acquisition.
- Regardless of the order of the transactions, the distribution was motivated in whole or substantial part by a business purpose other than to facilitate the acquisition or a similar acquisition of Distributing or Controlled.
- Regardless of the order of the transactions, the distribution 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).

Safe Harbors

The proposed regulations set forth safe harbors which, when satisfied, provide that a distribution and an acquisition will not be considered part of a plan:

- Where an acquisition occurs more than six months after a distribution, (i) there was no agreement, understanding, arrangement or substantial negotiations relating to the acquisition within six months after the distribution, and (ii) the distribution was motivated in whole or substantial part (A) by a nonacquisition business purpose, or (B) by a corporate business purpose to facilitate an acquisition or acquisitions of no more than 33-percent of the stock of Distributing or Controlled, and no more than 20-percent of the stock of the corporation whose stock was acquired was either acquired or the subject of an agreement,

understanding, arrangement or substantial negotiations within six months after the distribution.

- Where the transactions occur more than two years apart and there was no agreement, understanding, arrangement or substantial negotiations concerning the second transaction at the time of the first transaction or within six months thereafter.
- Subject to limitations, where the acquired Distributing or Controlled stock is listed on an established market and the acquisition is pursuant to a transfer between shareholders of Distributing or Controlled who are not 5-percent shareholders.
- Where the Distributing or Controlled stock is acquired by an employee or director of Distributing, Controlled or a person related to Distributing or Controlled in connection with the performance of services as an employee or director.

Operating Rules

Certain operating rules apply for purposes of the proposed regulations. For example, where an acquisition follows a distribution, evidence of a business purpose to facilitate an acquisition of Distributing or Controlled exists if, at the time of the distribution, it was reasonably certain that within six months after the distribution, (i) an acquisition would occur, (ii) an agreement, understanding or arrangement would exist or (iii) substantial negotiations would occur regarding an acquisition. Where a distribution follows an acquisition, if the acquisition occurred after the date of the public announcement of the planned distribution, or if, at the time of the acquisition, it was reasonably certain that within six months after the acquisition, (i) the distribution would occur, (ii) an agreement, understanding, or arrangement would exist, or (iii) substantial negotiations would occur regarding the distribution, then the announcement or reasonable certainty is evidence of a business purpose to facilitate an acquisition of Distributing or Controlled. The fact that internal discussions regarding an acquisition occurred may be indicative of the business purpose that motivated the distribution. The proposed regulations also set forth additional operating rules relating to the relevance of certain other facts and circumstances.

Options

The proposed regulations provide guidance with respect to stock acquired by the exercise of options, warrants, convertible obligations and other similar interests. In general, if stock of Distributing or Controlled is acquired pursuant to an option, the option is treated as an agreement to acquire the stock on the date the option is written unless Distributing can establish that on the later of the date of the stock distribution or the writing of the option, based on all of the facts and circumstances, the option was not more likely than not to be exercised. In addition, the proposed regulations address the treatment of an agreement, understanding or arrangement to write an option and enumerate certain instruments, including compensatory

options, which will generally not be treated as options unless written, transferred or listed with a principal purpose of avoiding the application of section 355(e) of the Code or the proposed regulations.

Multiple Controlled Corporations

Where stock of more than one controlled corporation is distributed pursuant to a plan and stock representing a 50-percent or greater interest is acquired in some, but not all, of the distributed controlled corporations, Distributing will recognize gain only on the stock of the distributed controlled corporations subject to 50-percent or greater acquisitions. However, where Distributing is the acquired corporation, this rule will not apply.

Valuation

Shares of stock within a single class will generally be considered to have the same value regardless of control premiums and minority and blockage discounts.

Effective Date

The regulations will apply to distributions that occur after the regulations are published as final regulations in the Federal Register.

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The foregoing is intended only as a general summary, and the new proposed regulations are more complex in their entirety. If you have any questions about the proposed regulations or would like more information regarding specific provisions, please do not hesitate to contact Steven Todrys (212-455-3750; s_todrys@stblaw.com), Rob Holo (212-455-2514; r_holo@stblaw.com), Gary Mandel (212-455-7963; g_mandel@stblaw.com), or any other member of our tax department.

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