Section 355.—Distribution of Stock and Securities of a Controlled Corporation

26 CFR 1.355–7T: Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

T.D. 8988

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Guidance Under Section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities in Connection With an Acquisition.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. Changes to the applicable law were made by the Taxpayer Relief Act of 1997. These temporary regulations affect corporations and are necessary to provide them with guidance needed to comply with these changes. The text of these temporary regulations also serves as the text of the proposed regulations (REG–163892–01) set forth in this issue of the Bulletin.

DATES: *Effective Date*: These temporary regulations are effective April 26, 2002.

Applicability Date: These temporary regulations apply to distributions occurring after April 26, 2002. For rules applicable to distributions occurring after August 3, 2001, and on or before April 26, 2002, see § 1.355–7T as in effect prior to April 26, 2002 (see 26 CFR part 1 revised April 1, 2002). Taxpayers, however, may apply these regulations in whole, but not in part, to a distribution occurring on or before April 26, 2002.

FOR FURTHER INFORMATION CONTACT: Amber R. Cook of the Office of Associate Chief Counsel (Corporate), (202) 622–7530 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 355(e) of the Internal Revenue Code of 1986 provides that the stock of a controlled corporation will not be qualified property under section 355(c)(2) or 361(c)(2) if the stock is distributed as "part of a plan (or series of related transactions) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation or any controlled corporation." For this purpose, a 50-percent or greater interest means stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock. See I.R.C. § 355(e)(4)(A) (referring to section 355(d)(4) for the definition of 50-percent or greater interest).

On January 2, 2001, the IRS and Treasury published in the **Federal Register** (REG–107566–00, 2001–1 C.B. 346 [66 F.R. 66]) a notice of proposed rulemaking (the 2001 proposed regulations) under section 355(e). The 2001 proposed regulations provide guidance concerning the interpretation of the phrase "plan (or series of related transactions)." The 2001 proposed regulations generally provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. The 2001 proposed regulations list a number of factors that tend to show that an acquisition and a distribution are part of a plan and a number of factors that tend to show that an acquisition and a distribution are not part of a plan. In addition, they set forth six safe harbors, the satisfaction of which confirms that a distribution and an acquisition are not part of a plan.

A public hearing regarding the 2001 proposed regulations was held on May 15, 2001. In addition, written comments were received. In response to comments that immediate guidance under section 355(e) was needed, on August 3, 2001, the IRS and Treasury published in the **Federal Register** (T.D. 8960, 2001–34 I.R.B. 176 [66 F.R. 40590]) the 2001 proposed regulations as temporary regulations (the original temporary regulations). The original temporary regulations were identical to the 2001 proposed regulations, except that, pending further study of the comments received regarding the 2001 proposed regulations, they reserved § 1.355–7(e)(6) (suspending the running of any time period prescribed in the 2001 proposed regulations during which there is a substantial diminution of risk of loss under the principles of section 355(d)(6)(B)) and *Example 7* of the 2001 proposed regulations (interpreting the term *similar acquisition* in the context of a situation involving multiple acquisitions).

Explanation of Provisions

The IRS and Treasury have studied the comments received regarding the 2001 proposed regulations and have concluded that it is desirable to revise various aspects of the original temporary regulations. Accordingly, the IRS and Treasury are promulgating these regulations (the revised temporary regulations) as temporary to amend the original temporary regulations. The following sections describe a number of the most significant comments and the extent to which they have been incorporated in the revised temporary regulations. Further changes to

the revised temporary regulations, however, are possible before these regulations are finalized.

A. *Facts and Circumstances Generally*

The 2001 proposed regulations identify a number of facts and circumstances that tend to show whether a distribution and an acquisition are part of a plan. While some of those facts and circumstances relating to a post-distribution acquisition focus on discussions before the distribution between the acquired corporation and the acquirer regarding the acquisition or a similar acquisition, others are unrelated to whether there were such discussions before the distribution. A number of comments suggested that the relevant facts and circumstances that evidence whether a distribution and a post-distribution acquisition are part of a plan for purposes of section 355(e) generally should focus more heavily on whether there were bilateral discussions or even an agreement, understanding, or arrangement regarding the acquisition within a certain period of time prior to the distribution.

The IRS and Treasury agree with these comments and, accordingly, have revised the 2001 proposed regulations to reflect this emphasis. In particular, the revised temporary regulations provide that, other than in the case of an acquisition involving a public offering, a distribution and a post-distribution acquisition can be part of a plan only 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. In addition, the list of facts and circumstances in the revised temporary regulations that tend to show that a distribution and an acquisition are part of a plan has been revised to reflect this change in emphasis.

B. *Special Rules Relating to Auctions*

As set forth in the 2001 proposed regulations, the facts and circumstances tending to show whether a distribution and an acquisition are part of a plan distinguish between acquisitions other than acquisitions involving a public offering or auction, on the one hand, and acquisitions involving a public offering or auction, on the other hand. For example, while the distributing or controlled corporation's discussions with an acquirer regarding a post-distribution acquisition involving a public offering or auction are not listed as evidence that the distribution and the acquisition are part of a plan, the distributing or controlled corporation's discussions with an acquirer regarding a post-distribution acquisition not involving a public offering or auction tend to show that the distribution and the acquisition are part of a plan.

One commentator suggested that the facts that tend to indicate that a distribution and an acquisition are part of a plan should not distinguish between an acquisition (other than an acquisition involving a public offering) that results from an auction and an acquisition (other than an acquisition involving a public offering) that does not result from an auction. In particular, the commentator asserted that although the factors might be weighted differently depending on the particular type of acquisition, in the context of both of these types of acquisitions, discussions with the acquirer regarding the acquisition are relevant to the determination of whether a distribution and an acquisition are part of a plan.

The IRS and Treasury believe that it is difficult to define an auction in a manner that identifies those situations to which it is appropriate to apply the special auction rules contained in the 2001 proposed regulations. For this reason, the revised temporary regulations eliminate the distinction between acquisitions (other than acquisitions involving a public offering) that result from an auction and acquisitions (other than acquisitions involving a public offering) that do not result from an auction. Accordingly, those facts and circumstances related to negotiations with the acquirer that evidence whether a post-distribution acquisition (other than an acquisition involving a public offering) that does not result from an auction is part of a plan are relevant to whether a post-distribution acquisition that results from an auction is part of a plan.

C. *Similar Acquisition*

As described above, the 2001 proposed regulations identify a number of facts and circumstances that are relevant for purposes of determining whether a distribution and an acquisition are part of a plan. In the case of an acquisition after a distribution, certain factors focus on whether certain persons engaged in discussions regarding the acquisition or a "similar acquisition" before the distribution. The 2001 proposed regulations provide that an acquisition and an intended acquisition may be similar even though the identity of the person acquiring stock of the distributing or controlled corporation, the timing of the acquisition or the terms of the actual acquisition are different from the intended acquisition.

Example 7 of the 2001 proposed regulations interprets the term *similar acquisition* in the context of multiple acquisitions following a distribution that was motivated by an acquisition business purpose. The example treats an acquisition where neither the distributing nor the controlled corporation had identified the acquirer prior to the distribution and another acquisition where the acquirer had been identified but not contacted regarding the acquisition prior to the distribution as similar to an acquisition that was in fact discussed with the acquirer prior to the distribution and that was consummated prior to these additional acquisitions. After analyzing the facts and circumstances, the example concludes that these additional acquisitions and the distribution are part of a plan.

A number of commentators asserted that the interpretation of the term plan in the 2001 proposed regulations is overly broad, principally as a result of the illustration of the scope of the term *similar acquisition* in *Example 7*. Some of these commentators suggested that the unilateral intentions of one party should not result in a distribution and an acquisition being treated as part of a plan, unless that party has the unilateral ability to control both the distribution and the acquisition. In the context of acquisitions other than public offerings, therefore, some of these commentators argued that a distribution and an acquisition should not be treated as part of a plan unless there is some objective evidence of a bilateral agreement regarding the significant economic terms of the acquisition.

In addition, while the comments generally reflected the view that an acquisition should not avoid being treated as part of a plan merely because the terms of the

specific acquisition intended at the time of the distribution were modified, some comments suggested that the term similar acquisition should be narrowed. For example, certain comments suggested that where there is a change in acquirer and the new acquirer is not related to the originally intended acquirer under section 267(b) or 707(b), the new acquisition should not be treated as similar to the originally intended acquisition.

Consistent with the comments' suggestions, the revised temporary regulations set forth a definition of *similar acquisition* that is narrower than the one set forth in the 2001 proposed regulations. The revised temporary regulations provide, in general, that an actual acquisition (other than a public offering or other stock issuance for cash) is similar to another potential acquisition if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business operations as the combination that would have been effected by such other potential acquisition. Further clarification is provided in the definition of *similar acquisition*, *Example 6*, and *Example 7* of the revised temporary regulations. The revised definition of *similar acquisition* (and the revisions to the plan and non-plan factors) have the effect of reversing the conclusion of *Example 7* of the 2001 proposed regulations that the additional acquisitions (*i.e.*, the Y and Z acquisitions) and the distribution are part of a plan.

D. *Substantial Negotiations*

In addition to the comments regarding the general approach of the 2001 proposed regulations, the IRS and Treasury received a number of technical comments regarding the 2001 proposed regulations. A number of commentators suggested that *substantial negotiations* be defined. The revised temporary regulations add a definition of *substantial negotiations* providing that, in the case of an acquisition other than a public offering, substantial negotiations 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 the distributing or controlled corporation, or another person or persons with the implicit or explicit permission of one or more officers, directors, or controlling shareholders of the distributing or controlled corporation, with the acquirer or a person or persons with the implicit or explicit permission of the acquirer. This definition is intended to clarify that both the content of, and persons engaging in, the discussions are probative of whether discussions are properly treated as substantial negotiations.

E. *Safe Harbors I and II*

Safe Harbors I and II of the 2001 proposed regulations provide certainty that a distribution and an acquisition occurring after the distribution will not be treated as part of a plan if, among other conditions, the acquisition occurs more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution. Safe Harbors I and II of the 2001 proposed regulations, therefore, are not available if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition at any time prior to the distribution. Commentators, however, suggested that not all pre-distribution substantial negotiations should prevent those Safe Harbors from being available. In particular, a number of commentators suggested that, even if the relevant parties engage in substantial negotiations regarding an acquisition prior to a distribution, provided that those negotiations terminate without agreement prior to the distribution and do not resume until 6 months or 1 year after the distribution, those substantial negotiations should not cause Safe Harbors I and II of the 2001 proposed regulations to be unavailable. After consideration of these comments, the IRS and Treasury have decided that an agreement, understanding, arrangement, or substantial negotiations concerning the acquisition should make Safe Harbors I and II unavailable only if such events exist or occur during the period that begins 1 year prior to the distribution and ends 6 months thereafter.

A number of commentators noted that Safe Harbors I and II of the 2001 proposed regulations would be available if there was an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition similar to another acquisition prior to the date that is 6 months after the distribution. At least one commentator suggested that these Safe Harbors should not be available in these circumstances. The IRS and Treasury agree and have modified those Safe Harbors accordingly.

Safe Harbor I of the 2001 proposed regulations states that it is only available if "[t]he distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate an acquisition of Distributing or Controlled." Commentators proposed that Safe Harbor I of the 2001 proposed regulations be modified so that in testing the qualification of an acquisition for the Safe Harbor, only acquisitive business purposes related to the acquired corporation should be relevant. Safe Harbor I of the revised temporary regulations reflects this comment.

Safe Harbor II of the 2001 proposed regulations is available only where (1) the amount of stock of the distributing corporation or the controlled corporation that is subject to an acquisition business purpose is not more than 33 percent of the distributing corporation or the controlled corporation; and (2) no more than 20 percent of the acquired corporation is acquired before a date that is 6 months after the distribution. Commentators suggested the elimination of one of the 2 prongs. Alternatively, they suggested increasing the percentage of stock in the second prong. One commentator also suggested that certain acquisitions that were not treated as part of a plan that includes a distribution be disregarded for purposes of the second prong.

To simplify Safe Harbor II of the 2001 proposed regulations, the revised temporary regulations eliminate the quantitative restriction of the first prong and increase the percentage of stock in the second prong to 25 percent. Furthermore, for purposes of the 25-percent test, only stock that is acquired or is the subject of an agreement, understanding, arrangement, or substantial negotiations at some time during the period that begins 1 year before the distribution and ends 6 months thereafter, other than stock that is acquired in a transaction described in Safe Harbor V, Safe Harbor VI, or new Safe Harbor VII, described below, of the revised temporary regulations, is counted.

F. *Safe Harbor V*

Subject to certain exceptions, Safe Harbor V of the 2001 proposed regulations provides that an acquisition of stock of the distributing or controlled corporation that is listed on an established market is not part of a plan if the acquisition occurs pursuant to a transfer between shareholders of the distributing corporation or the controlled corporation, neither of which is a 5-percent shareholder. Some commentators suggested that this Safe Harbor should be available for stock transfers between persons that do not actively participate in the management of the corporation, even if such persons are 5-percent shareholders. These commentators suggested that such acquisitions of stock are not part of a plan that includes a distribution. The IRS and Treasury generally agree that the trading activities of persons that do not actively participate in the management of the corporation should not cause an acquisition and a distribution to be treated as part of a plan. Accordingly, the revised temporary regulations extend the availability of Safe Harbor V to persons that are neither controlling shareholders nor 10-percent shareholders either immediately before or immediately after the transfer.

Finally, the IRS and Treasury have become aware of the proposed use of publicly-traded stock, the voting rights associated with which decrease upon certain transfers, in connection with acquisitions that are part of a plan that includes a distribution. Questions have been asked regarding whether acquisitions of stock that result from public trading between persons that are not 5-percent shareholders immediately before or immediately after the transfer are protected by Safe Harbor V, even where the transferee does not succeed to all of the voting rights exercisable by the transferor with respect to such stock.

Although the IRS and Treasury believe that Safe Harbor V may be available to prevent the acquisition of such stock that is listed on an established market from being treated as part of a plan, the revised temporary regulations clarify that, if Safe Harbor V applies to an acquisition of stock that is listed on an established market and that acquisition results in an indirect acquisition of voting power by a person other than the acquirer of such stock, Safe Harbor V does not prevent an acquisition of stock (with the voting power such stock represents after the acquisition to which Safe Harbor V applies) by such other person from being treated as part of a plan. New *Example 5* of the revised temporary regulations illustrates the application of Safe Harbor V of the revised temporary regulations and the plan and non-plan factors in the context of the public trading of stock, the relative voting power associated with which varies as a result of the trading.

G. *Safe Harbor VI and New Safe Harbor VII*

Safe Harbor VI of the 2001 proposed regulations generally applies to acquisitions of the stock of the distributing or controlled corporation "by an employee or director of Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A), in connection with the performance of services as an employee or director for the corporation or a person related to it under section 355(d)(7)(A)." One commentator suggested that Safe Harbor VI of the 2001 proposed regulations should be extended to stock acquired by independent contractors in connection with the performance of services and stock acquired pursuant to certain stock compensation plans. Another commentator suggested that Safe Harbor VI of the 2001 proposed regulations should not protect management leveraged buy-outs and going private transactions that are part of a plan that includes a distribution. Safe Harbor VI of the revised temporary regulations incorporates these comments and other technical comments received.

Commentators also suggested that Safe Harbor VI of the 2001 proposed regulations be extended to acquisitions of stock by qualified plans under section 401. In response to these commentators, the revised temporary regulations add new Safe Harbor VII. Subject to certain limitations, new Safe Harbor VII provides that acquisitions of stock of the distributing or controlled corporation by a retirement plan of an employer that qualifies under section 401(a) or 403(a) will not be treated as part of a plan that includes a distribution.

H. *Operating Rules*

1. *Reasonable certainty*

Under the 2001 proposed regulations, the fact that the distribution was motivated by a business purpose to facilitate the acquisition or a similar acquisition of the distributing or controlled corporation tends to show that a distribution and an acquisition are part of a plan. The 2001 proposed regulations provide that evidence of a business purpose to facilitate an acquisition after a distribution exists if, at the time of the distribution, there was "reasonable certainty" that, within six months after the distribution, an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition. In addition, the 2001 proposed regulations provide that in the case of an acquisition before a distribution, if at the time of the acquisition, it was reasonably certain that before a date that is 6 months after the acquisition the distribution would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding the distribution, the reasonable certainty is evidence of a business purpose to facilitate an acquisition. The IRS and Treasury received a number of comments regarding the reasonable certainty rule. The revised temporary regulations delete the reasonable certainty operating rules in light of the emphasis in the revised temporary regulations on discussions or an agreement, understanding, arrangement, or substantial negotiations regarding the first step before the second step.

2. *Substantial diminution of risk*

The 2001 proposed regulations contain an operating rule that suspends the running of any time period prescribed in the regulations during which risk of loss is diminished under the principles of section 355(d)(6)(B). Commentators questioned the proper application of this rule. In light of these comments, as stated above, the original temporary regulations reserve as to the substantial diminution of risk rule pending IRS and Treasury consideration of its proper application. Although the revised temporary regulations have eliminated the substantial diminution of risk

rule, the IRS and Treasury continue to consider its proper application.

I. *Options*

The 2001 proposed regulations provide that under certain circumstances, the acquisition of stock upon the exercise of an option, as that term is defined in the 2001 proposed regulations, may be treated as an agreement to acquire stock on the date the option was written, unless the distributing corporation establishes that on the later of the date of the stock distribution or the writing of the option, the option was not more likely than not to be exercised. Commentators suggested that, because an option may become more likely than not to be exercised for reasons other than the distribution, the date of the distribution should not be relevant in testing for the existence of a plan. Instead, the date the option is written, transferred or modified in a manner that materially increases the likelihood of exercise should be the relevant dates for purposes of determining whether an option is properly treated as an agreement to acquire stock. The revised temporary regulations modify the rule for determining whether and when an option will be treated as an agreement, understanding, or arrangement to acquire stock in a manner consistent with these comments and certain other technical comments received.

J. *Effective Date*

The revised temporary regulations are effective for distributions occurring after April 26, 2002. A number of commentators requested that taxpayers be permitted to rely on the 2001 proposed regulations for distributions occurring after April 16, 1997. In response to these comments, the revised temporary regulations permit taxpayers to apply the revised temporary regulations in whole, but not in part, to distributions occurring after April 16, 1997, and on or before April 26, 2002.

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these temporary regulations, and, because no preceding notice of proposed rulemaking is required for these temporary regulations, the provisions of the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Amber R. Cook. However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.355–7T also issued under 26 U.S.C. 355(e)(5). * * *

Par. 2. Section 1.355–0 is amended by revising the heading and the entry for § 1.355–7T to read as follows:

§ 1.355–0 Table of contents.

* * * * *

§ 1.355–7T Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

(a) In general.
(b) Plan.
(1) In general.
(2) Certain post-distribution acquisitions.
(3) Plan factors.
(4) Non-plan factors.
(c) Operating rules.
(1) Internal discussions and discussions with outside advisors evidence of business purpose.
(2) Takeover defense.
(3) Effect of distribution on trading in stock.
(4) Consequences of section 355(e) disregarded for certain purposes.
(5) Multiple acquisitions.
(d) Safe harbors.
(1) Safe Harbor I.
(2) Safe Harbor II.
(3) Safe Harbor III.
(4) Safe Harbor IV.
(5) Safe Harbor V.
(i) In general.
(ii) Special rules.
(6) Safe Harbor VI.
(i) In general.
(ii) Special rule.
(7) Safe Harbor VII.
(i) In general.
(ii) Special rule.
(e) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests.
(1) Treatment of options.
(i) General rule.
(ii) Agreement, understanding, or arrangement to write an option.
(iii) Substantial negotiations related to options.
(2) Instruments treated as options.
(3) Instruments generally not treated as options.
(i) Escrow, pledge, or other security agreements.
(ii) Compensatory options.
(iii) Options exercisable only upon death, disability, mental incompetency, or separation from service.
(iv) Rights of first refusal.
(v) Other enumerated instruments.
(f) Multiple controlled corporations.
(g) Valuation.
(h) Definitions.
(1) Agreement, understanding, arrangement, or substantial negotiations.
(2) Controlled corporation.
(3) Controlling shareholder.
(4) Coordinating group.
(5) Discussions.
(6) Established market.
(7) Five-percent shareholder.
(8) Similar acquisition.
(9) Ten-percent shareholder.
(i) [Reserved]
(j) Examples.
(k) Effective date.

Par. 3. Section 1.355–7T is revised to read as follows:

§ 1.355–7T Recognition of gain on certain distributions of stock or securities in connection with an acquisition.

(a) *In general*. Except as provided in section 355(e) and in this section, section 355(e) applies to any distribution—

(1) To which section 355 (or so much of section 356 as relates to section 355) applies; and

(2) That is part of a plan (or series of related transactions) (hereinafter, plan) pursuant to which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest in the distributing corporation (Distributing) or any controlled corporation (Controlled).

(b) *Plan*—(1) *In general*. Whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. The facts and circumstances to be considered in demonstrating whether a distribution and an acquisition are part of a plan include, but are not limited to, the facts and circumstances set forth in paragraphs (b)(3) and (4) of this section. In general, the weight to be given each of the facts and circumstances depends on the particular case. Whether a distribution and an acquisition are part of a plan does not depend on the relative number of facts and circumstances set forth in paragraph (b)(3) that evidence that a distribution and an acquisition are part of a plan as compared to the relative number of facts and circumstances set forth in paragraph (b)(4) that evidence that a distribution and an acquisition are not part of a plan.

(2) *Certain post-distribution acquisitions*. In the case of an acquisition (other than involving a public offering) after a distribution, the distribution and the acquisition can be part of a plan only 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. In the case of an acquisition (other than involving a public offering) after a distribution, the existence of 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 tends to show that the distribution and the acquisition are part of a plan. See paragraph (b)(3)(i) of this section. However, all facts and circumstances must be considered to determine whether the distribution and the acquisition are part of a plan. For example, in the case of an acquisition (other than involving a public offering) after a distribution, if the distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled (see paragraph (b)(4)(v) of this section) and would have occurred at approximately the same time and in similar form regardless of whether the acquisition or a similar acquisition was effected (see paragraph (b)(4)(vi) of this section), the taxpayer may be able to establish that the distribution and the acquisition are not part of a plan.

(3) *Plan factors*. Among the facts and circumstances tending to show that a distribution and an acquisition are part of a plan are the following:

(i) 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. The weight to be accorded this fact depends on the nature, extent, and timing of the agreement, understanding, arrangement, or substantial negotiations. The existence of an agreement, understanding, or arrangement at the time of the distribution is given substantial weight.

(ii) 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. The weight to be accorded this fact depends on the nature, extent, and timing of the discussions.

(iii) 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. The weight to be accorded this fact depends on the nature, extent, and timing of the discussions. In addition, in the case of an acquisition (other than involving a public offering) before a distribution where 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.

(iv) 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. The weight to be accorded this fact depends on the nature, extent, and timing of the discussions.

(v) 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.

(4) *Non-plan factors*. Among the facts and circumstances tending to show that a distribution and an acquisition are not part of a plan are the following:

(i) 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.

(ii) In the case of an acquisition 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.

(iii) 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. This paragraph (b)(4)(iii) does not apply if the acquisition occurred after the date of the public announcement of the planned distribution. In addition, this paragraph (b)(4)(iii) does not apply in the case of an acquisition where 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.

(iv) In the case of an acquisition before a distribution, there was an identifiable, unexpected change in market or business conditions occurring after the acquisition that resulted in a distribution that was otherwise unexpected.

(v) 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 (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition.

(vi) 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.

(c) *Operating rules*. The operating rules contained in this paragraph (c) apply for all purposes of this section.

(1) *Internal discussions and discussions with outside advisors evidence of business purpose*. Internal discussions and discussions with outside advisors by or on behalf of officers or directors of Distributing or Controlled may be indicative of one or more business purposes for the distribution and the relative importance of such purposes.

(2) *Takeover defense*. If Distributing engages in discussions with a potential acquirer regarding an acquisition of Distributing or Controlled and distributes Controlled stock intending, in whole or substantial part, to decrease the likelihood of the acquisition of Distributing or Controlled by separating it from another corporation that is likely to be acquired, Distributing will be treated as having a business purpose to facilitate the acquisition of the corporation that was likely to be acquired.

(3) *Effect of distribution on trading in stock*. The fact that the distribution made all or a part of the stock of Controlled available for trading or made Distributing's or Controlled's stock trade more actively is not taken into account in determining whether the distribution and an acquisition of Distributing or Controlled stock were part of a plan.

(4) *Consequences of section 355(e) disregarded for certain purposes*. For purposes of determining the intentions of the relevant parties under this section, the consequences of the application of section 355(e), and the existence of any contractual indemnity by Controlled for tax resulting from the application of section 355(e) caused by an acquisition of Controlled, are disregarded.

(5) *Multiple acquisitions*. All acquisitions of stock of Distributing or Controlled that are considered to be part of a plan with a distribution pursuant to paragraph (b) of this section will be aggregated for purposes of the 50–percent test of paragraph (a)(2) of this section.

(d) *Safe harbors*—(1) *Safe Harbor I*. A distribution and an acquisition occurring after the distribution will not be considered part of a plan if—

(i) The distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of § 1.355–2(b)), other than a business purpose to facilitate an acquisition of the acquired corporation (Distributing or Controlled); and

(ii) 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.

(2) *Safe Harbor II*. (i) A distribution and an acquisition occurring after the distribution will not be considered part of a plan if—

(A) The distribution was not motivated by a business purpose to facilitate the acquisition or a similar acquisition;

(B) 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

(C) No more than 25 percent of the stock of the acquired corporation (Distributing or Controlled) 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.

(ii) For purposes of paragraph (d)(2)(i)(C) of this section, acquisitions of stock that are treated as not part of a plan pursuant to Safe Harbor V, Safe Harbor VI, or Safe Harbor VII are disregarded.

(3) *Safe Harbor III*. If an acquisition occurs after a distribution, there was no agreement, understanding, or arrangement concerning the acquisition or a similar acquisition at the time of the distribution, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition or a similar acquisition within 1 year after the distribution, the acquisition and the distribution will not be considered part of a plan.

(4) *Safe Harbor IV*. If a 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, the acquisition and the distribution will not be considered part of a plan.

(5) *Safe Harbor V*—(i) *In general*. An acquisition of Distributing or Controlled stock that is listed on an established market is not part of a plan if, immediately before or immediately after the transfer, none of the transferor, the transferee, and any coordinating group of which either the transferor or the transferee is a member is—

(A) the acquired corporation (Distributing or Controlled);

(B) a corporation that the acquired corporation (Distributing or Controlled) controls within the meaning of section 368(c);

(C) a member of a controlled group of corporations within the meaning of section 1563 of which the acquired corporation (Distributing or Controlled) is a member;

(D) an underwriter with respect to such acquisition;

(E) a controlling shareholder of the acquired corporation (Distributing or Controlled); or

(F) a 10-percent shareholder of the acquired corporation (Distributing or Controlled).

(ii) *Special rules*. (A) This paragraph (d)(5) does not apply to a transfer of stock by or to a person if the corporation the stock of which is being transferred knows, or has reason to know, that the person or a coordinating group of which

such person is a member intends to become a controlling shareholder or a 10-percent shareholder of the acquired corporation (Distributing or Controlled) at any time after the acquisition and before the date that is 2 years after the distribution.

(B) If a transfer of stock to which this paragraph (d)(5) applies results immediately, or upon a subsequent event or the passage of time, in an indirect acquisition of voting power by a person other than the transferee, this paragraph (d)(5) does not prevent an acquisition of stock (with the voting power such stock represents after the transfer to which this paragraph (d)(5) applies) by such other person from being treated as part of a plan.

(6) *Safe Harbor VI*—(i) *In general*. If stock of Distributing or Controlled is acquired by a person in connection with such person's performance of services as an employee, director, or independent contractor for Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) in a transaction to which section 83 or section 421(a) applies, the acquisition and the distribution will not be considered part of a plan.

(ii) *Special rule*. This paragraph (d)(6) does not apply to a stock acquisition described in (d)(6)(i) if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a 10-percent shareholder of the acquired corporation (Distributing or Controlled) immediately after the acquisition.

(7) *Safe Harbor VII*—(i) *In general*. If stock of Distributing or Controlled is acquired by a retirement plan of an employer that qualifies under section 401(a) or 403(a), the acquisition and the distribution will not be considered part of a plan.

(ii) *Special rule*. This paragraph (d)(7) does not apply to stock acquisitions described in (d)(7)(i) of this section to the extent that the stock acquired pursuant to such acquisitions by all of the qualified plans of the employer described in paragraph (d)(7)(i) of this section, and any other person treated as the same employer as that described in paragraph (d)(7)(i) of this section under section 414(b), (c), (m), or (o), during the 4-year period beginning 2 years before the distribution, in the aggregate, represents 10 percent or more of the total combined voting power of all classes of stock entitled to vote, or 10 percent or more of the total value of shares of all classes of stock, of the acquired corporation (Distributing or Controlled).

(e) *Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests*—(1) *Treatment of options*—(i) *General rule*. For purposes of this section, if stock of Distributing or Controlled is acquired pursuant to an option, the option will be treated as an agreement, understanding, or arrangement to acquire the stock on the earliest of the following dates: the date that the option is written, if the option was more likely than not to be exercised as of such date; the date that the option is transferred, if the option was more likely than not to be exercised as of such date; and the date that the option is modified in a manner that materially increases the likelihood of exercise, if the option was more likely than not to be exercised as of such date; provided, however, if the writing, transfer, or modification had a principal purpose of avoiding section 355(e), the option will be treated as an agreement, understanding, arrangement, or substantial negotiations to acquire the stock on the date of the distribution. The determination of whether an option was more likely than not to be exercised is based on all the facts and circumstances, taking control premiums and minority and blockage discounts into account in determining the fair market value of stock underlying an option.

(ii) *Agreement, understanding, or arrangement to write an option*. If there is an agreement, understanding, or arrangement to write an option, the option will be treated as written on the date of the agreement, understanding, or arrangement.

(iii) *Substantial negotiations related to options*. If an option is treated as an agreement, understanding, or arrangement to acquire the stock on the date that the option is written, substantial negotiations to acquire the option will be treated as substantial negotiations to acquire the stock subject to such option. If an option is treated as an agreement, understanding, or arrangement to acquire the stock on the date that the option is transferred, substantial negotiations regarding the transfer of the option will be treated as substantial negotiations to acquire the stock subject to such option. If an option is treated as an agreement, understanding, or arrangement to acquire the stock on the date that the option is modified in a manner that materially increases the likelihood of exercise, substantial negotiations regarding such modifications to the option will be treated as substantial negotiations to acquire the stock subject to such option.

(2) *Instruments treated as options*. For purposes of this paragraph (e), except to the extent provided in paragraph (e)(3) of this section, call options, warrants, convertible obligations, the conversion feature of convertible stock, put options, redemption agreements (including rights to cause the redemption of stock), any other instruments that provide for the right or possibility to issue, redeem, or transfer stock (including an option on an option), or any other similar interests are treated as options.

(3) *Instruments generally not treated as options*. For purposes of this paragraph (e), the following are not treated as options unless (in the case of paragraphs (e)(3)(i), (iii), and (iv) of this section) written, transferred (directly or indirectly), modified, or listed with a principal purpose of avoiding the application of section 355(e) or this section.

(i) *Escrow, pledge, or other security agreements*. An option that is part of a security arrangement in a typical lending transaction (including a purchase money loan), if the arrangement is subject to customary commercial conditions. For this purpose, a security arrangement includes, for example, an agreement for holding stock in escrow or under a pledge or other security agreement, or an option to acquire stock contingent upon a default under a loan.

(ii) *Compensatory options*. An option to acquire stock in Distributing or Controlled with customary terms and conditions provided to a person in connection with such person's performance of services as an employee, director, or independent contractor for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), provided that—

(A) The transfer of stock pursuant to such option is described in section 421(a); or

(B) The option is nontransferable within the meaning of § 1.83–3(d) and does not have a readily ascertainable fair market value as defined in § 1.83–7(b).

(iii) *Options exercisable only upon death, disability, mental incompetency, or separation from service*. Any option entered into between shareholders of a corporation (or a shareholder and the corporation) that is exercisable only upon the death, disability, or mental incompetency of the shareholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), the shareholder's separation from service.

(iv) *Rights of first refusal*. A *bona fide* right of first refusal regarding the corporation's stock with customary terms, entered into between shareholders of a corporation (or between the corporation and a shareholder).

(v) *Other enumerated instruments*. Any other instrument the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(f) *Multiple controlled corporations*. Only the stock or securities of a controlled corporation in which 1 or more persons acquire directly or indirectly stock representing a 50-percent or greater interest as part of a plan involving the distribution of that corporation will be treated as not qualified property under section 355(e)(1) if—

(1) The stock or securities of more than 1 controlled corporation are distributed in distributions to which section 355 (or so much of section 356 as relates to section 355) applies; and

(2) One or more persons do not acquire, directly or indirectly, stock representing a 50-percent or greater interest in Distributing pursuant to a plan involving any of those distributions.

(g) *Valuation*. Except as provided in paragraph (e)(1)(i) of this section, for purposes of section 355(e) and this section, all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(h) *Definitions*—(1) *Agreement, understanding, arrangement, or substantial negotiations*. (i) Whether an agreement, understanding, or arrangement exists depends on the facts and circumstances. The parties do not necessarily have to have entered into a binding contract or have reached agreement on all significant economic terms to have an agreement, understanding, or arrangement. However, an agreement, understanding, or arrangement clearly exists if a binding contract to acquire stock exists.

(ii) Substantial negotiations in the case of an acquisition (other than involving a public offering) 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.

(iii) 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.

(2) *Controlled corporation*. For purposes of this section, a controlled corporation is a corporation the stock of which is distributed in a distribution to which section 355 (or so much of section 356 as relates to section 355) applies.

(3) *Controlling shareholder*. (i) 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. For purposes of this paragraph (h)(3)(i), a corporate director will be treated as actively participating in the management of the corporation.

(ii) A controlling shareholder of a corporation the stock of which is not listed on an established market is any person that owns, actually or constructively under the rules of section 318, stock possessing voting power representing a meaningful voice in the governance of the corporation.

(iii) For purposes of this section, a person is a controlling shareholder if that person meets the definition of controlling shareholder in this paragraph (h)(3) immediately before or immediately after the acquisition being tested.

(iv) If a distribution precedes an acquisition, Controlled's controlling shareholders immediately after the distribution and Distributing are included among Controlled's controlling shareholders at the time of the distribution.

(4) *Coordinating group*. A coordinating group includes 2 or more persons that, pursuant to a formal or informal understanding, join in one or more coordinated acquisitions or dispositions of stock of Distributing or Controlled. A principal element in determining if such an understanding exists is whether the investment decision of each person is based on the investment decision of one or more other existing or prospective shareholders. A coordinating group is treated as a single shareholder for purposes of determining whether the coordinating group is treated as a controlling shareholder or a 10-percent shareholder.

(5) *Discussions*. Discussions by Distributing or Controlled generally require 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. Discussions with the acquirer generally require discussions with the acquirer or a person or persons with the implicit or explicit permission of the acquirer.

(6) *Established market*. An established market is—

(i) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(ii) An interdealer quotation system sponsored by a national securities association registered under section 15A of the Securities Act of 1934 (15 U.S.C. 78o–3); or

(iii) Any additional market that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(7) *Five-percent shareholder*. A person will be considered a 5-percent shareholder of a corporation the stock of which is listed on an established market if the person owns, actually or constructively under the rules of section 318, 5 percent or more of any class of stock of the corporation whose stock is transferred. A person is a 5-percent shareholder if the person meets the requirements described above immediately before or immediately after the transfer. All options owned by a person are treated as exercised for the purpose of determining whether such person is a 5-percent shareholder. Absent actual knowledge that a person is a 5-percent shareholder, a corporation can rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its 5-percent shareholders.

(8) *Similar acquisition*. In general, an actual acquisition (other than a public offering or other stock issuance for cash) is similar to another potential acquisition if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business operations as the combination that would have been effected by such other potential acquisition. Thus, an actual acquisition may be similar to another acquisition even if the timing or terms of the actual acquisition are different from the timing or terms of the other acquisition. For example, an actual acquisition of Distributing by shareholders of another corporation in connection with a merger of such other corporation with and into Distributing is similar to another acquisition of Distributing by merger into such other corporation or into a subsidiary of such other corporation. However, in general, an actual acquisition (other than a public offering or other stock issuance for cash) is not similar to another acquisition if the ultimate owners of the business operations with which Distributing or Controlled is combined in the actual acquisition are substantially different from the ultimate owners of the business operations with which Distributing or Controlled was to be combined in such other acquisition. 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.

(9) *Ten-percent shareholder*. A person will be considered a 10-percent shareholder of a corporation the stock of which is listed on an established market if the person owns, actually or constructively under the rules of section 318, 10 percent or more of any class of stock of the corporation whose stock is transferred. A person will be considered a 10-percent shareholder of a corporation the stock of which is not listed on an established market if the person owns, actually or constructively under the rules of section 318, stock possessing 10 percent or more of the total voting power of the stock of the corporation whose stock is transferred or stock having a value equal to 10 percent or more of the total value of the stock of the corporation whose stock is transferred. A person is a 10-percent shareholder if the person meets the requirements described above immediately before or immediately after the transfer. All options owned by a person are treated as exercised for the purpose of determining whether such person is a 10-percent shareholder. Absent actual knowledge that a person is a 10-percent shareholder, a corporation the stock of which is listed on an established market can rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its 10-percent shareholders.

(i) [Reserved]

(j) *Examples*. The following examples illustrate paragraphs (a) through (h) of this section. Throughout these examples, assume that Distributing (D) owns all of the stock of Controlled (C). Assume further that D distributes the stock of C in a distribution to which section 355 applies and to which section 355(d) does not apply. Unless otherwise stated, assume the corporations do not have controlling shareholders. No inference should be drawn from any example concerning whether any requirements of section 355 other than those of section 355(e) are satisfied. The examples are as follows:

Example 1. Unwanted assets. (i) D is in business 1. C is in business 2. D is relatively small in its industry. D wants to combine with X, a larger corporation also engaged in business 1. X and D begin negotiating for X to acquire D, but X does not want to acquire C. To facilitate the acquisition of D by X, D agrees to distribute all the stock of C *pro rata* before the acquisition. Prior to the distribution, D and X enter into a contract for D to merge into X subject to several conditions. One month after D and X enter into the contract, D distributes C and, on the day after the distribution, D merges into X. As a result of the merger, D's former shareholders own less than 50 percent of the stock of X.

(ii) The issue is whether the distribution of C and the merger of D into X are part of a plan. No Safe Harbor applies to this acquisition. To determine whether the distribution of C and the merger of D into X are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (b) of this section.

(iii) The following tends to show that the distribution of C and the merger of D into X are part of a plan: X and D had an agreement regarding the acquisition during the 2-year period ending on the date of the distribution (paragraph (b)(3)(i) of this section), and the distribution was motivated by a business purpose to facilitate the merger (paragraph (b)(3)(v) of this section). Because the merger was agreed to at the time of the distribution, the fact described in paragraph (b)(3)(i) of this section is given substantial weight.

(iv) None of the facts and circumstances listed in paragraph (b)(4) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(v) The distribution of C and the merger of D into X are part of a plan under paragraph (b) of this section.

Example 2. Public offering. (i) D's managers, directors, and investment banker discuss the possibility of offering D stock to the public. They decide a public offering of 20 percent of D's stock with D as a stand alone corporation would be in D's best interest. One month later, to facilitate a stock offering by D of 20 percent of its stock, D distributes all the stock of C *pro rata* to D's shareholders. D issues new shares amounting to 20 percent of its stock to the public in a public offering 7 months after the distribution.

(ii) The issue is whether the distribution of C and the public offering by D are part of a plan. No Safe Harbor applies to this acquisition. Safe Harbor V, relating to public trading, does not apply to public offerings (see paragraph (d)(5)(i)(A) of this section). To determine whether the distribution of C and the public offering by D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (b) of this section.

(iii) The following tends to show that the distribution of C and the public offering by D are part of a plan: D discussed the public offering with its investment banker during the 2-year period ending on the date of the distribution (paragraph (b)(3)(ii) of this section), and the distribution was motivated by a business purpose to facilitate the public offering (paragraph (b)(3)(v) of this section).

(iv) None of the facts and circumstances listed in paragraph (b)(4) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(v) The distribution of C and the public offering by D are part of a plan under paragraph (b) of this section.

Example 3. Hot market. (i) D is a widely-held corporation the stock of which is listed on an established market. D announces a distribution of C and distributes C *pro rata* to D's shareholders. By contract, C agrees to indemnify D for any imposition of tax under section 355(e) caused by the acts of C. The distribution is motivated by a desire to improve D's access to financing at preferred customer interest rates, which will be more readily available if D separates from C. At the time of the distribution, although neither D nor C has been approached by any potential acquirer of C, it is reasonably certain that soon after the distribution either an acquisition of C will occur or there will be an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition of C. Corporation Y acquires C in a merger described in section 368(a)(2)(E) within 6 months after the distribution. The C shareholders receive less than 50 percent of the stock of Y in the exchange.

(ii) The issue is whether the distribution of C and the acquisition of C by Y are part of a plan. No Safe Harbor applies to this acquisition. Under paragraph (b)(2) of this section, because prior to the distribution neither D nor C and Y had an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition, the distribution of C by D and the acquisition of C by Y are not part of a plan under paragraph (b) of this section.

Example 4. Unexpected opportunity. (i) D, the stock of which is listed on an established market, announces that it will distribute all the stock of C *pro rata* to D's shareholders. At the time of the announcement, the distribution is motivated wholly by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate an acquisition. After the announcement but before the distribution, widely-held X becomes available as an acquisition target. There were no discussions between D or C and X before the announcement. D negotiates with and acquires X before the distribution. After the acquisition, X's former shareholders own 55 percent of D's stock. D distributes the stock of C *pro rata* within 6 months after the acquisition of X.

(ii) The issue is whether the acquisition of X by D and the distribution of C are part of a plan. No Safe Harbor applies to this acquisition. To determine whether the acquisition of X by D and the distribution of C are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (b) of this section.

(iii) Depending on whether a person other than D or C intends to cause a distribution and, as a result of the acquisition, can meaningfully participate in the decision regarding whether to cause a distribution, the fact described in (b)(3)(iii) of this section, tending to show that a distribution and an acquisition are part of a plan, may exist in this case.

(iv) Under paragraph (b)(4) of this section, D would assert that the following tends to show that the distribution of C and the acquisition of X by D are not part of a plan: the distribution was motivated by a corporate business purpose (within the meaning of § 1.355–2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition (paragraph (b)(4)(v) of this section), and the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition or a similar acquisition (paragraph (b)(4)(vi) of this section). That D decided to distribute C and announced that decision before it became aware of the opportunity to acquire X suggests that the distribution would have occurred at approximately the same time and in similar form regardless of D's acquisition of X or a similar acquisition. X's lack of participation in the decision to distribute C, even though the X shareholders may have been able to prevent a distribution of C, also helps establish that fact.

(v) In determining whether the distribution of C and acquisition of X by D are part of a plan, one should consider the importance of D's business purpose for the distribution in light of D's opportunity to acquire X. If D can establish that the distribution continued to be motivated by the stated business purpose, and if D would have distributed C regardless of D's acquisition of X, then D's acquisition of X and D's distribution of C are not part of a plan under paragraph (b) of this section.

Example 5. Vote shifting transaction. (i) D is in business 1. C is in business 2. D wants to combine with X, a larger corporation also engaged in business 1. The stock of X is closely held. X and D begin negotiating for D to acquire X, but the X shareholders do not want to acquire an indirect interest in C. To facilitate the acquisition of X by D, D agrees to distribute all the stock of C *pro rata* before the acquisition of X. D and X enter into a contract for X to merge into D subject to several conditions. Among those conditions is that D will amend its corporate charter to provide for 2 classes of stock: Class A and Class B. Under all circumstances, each share of Class A stock will be entitled to 10 votes in the election of each director on D's board of directors. Upon issuance, each share of Class B stock will be entitled to 10 votes in the election of each director on D's board of directors; however, a disposition of such share by its original holder will result in such share being entitled to only 1 vote, rather than 10 votes, in the election of each director. Immediately after the merger, the Class B shares will be listed on an established market. One month after D and X enter into the contract, D distributes C. Immediately after the distribution, the shareholders of D exchange their D stock for the new Class B shares. On the day after the distribution, X merges into D. In the merger, the former shareholders of X exchange their X stock for Class A shares of D. Immediately after the merger, D's historic shareholders own stock of D representing 51 percent of the total combined voting power of all classes of stock of D entitled to vote. During the 30-day period following the merger, none of the Class A shares are transferred, but a number of D's historic shareholders sell their Class B stock of D in public trading with the result that, at the end of that 30-day period, the Class A shares owned by the former X shareholders represent 52 percent of the total combined voting power of all classes of stock of D entitled to vote.

(ii) *X acquisition.* (A) The issue is whether the distribution of C and the merger of X into D are part of a plan. No Safe Harbor applies to this acquisition. To determine whether the distribution of C and the merger of X into D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (b) of this section.

(B) The following tends to show that the distribution of C and the merger of X into D are part of a plan: X and D had an agreement regarding the acquisition during the 2-year period ending on the date of the distribution (paragraph (b)(3)(i) of this section), and the distribution was motivated by a business purpose to facilitate the merger (paragraph (b)(3)(v) of this section). Because the merger was agreed to at the time of the distribution, the fact described in paragraph (b)(3)(i) of this section is given substantial weight.

(C) None of the facts and circumstances listed in paragraph (b)(4) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(D) The distribution of C and the merger of X into D are part of a plan under paragraph (b) of this section.

(iii) *Public trading of Class B shares*. (A) Assuming that each of the transferors and the transferees of the Class B stock of D in public trading is not one of the prohibited transferors or transferees listed in paragraph (d)(5)(i), Safe Harbor V will apply to the acquisitions of the Class B stock during the 30-day period following the merger such that the distribution and those acquisitions will not be treated as part of the plan. However, to the extent that those acquisitions result in an indirect acquisition of voting power by a person other than the acquirer of the transferred stock, Safe Harbor V does not prevent the acquisition of the D stock (with the voting power such stock represents after those acquisitions) by the former X shareholders from being treated as part of a plan.

(B) To the extent that the transfer of the Class B shares causes the voting power of D to shift to the Class A stock acquired by the former X shareholders, such shifted voting power will be treated as attributable to the stock acquired by the former X shareholders as part of the plan that includes the distribution and the X acquisition.

Example 6. Acquisition that is not similar. (i) D, X, and Y are each corporations the stock of which is publicly traded and widely held. Each of D, X, and Y are engaged in the manufacture and sale of trucks. C is engaged in the manufacture and sale of buses. D and X engage in substantial negotiations concerning X's acquisition of the stock of D from the D shareholders in exchange for stock of X. D and X do not reach an agreement regarding that acquisition. Three months after D and X first began negotiations regarding that acquisition, D distributes the stock of C *pro rata* to its shareholders. Three months after the distribution, Y acquires the stock of D from the D shareholders in exchange for stock of Y.

(ii) Although both X and Y engage in the manufacture and sale of trucks, X's truck business and Y's truck business are not the same business operations. Therefore, because Y's acquisition of D does not effect a combination of the same business operations as X's acquisition of D would have effected, Y's acquisition of D is not similar to X's potential acquisition of D that was the subject of earlier negotiations.

Example 7. Acquisition that is similar. (i) D is engaged in the business of writing custom software for several industries (industries 1 through 6). The software business of D related to industries 4, 5, and 6 is significant relative to the software business of D related to industries 3, 4, 5, and 6. X, an unrelated corporation, is engaged in the business of writing software and the business of manufacturing and selling hardware devices. X's business of writing software is significant relative to its total businesses. X and D engage in substantial negotiations regarding X's acquisition of D stock from the D shareholders in exchange for stock of X. Because X does not want to acquire the software businesses related to industries 1 and 2, these negotiations relate to an acquisition of D stock where D owns the software businesses related only to industries 3, 4, 5, and 6. Thereafter, D concludes that the intellectual property licenses central to the software business related to industries 1 and 2 are not transferable and that a separation of the software business related to industry 3 from the software business related to industry 2 is not desirable. One month after D begins negotiating with X, D contributes the software businesses related to industries 4, 5, and 6 to C, and distributes the stock of C *pro rata* to its shareholders. In addition, X sells its hardware businesses for cash. After the distribution, C and X negotiate for X's acquisition of the C stock from the C shareholders in exchange for X stock, and X acquires the stock of C.

(ii) Although D and C are different corporations, C does not own the custom software business related to industry 3, and X sold its hardware business prior to the acquisition of C, because X's acquisition of C involves a combination of a significant portion of the same business operations as the combination that would have been effected by the acquisition of D that was the subject of negotiations between D and X, X's acquisition of C is the same as or similar to X's potential acquisition of D that was the subject of earlier negotiations.

(k) *Effective dates.* This section applies to distributions occurring after April 26, 2002. Taxpayers, however, may apply these regulations in whole, but not in part, to a distribution occurring after April 16, 1997, and on or before April 26, 2002. For distributions occurring after August 3, 2001, and on or before April 26, 2002, with respect to which a taxpayer chooses not to apply these regulations, see § 1.355–7T as in effect prior to April 26, 2002 (see 26 CFR part 1 revised April 1, 2002).

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved April 15, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on April 23, 2002, 12:14 p.m., and published in the issue of the Federal Register for April 26, 2002, 67 F.R. 20632)