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**Note 1:** The subject of this AD is addressed in Swedish airworthiness directive 1-170, dated December 17, 2001.

#### Effective Date

(e) This amendment becomes effective on May 24, 2005.

Issued in Renton, Washington, on April 11, 2005.

**Ali Bahrami,**

*Manager, Transport Airplane Directorate,  
Aircraft Certification Service.*

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## DEPARTMENT OF THE TREASURY

### Internal Revenue Service

#### 26 CFR Part 1

[TD 9198]

**RIN 1545-AY42**

#### **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:** Final regulations and removal of temporary regulations.

**SUMMARY:** This document contains final regulations under section 355(e) of the Internal Revenue Code relating to the 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 regulations affect corporations and are necessary to provide them with guidance needed to comply with those changes.

**DATES:** *Effective Date:* These regulations are effective April 19, 2005.

*Applicability Date:* For dates of applicability, see § 1.355-7(k).

**FOR FURTHER INFORMATION CONTACT:** Amber R. Cook, (202) 622-7530 (not a toll-free number).

**SUPPLEMENTARY INFORMATION:**

#### **Background and Explanation of Provisions**

This document contains amendments to 26 CFR part 1 under section 355(e) of the Internal Revenue Code (Code). Section 355(e) 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.”

On April 26, 2002, temporary regulations (TD 8988) (the 2002 temporary regulations) were published in the **Federal Register** (67 FR 20632). The 2002 temporary regulations provide guidance concerning the interpretation of the phrase “plan (or series of related transactions).” A notice of proposed rulemaking (REG-163892-01) (the 2002 proposed regulations) cross-referencing the 2002 temporary regulations was published in the **Federal Register** for the same day (67 FR 20711).

The 2002 temporary regulations provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances and set forth a nonexclusive list of factors that are relevant in making that determination. The 2002 temporary regulations also provide that a distribution and a post-distribution acquisition not involving a public offering 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 two-year period preceding the distribution (the post-distribution acquisition rule). Finally, the 2002 temporary regulations set forth seven safe harbors. The satisfaction of any one of these safe harbors confirms that a distribution and an acquisition are not part of a plan.

No public hearing was requested or held for the 2002 proposed regulations. Written and electronic comments responding to the notice of proposed rulemaking were received. After consideration of the comments, the 2002 proposed regulations are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed. The more significant comments and revisions are discussed below.

#### *A. Pre-Distribution Acquisitions Not Involving a Public Offering*

The 2002 temporary regulations include a safe harbor, Safe Harbor IV, that may be available for a pre-distribution acquisition. That safe harbor provides that an acquisition and a distribution that occurs more than two years after the acquisition are not part of a plan if there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within six months thereafter. In addition to Safe Harbor IV, the 2002 temporary regulations identify a number of factors that are relevant in determining whether a distribution and a pre-distribution acquisition not involving a public offering are part of a plan. Among the factors tending to show that a distribution and a pre-distribution acquisition not involving a public offering are not part of a plan is the absence of discussions by the distributing corporation (Distributing) or the controlled corporation (Controlled) with the acquirer regarding a distribution during the two-year period before the acquisition (the no-discussions factor). The absence of such discussions, however, will not tend to show that a distribution and an acquisition are not part of a plan if the acquisition occurs after the date of the public announcement of the planned distribution (the public announcement restriction).

Commentators have suggested that, under the 2002 temporary regulations, it is more difficult to establish that a distribution and a pre-distribution acquisition not involving a public offering are not part of a plan than it is to establish that a distribution and a post-distribution acquisition are not part of a plan. This suggestion is based in part on the fact that the 2002 temporary regulations include the post-distribution acquisition rule for post-distribution acquisitions but no analogous rule for pre-distribution acquisitions.

Commentators have proposed extending the availability of Safe Harbor IV by reducing the period between the acquisition and the distribution from two years to one year. They have also suggested adopting a new safe harbor that would be available for acquisitions of Distributing that occur before a pro rata distribution. Finally, commentators have suggested that the public announcement restriction on the no-discussions factor be eliminated because a public announcement, as a practical matter, commits Distributing to attempt the distribution and, thus, is strong evidence that the distribution would

have occurred regardless of the acquisition.

The IRS and Treasury Department believe that it is desirable to provide for additional bright-line rules for determining whether a distribution and a pre-distribution acquisition not involving a public offering are part of a plan. Accordingly, these final regulations amend Safe Harbor IV, add a new safe harbor for acquisitions of Distributing prior to a pro rata distribution, and amend the no-discussions factor.

#### 1. Revisions to Safe Harbor IV of the 2002 Temporary Regulations

The IRS and Treasury Department generally believe that if an acquirer had no knowledge of Distributing's intention to effect a distribution and had no intention or ability to cause a distribution, a pre-distribution acquisition and a distribution should not be considered part of a plan, regardless of whether the distribution occurs more than two years after the acquisition. The IRS and Treasury Department, however, are concerned that conditioning the availability of a safe harbor on an absence of knowledge may be inadministrable and lead to uncertainty. Accordingly, these final regulations amend Safe Harbor IV of the 2002 temporary regulations to provide that a distribution and a pre-distribution acquisition not involving a public offering will not be considered part of a plan if the acquisition occurs before the first disclosure event regarding the distribution. The final regulations define a disclosure event as any communication by an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor of any of those persons (where such advisor makes the communication on behalf of such person), regarding the distribution, or the possibility thereof, to the acquirer or any other person (other than an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor of any of those persons).

To ensure that Safe Harbor IV of the 2002 temporary regulations is not available for acquisitions by persons who could participate in the decision to effect a distribution, these final regulations provide that Safe Harbor IV is not available for acquisitions by a person that was a controlling shareholder or a ten-percent shareholder of the acquired corporation at any time during the period beginning

immediately after the acquisition and ending on the date of the distribution. The safe harbor is also unavailable if the acquisition occurs in connection with a transaction in which the aggregate acquisitions represent 20 percent or more of the stock of the acquired corporation by vote or value.

#### 2. New Safe Harbor for Acquisitions Before a Pro Rata Distribution

The IRS and Treasury Department believe that acquisitions of Distributing not involving a public offering that occur before a pro rata distribution are not likely to be part of a plan including the distribution where there has been a public announcement of the distribution prior to the acquisition, there were no discussions regarding the acquisition prior to the public announcement, and the acquirer did not have the ability to participate in or influence the distribution decision. The facts that the distribution was publicly announced prior to discussions regarding the acquisition and that the acquisition was small in size suggest that the distribution would have occurred regardless of the acquisition. Moreover, the fact that a pre-distribution shareholder of Distributing has the same interest in both Distributing and Controlled, directly or indirectly, both immediately before and immediately after a pro rata distribution reduces the likelihood that the acquisition and the distribution were part of a plan. Accordingly, these final regulations include a new safe harbor, Safe Harbor V, that applies to acquisitions of Distributing not involving a public offering that occur prior to a pro rata distribution. That safe harbor provides that a distribution that is pro rata among the Distributing shareholders and a pre-distribution acquisition of Distributing not involving a public offering will not be considered part of a plan if the acquisition occurs after the date of a public announcement regarding the distribution and there were no discussions by Distributing or Controlled with the acquirer regarding a distribution on or before the date of the first public announcement regarding the distribution. A public announcement regarding the distribution is any communication by Distributing or Controlled regarding Distributing's intention to effect the distribution where the communication is generally available to the public. A public announcement includes, for example, a press release issued by Distributing announcing the distribution. It also includes a conversation between an officer of Distributing and stock analysts in which the officer communicates

Distributing's intention to effect a distribution. New Safe Harbor V is intended to apply only to acquisitions by persons that do not have the ability to effect the distribution. Therefore, new Safe Harbor V is unavailable for acquisitions by persons that were controlling shareholders or ten-percent shareholders of Distributing at any time during the period beginning immediately after the acquisition and ending on the date of the distribution. In addition, new Safe Harbor V is unavailable if the acquisition occurs in connection with a transaction in which the aggregate acquisitions represent 20 percent or more of the stock of Distributing by vote or value.

#### 3. No-Discussions Factor

As discussed above, the IRS and Treasury Department believe that the occurrence of a public announcement of a distribution before the discussion of an acquisition not involving a public offering suggests that the distribution would have occurred regardless of the acquisition. Therefore, these final regulations amend the no-discussions factor to remove the public announcement restriction.

#### B. Public Offerings

The 2002 temporary regulations distinguish between acquisitions not involving a public offering and acquisitions involving a public offering. A number of commentators have suggested that it is difficult to apply the 2002 temporary regulations to acquisitions involving public offerings and have requested (1) clarification of the definition of public offering, (2) additional safe harbors for acquisitions involving public offerings, and (3) guidance regarding when an acquisition is similar to a potential acquisition involving a public offering. These final regulations address these requests.

##### 1. Definition of Public Offering

Questions have arisen regarding whether a public offering includes stock issuances that are not for cash, including stock issuances for assets or stock in tax-free reorganizations. These final regulations define an acquisition involving a public offering as a stock acquisition for cash where the terms of the acquisition are established by the acquired corporation (Distributing or Controlled) or the seller with the involvement of one or more investment bankers, and the potential acquirers have no opportunity to negotiate the terms of the acquisition. Under this definition, while an initial public offering and a secondary offering will be treated as public offerings, a private

placement involving bilateral discussions and a stock issuance for assets or stock in a tax-free reorganization will not be treated as public offerings.

## 2. New Safe Harbor for Public Offerings

These final regulations add new Safe Harbor VI. Under new Safe Harbor VI, a distribution and an acquisition involving a public offering occurring before the distribution will not be considered part of a plan if the acquisition occurs before the first disclosure event regarding the distribution in the case of an acquisition of stock that is not listed on an established market, or before the date of the first public announcement regarding the distribution in the case of an acquisition of stock that is listed on an established market. The new safe harbor is based on the view of the IRS and Treasury Department that a public offering and a distribution are not likely to be part of a plan if the acquirers in the offering are unaware that a distribution will occur.

## 3. Similar Acquisitions Involving Public Offerings

In the plan and non-plan factors and a number of safe harbors, the 2002 temporary regulations refer to acquisitions that are similar to the actual acquisition. The 2002 temporary regulations provide that an acquisition involving a public offering may be similar to another acquisition involving a public offering 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. This provision is intended to ensure that certain changes in the terms of the offering that is intended at the time of the distribution do not prevent the distribution and the offering that actually occurs from being considered part of a plan.

Commentators have requested further guidance regarding when an acquisition will be treated as similar to another acquisition involving a public offering. The IRS and Treasury Department believe, and these final regulations provide, that more than one actual acquisition may be similar to a potential acquisition involving a public offering. However, the IRS and Treasury Department also believe, and these final regulations provide that, if there is an actual acquisition involving a public offering (the first public offering) that is the same as, or similar to, a potential acquisition involving a public offering, then another actual acquisition involving a public offering (the second

public offering) cannot be similar to the potential acquisition unless the purpose of the second public offering is similar to that of the potential acquisition and occurs close in time to the first public offering. The final regulations include three new examples that illustrate the application of this rule.

### *C. Acquisitions Pursuant to Publicly Offered Options*

The IRS and Treasury Department believe that, in certain cases, whether an acquisition that is pursuant to an option and a distribution are part of a plan should be determined pursuant to the rules related to acquisitions involving a public offering. In particular, suppose that, after consulting with its investment banker, Distributing issues options to acquire its stock. The options are marketed and sold through a distribution process that is similar to that utilized in a public offering. In these cases, the acquirer may never discuss the acquisition with Distributing. The investment banker, however, will discuss the acquisition with Distributing. Therefore, it seems more appropriate to analyze whether a distribution and an acquisition of stock pursuant to such an option are part of a plan under the rules that apply to acquisitions involving a public offering, rather than the rules that apply to acquisitions not involving a public offering. Accordingly, these final regulations provide that, if an option is issued for cash, the terms of the acquisition of the option and the terms of the option are established by the corporation the stock of which is subject to the option (Distributing or Controlled) or the writer with the involvement of one or more investment bankers, and the potential acquirers of the option have no opportunity to negotiate the terms of the acquisition of the option or the terms of the option, then an acquisition pursuant to that option will be treated as an acquisition involving a public offering occurring after a distribution if the option is exercised after the distribution or an acquisition involving a public offering occurring before the distribution if the option is exercised before the distribution. Otherwise, an acquisition pursuant to an option will be treated as an acquisition not involving a public offering.

### *D. Agreement, Understanding, or Arrangement*

Throughout the 2002 temporary regulations reference is made to the phrase "agreement, understanding, or arrangement." The 2002 temporary regulations provide that whether an

agreement, understanding, or arrangement exists depends on the facts and circumstances. One commentator questioned whether an agreement by a person who does not actively participate in the management of the acquired corporation should be treated as an agreement, understanding, or arrangement. The IRS and Treasury Department believe that the activities of those who have the authority to act on behalf of Distributing or Controlled as well as the activities of the controlling shareholders of Distributing and Controlled are relevant to the determination of whether a distribution and an acquisition are part of a plan. Therefore, these final regulations provide that an agreement, understanding, or arrangement generally requires either (1) an agreement, understanding, or arrangement by one or more officers or directors acting on behalf of Distributing or Controlled, by a controlling shareholder of Distributing or Controlled, or by another person with the implicit or explicit permission of one or more of such persons, with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer; or (2) an agreement, understanding, or arrangement by an acquirer that is a controlling shareholder of Distributing or Controlled immediately after the acquisition that is the subject of the agreement, understanding, or arrangement, or by a person or persons with the implicit or explicit permission of such acquirer, with the transferor or with a person or persons with the implicit or explicit permission of the transferor. These final regulations also make conforming changes to the rules related to when an option will be treated as an agreement, understanding, or arrangement to acquire stock, and the definition of substantial negotiations.

### *E. Substantial Negotiations and Discussions*

Under the 2002 temporary regulations, the presence or absence of "substantial negotiations" or "discussions" regarding an acquisition or a distribution is relevant to the determination of whether a distribution and an acquisition are part of a plan. The 2002 temporary regulations provide that, in the case of an acquisition other than a public offering, substantial negotiations generally require discussions of significant economic terms 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. In addition, the 2002 temporary regulations provide that (i) 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; and (ii) discussions with the acquirer generally require discussions with the acquirer or a person or persons with the implicit or explicit permission of the acquirer.

Commentators have requested that final regulations clarify that, where the acquirer is a corporation, substantial negotiations and discussions must involve one or more officers, directors, or controlling shareholders of the acquirer, or another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders. These final regulations reflect those clarifications.

#### *F. Safe Harbor VI of the 2002 Temporary Regulations*

##### **1. Asset Reorganizations Involving Distributing or Controlled**

Safe Harbor VI of the 2002 temporary regulations generally provides that 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 related person 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. Questions have arisen regarding whether this safe harbor is available for an acquisition of Distributing or Controlled stock to which section 83 or section 421(a) applies when the acquirer performed services for a corporation other than Distributing, Controlled, or a person related to Distributing or Controlled. For example, assume that X, a corporation unrelated to Distributing and Controlled, grants A, an employee, an incentive stock option in connection with A's performance of services as an employee of X. Before A exercises the option, Distributing acquires the assets of X in a reorganization under section 368(a)(1)(A) and A's incentive stock option to acquire stock of X is substituted within the meaning of § 1.424-1(a) with an incentive stock

option to acquire stock of Distributing. Commentators have asked whether Safe Harbor VI of the 2002 temporary regulations applies to A's exercise of the option to acquire stock of Distributing, even though A performed services for X rather than Distributing. These final regulations modify this safe harbor (Safe Harbor VIII of these final regulations) to ensure its availability in this and similar situations.

##### **2. Disqualifying Dispositions**

As described above, Safe Harbor VI of the 2002 temporary regulations may be available for acquisitions of stock in a transaction to which section 421(a) applies. In order to qualify as a transaction to which section 421(a) applies, the acquirer must satisfy the requirements of section 422(a) or section 423(a), including the holding period requirements of section 422(a)(1) or section 423(a)(1). In particular, the acquirer must not dispose of the acquired stock within two years from the date of the granting of the option or within one year after the transfer of such stock to the acquirer. The IRS and Treasury Department do not believe that a disposition of stock acquired pursuant to an option that otherwise satisfies the requirements of section 422 or section 423 prior to the period prescribed in section 422(a)(1) or 423(a)(1) evidences that the acquisition of stock pursuant to the option and the distribution are part of a plan. Therefore, these final regulations extend the application of Safe Harbor VI of the 2002 temporary regulations to not only transactions to which section 421(a) applies, but also transactions to which section 421(b) applies.

#### *G. Safe Harbor VII of the 2002 Temporary Regulations*

Safe Harbor VII of the 2002 temporary regulations generally provides that if stock of Distributing or Controlled is acquired by an employer's retirement plan that qualifies under section 401(a) or 403(a), the acquisition and the distribution will not be considered part of a plan. That safe harbor, however, does not apply to the extent that the stock acquired by all of the employer's qualified plans during the four-year period beginning two years before the distribution, in the aggregate, represents ten percent or more of the total combined voting power of all classes of stock entitled to vote, or ten percent or more of the total value of shares of all classes of stock, of the acquired corporation. Questions have arisen regarding whether this safe harbor is available at all if the acquisitions by the employer's retirement plans exceed ten

percent of the acquired corporation's stock during the prescribed period.

These final regulations revise Safe Harbor VII of the 2002 temporary regulations (Safe Harbor IX of these final regulations) to clarify that, if the acquisitions by an employer's retirement plan total in excess of ten percent, the safe harbor is available for the first ten percent acquired during the prescribed period. These final regulations also revise this safe harbor to reflect that it is only available for acquisitions by a retirement plan of Distributing, Controlled, or any person that is treated as the same employer as Distributing or Controlled under section 414(b), (c), (m), or (o).

#### *H. Compensatory Options*

The 2002 temporary regulations include special rules that treat an option as an agreement, understanding, or arrangement to acquire the stock subject to the option on the earliest of the date the option was written, transferred, or modified, if on that date the option was more likely than not to be exercised. The 2002 temporary regulations except compensatory options from these rules. For this purpose, a compensatory option is 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 related person (and that is not excessive by reference to the services performed), provided that the transfer of stock pursuant to such option is described in section 421(a) or 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).

The IRS and Treasury Department have become aware that arrangements using compensatory options have been structured to prevent an acquisition of stock from being treated as part of a plan that includes a distribution in avoidance of section 355(e). Accordingly, these final regulations revise the 2002 temporary regulations to treat compensatory options as options.

#### **Special Analysis**

It has been determined that this Treasury decision is 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 regulations, and, because these regulations do not impose a collection

of information requirement on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### Drafting Information

The principal author of these regulations is Amber R. Cook of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury Department participated in their development.

#### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Adoption of Amendments to Regulations

■ Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by removing the entry for § 1.355–7T and adding the following entry to read, in part, as follows:

**Authority:** 26 U.S.C. 7805. \* \* \*  
Section 1.355–7 also issued under 26 U.S.C. 355(e)(5). \* \* \*

■ **Par. 2.** Section 1.355–0 is amended as follows:

- 1. Revise the introductory text.
- 2. Remove the entries for § 1.355–7T and add the entries for § 1.355–7.

The revision and addition read as follows:

#### § 1.355–0. Outline of sections.

In order to facilitate the use of §§ 1.355–1 through 1.355–7, this section lists the major paragraphs in those sections as follows:

\* \* \* \* \*

§ 1.355–7 *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.
- (i) In general.
- (ii) Special rule.
- (3) Safe Harbor III.
- (4) Safe Harbor IV.
- (i) In general.
- (ii) Special rules.
- (5) Safe Harbor V.
- (i) In general.
- (ii) Special rules.
- (6) Safe Harbor VI.
- (7) Safe Harbor VII.
- (i) In general.
- (ii) Special rules.
- (8) Safe Harbor VIII.
- (i) In general.
- (ii) Special rule.
- (9) Safe Harbor IX.
- (i) In general.
- (ii) Special rule.
- (e) Options, warrants, convertible obligations, and other similar interests.
- (1) Treatment of options.
- (i) General rule.
- (ii) Agreement, understanding, or arrangement to write, transfer, or modify an option.
- (iii) Substantial negotiations related to options.
- (2) Stock acquired pursuant to options.
- (3) Instruments treated as options.
- (4) Instruments generally not treated as options.
- (i) Escrow, pledge, or other security agreements.
- (ii) Options exercisable only upon death, disability, mental incompetency, or separation from service.
- (iii) Rights of first refusal.
- (iv) 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) Disclosure event.
- (6) Discussions.
- (7) Established market.
- (8) Five-percent shareholder.
- (9) Implicit permission.
- (10) Public announcement.
- (11) Public offering.
- (12) Similar acquisition (not involving a public offering).
- (13) Similar acquisition involving a public offering.
- (i) One public offering.
- (ii) More than one public offering.
- (iii) Potential acquisition involving a public offering.
- (14) Ten-percent shareholder.
- (i) [Reserved].
- (j) Examples.
- (k) Effective dates.

■ **Par. 3.** Section 1.355–7 is added to read as follows:

#### § 1.355–7 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 two-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 two-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 two-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 two-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 two-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, the acquirer intends to cause a distribution and, immediately after 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

two-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 two-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 two-year period ending on the date of the earlier to occur of the acquisition or the first public announcement regarding the distribution, there were no discussions by Distributing or Controlled with the acquirer regarding a distribution. Paragraph (b)(4)(iii) of this section does not apply to an acquisition where the acquirer intends to cause a distribution and, immediately after 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.*

Discussions by Distributing or Controlled with outside advisors and internal discussions 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 six 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 one year before the distribution and ends six months thereafter.

(2) *Safe Harbor II*—(i) *In general.* 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 six 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 one year before the distribution and ends six 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 one year before the distribution and ends six months thereafter.

(ii) *Special rule.* 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 VII, Safe Harbor VIII, or Safe Harbor IX 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 one year after the distribution, the acquisition and the distribution will not be considered part of a plan.

(4) *Safe Harbor IV*—(i) *In general.* A distribution and an acquisition (other than involving a public offering) occurring before the distribution will not be considered part of a plan if the acquisition occurs before the date of the first disclosure event regarding the distribution.

(ii) *Special rules.* (A) Paragraph (d)(4)(i) of this section does not apply to a stock acquisition if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a ten-percent shareholder of the acquired corporation (Distributing or Controlled) at any time during the period beginning immediately after the acquisition and ending on the date of the distribution.

(B) Paragraph (d)(4)(i) of this section does not apply to an acquisition that occurs in connection with a transaction in which the aggregate acquisitions are of stock possessing 20 percent or more of the total voting power of the stock of the acquired corporation (Distributing or Controlled) or stock having a value of 20 percent or more of the total value of the stock of the acquired corporation (Distributing or Controlled).

(5) *Safe Harbor V*—(i) *In general.* A distribution that is pro rata among the Distributing shareholders and an acquisition (other than involving a public offering) of Distributing stock occurring before the distribution will not be considered part of a plan if—

(A) The acquisition occurs after the date of a public announcement regarding the distribution; and

(B) There were no discussions by Distributing or Controlled with the acquirer regarding a distribution on or before the date of the first public announcement regarding the distribution.

(ii) *Special rules.* (A) Paragraph (d)(5)(i) of this section does not apply to a stock acquisition if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a ten-percent shareholder of Distributing at any time during the period beginning immediately after the acquisition and ending on the date of the distribution.

(B) Paragraph (d)(5)(i) of this section does not apply to an acquisition that occurs in connection with a transaction in which the aggregate acquisitions are of stock possessing 20 percent or more of the total voting power of the stock of Distributing or stock having a value of 20 percent or more of the total value of the stock of Distributing.

(6) *Safe Harbor VI.* A distribution and an acquisition involving a public offering occurring before the distribution will not be considered part of a plan if the acquisition occurs before the date of the first disclosure event regarding the distribution in the case of an acquisition of stock that is not listed on an established market immediately after the acquisition, or before the date of the first public announcement regarding the distribution in the case of an acquisition of stock that is listed on an established market immediately after the acquisition.

(7) *Safe Harbor VII*—(i) *In general.* An acquisition (other than involving a public offering) 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) A controlling shareholder of the acquired corporation (Distributing or Controlled); or

(E) A ten-percent shareholder of the acquired corporation (Distributing or Controlled).

(ii) *Special rules.* (A) Paragraph (d)(7)(i) of this section 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 ten-percent shareholder of the acquired corporation (Distributing or Controlled) at any time after the acquisition and before the date that is two years after the distribution.

(B) If a transfer of stock to which paragraph (d)(7)(i) of this section 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, paragraph (d)(7)(i) of this section does not prevent an acquisition of stock (with the voting power such stock represents after the transfer to which paragraph (d)(7)(i) of this section applies) by such other person from being treated as part of a plan.

(8) *Safe Harbor VIII*—(i) *In general.* If, in a transaction to which section 83 or section 421(a) or (b) applies, 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, a related person, a corporation the assets of which Distributing, Controlled, or a related person acquires in a reorganization under section 368(a), or a corporation that acquires the assets of Distributing or Controlled in such a reorganization (and the stock acquired is not excessive by reference to the services performed), the acquisition and the distribution will not be considered part of a plan. For purposes of this paragraph (d)(8)(i), a related person is a person related to Distributing or Controlled under section 355(d)(7)(A).

(ii) *Special rule.* Paragraph (d)(8)(i) of this section does not apply to a stock acquisition if the acquirer or a coordinating group of which the acquirer is a member is a controlling shareholder or a ten-percent shareholder of the acquired corporation (Distributing or Controlled) immediately after the acquisition.

(9) *Safe Harbor IX*—(i) *In general.* If stock of Distributing or Controlled is acquired by a retirement plan of Distributing or Controlled (or a retirement plan of any other person that is treated as the same employer as Distributing or Controlled under section 414(b), (c), (m), or (o)) 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.* Paragraph (d)(9)(i) of this section does not apply to the extent that the stock acquired pursuant to acquisitions by all of the qualified plans of the persons described in paragraph (d)(9)(i) of this section during the four-year period beginning two years before the distribution, in the aggregate, represents more than ten percent of the total combined voting power of all classes of stock entitled to vote, or more than ten percent of the total value of shares of all classes of stock, of the acquired corporation (Distributing or Controlled).

(e) *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 that is written by Distributing, Controlled, or a person that is a controlling shareholder of Distributing or Controlled at the time the option is written, or that is acquired by a person that is a controlling shareholder of Distributing or Controlled immediately after the option is written, 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, immediately before or immediately after the transfer, the transferor or transferee was Distributing, Controlled, a corporation that Distributing or Controlled controls within the meaning of section 368(c), a member of a controlled group of corporations within the meaning of section 1563 of which Distributing or Controlled is a member, or a controlling shareholder or a ten-percent shareholder of Distributing or Controlled and 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, transfer, or modify 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. If there is an agreement, understanding, or arrangement to transfer an option, the option will be treated as transferred on the date of the agreement, understanding, or arrangement. If there is an agreement, understanding, or arrangement to modify an option in a manner that materially increases the likelihood of exercise, the option will be treated as so modified 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) *Stock acquired pursuant to options.* For purposes of this section, if an option is issued for cash, the terms of the acquisition of the option and the

terms of the option are established by the corporation the stock of which is subject to the option (Distributing or Controlled) or the writer with the involvement of one or more investment bankers, and the potential acquirers of the option have no opportunity to negotiate the terms of the acquisition of the option or the terms of the option, then an acquisition pursuant to such option shall be treated as an acquisition involving a public offering occurring after the distribution if the option is exercised after the distribution or an acquisition involving a public offering before a distribution if the option is exercised before the distribution. Otherwise, an acquisition pursuant to an option shall be treated as an acquisition not involving a public offering.

(3) *Instruments treated as options.* For purposes of this section, except to the extent provided in paragraph (e)(4) 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.

(4) *Instruments generally not treated as options.* For purposes of this section, the following are not treated as options unless (in the case of paragraphs (e)(4)(i), (ii), and (iii) 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) *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.

(iii) *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).

(iv) *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 one 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 one 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.* For purposes of this section, the following definitions shall apply:

(1) *Agreement, understanding, arrangement, or substantial negotiations.* (i) An agreement, understanding, or arrangement generally requires either—

(A) An agreement, understanding, or arrangement by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders, with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer; or

(B) An agreement, understanding, or arrangement by an acquirer that is a controlling shareholder of Distributing

or Controlled immediately after the acquisition that is the subject of the agreement, understanding, or arrangement, or by a person or persons with the implicit or explicit permission of such acquirer, with the transferor or with a person or persons with the implicit or explicit permission of the transferor.

(ii) In the case of an acquisition by a corporation, an agreement, understanding, or arrangement with the acquiring corporation generally requires an agreement, understanding, or arrangement with one or more officers or directors acting on behalf of the acquiring corporation, with controlling shareholders of the acquiring corporation, or with another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.

(iii) 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.

(iv) 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, either—

(A) By one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders, with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer; or

(B) If the acquirer is a controlling shareholder of Distributing or Controlled immediately after the acquisition that is the subject of substantial negotiations, by the acquirer or by a person or persons with the implicit or explicit permission of the acquirer, with the transferor or with a person or persons with the implicit or explicit permission of the transferor.

(v) In the case of an acquisition (other than involving a public offering) by a corporation, substantial negotiations generally require discussions of significant economic terms with one or more officers or directors acting on behalf of the acquiring corporation, with

controlling shareholders of the acquiring corporation, or with another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.

(vi) In the case of an acquisition involving a public offering, the existence of an agreement, understanding, arrangement, or substantial negotiations will be based on discussions by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders, with an investment banker.

(2) *Controlled corporation.* 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 five-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 stock possessing voting power representing a meaningful voice in the governance of the corporation. For purposes of determining whether a person owns stock possessing voting power representing a meaningful voice in the governance of the corporation, the person shall be treated as owning the stock that such person owns actually and constructively under the rules of section 318 (without regard to section 318(a)(4)). In addition, if the exercise of an option (whether by itself or in conjunction with the deemed exercise of one or more other options) would cause the holder to own stock possessing voting power representing a meaningful voice in the governance of the corporation, then the option will be treated as exercised.

(iii) 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 two 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, a five-percent shareholder, or a ten-percent shareholder.

(5) *Disclosure event.* A disclosure event regarding the distribution means any communication by an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor of any of those persons (where such advisor makes the communication on behalf of such person), regarding the distribution, or the possibility thereof, to the acquirer or any other person (other than an officer, director, controlling shareholder, or employee of Distributing, Controlled, or a corporation related to Distributing or Controlled, or an outside advisor of any of those persons). For purposes of this paragraph (h)(5), a corporation is related to Distributing or Controlled if it is a member of an affiliated group (as defined in section 1504(a) without regard to section 1504(b)) that includes either Distributing or Controlled or it is a member of a qualified group (as defined in § 1.368-1(d)(4)(ii)) that includes either Distributing or Controlled.

(6) *Discussions.* Discussions by Distributing or Controlled generally require discussions by one or more officers or directors acting on behalf of Distributing or Controlled, by controlling shareholders of Distributing or Controlled, or by another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders. Discussions with the acquirer generally require discussions with the acquirer or with a person or persons with the implicit or explicit permission of the acquirer. In the case of an acquisition by a corporation, discussions with the acquiring corporation generally require discussions with one or more officers or directors acting on behalf of the acquiring corporation, with controlling shareholders of the acquiring

corporation, or with another person or persons with the implicit or explicit permission of one or more of such officers, directors, or controlling shareholders.

(7) *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).

(8) *Five-percent shareholder.* A person will be considered a five-percent shareholder of a corporation the stock of which is listed on an established market if the person owns five percent or more of any class of stock of the corporation whose stock is transferred. For purposes of determining whether a person owns five percent or more of any class of stock of the corporation whose stock is transferred, the person shall be treated as owning the stock that such person owns actually and constructively under the rules of section 318 (without regard to section 318(a)(4)). In addition, if the exercise of an option (whether by itself or in conjunction with the deemed exercise of one or more other options) would cause the holder to become a five-percent shareholder, then the option will be treated as exercised. Absent actual knowledge that a person is a five-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 five-percent shareholders.

(9) *Implicit permission.* A corporation is treated as having the implicit permission of its shareholders when it engages in discussions or negotiations, or enters into an agreement, understanding, or arrangement.

(10) *Public announcement.* A public announcement regarding the distribution means any communication by Distributing or Controlled regarding Distributing's intention to effect the distribution where the communication is generally available to the public.

(11) *Public offering.* An acquisition involving a public offering means an acquisition of stock for cash where the terms of the acquisition are established by the acquired corporation (Distributing or Controlled) or the seller

with the involvement of one or more investment bankers and the potential acquirers have no opportunity to negotiate the terms of the acquisition. For example, a public offering includes an underwritten offering of registered stock for cash.

(12) *Similar acquisition (not involving a public offering).* In general, an actual acquisition (other than involving a public offering) 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 involving a public offering) 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.

(13) *Similar acquisition involving a public offering—(i) One public offering.* In general, an actual acquisition involving a public offering may be similar to a potential acquisition involving a public offering, 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.

(ii) *More than one public offering.* More than one actual acquisition involving a public offering may be similar to a potential acquisition involving a public offering. If there is an actual acquisition involving a public offering (the first public offering) that is the same as, or similar to, a potential acquisition involving a public offering, then another actual acquisition involving a public offering (the second public offering) cannot be similar to the potential acquisition unless the purpose of the second public offering is similar to that of the potential acquisition and occurs close in time to the first public offering.

(iii) *Potential acquisition involving a public offering.* For purposes of paragraph (h)(13)(i) and (ii) of this section, as the context may require, a potential acquisition involving a public offering means a potential acquisition involving a public offering that was discussed by Distributing or Controlled with an investment banker, that motivated the distribution, or that was the subject of an agreement, understanding, arrangement, or substantial negotiations.

(14) *Ten-percent shareholder.* A person will be considered a ten-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 (without regard to section 318(a)(4)), ten percent or more of any class of stock of the corporation whose stock is transferred. A person will be considered a ten-percent shareholder of a corporation the stock of which is not listed on an established market if the person owns stock possessing ten 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 ten percent or more of the total value of the stock of the corporation whose stock is transferred. For purposes of determining whether a person owns ten percent or more of the total voting power or value of the stock of the corporation whose stock is transferred, the person shall be treated as owning the stock that such person owns actually and constructively under the rules of section 318 (without regard to section 318(a)(4)). In addition, if the exercise of an option (whether by itself or in conjunction with the deemed exercise of one or more other options) would cause the holder to become a ten-percent shareholder, then the option will be treated as exercised. Absent actual knowledge that a person is a ten-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 ten-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 two-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 seven 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 VII, relating to public trading, does not apply to public offerings (see paragraph (d)(7)(i) 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 two-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)(1)(A) by reason of section 368(a)(2)(E) within six 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, makes a public announcement that it will distribute all the stock of C pro rata to D's shareholders. After the public announcement but before the distribution, widely-held X becomes available as an acquisition target. There were no discussions by D or C with X before the date of the public announcement. D negotiates with X and X merges into D before the distribution. In the merger, X's shareholders receive ten percent of D's stock. D distributes the stock of C pro rata within six months after the acquisition of X. No shareholder of X was a controlling shareholder or a ten-percent shareholder of D at any time during the period beginning immediately after the merger and ending on the date of the distribution.

(ii) The issue is whether the acquisition of X by D and the distribution of C are part of a plan. Safe Harbor V applies to this acquisition because the distribution is pro rata among D's shareholders, the acquisition occurs after the date of a public announcement regarding the distribution,

there were no discussions by D or C with X on or before the date of the public announcement, no acquirer was a controlling shareholder or a ten-percent shareholder of D during the period beginning immediately after the merger and ending on the date of the distribution, and not more than 20 percent of D's stock was acquired by the X shareholders in the merger.

**Example 5. Vote shifting transaction.** (i) D is in business 1. C is in business 2. D wants to combine with X, which is 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 two classes of stock: Class A and Class B. Under all circumstances, each share of Class A stock will be entitled to ten 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 ten 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 one vote, rather than ten 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 and more than 50 percent of the total value of all classes of stock of D. 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 two-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)(7)(i), Safe Harbor VII 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 a 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 VII 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 a plan that includes the distribution and the X acquisition.

**Example 6. Acquisition not involving a public offering 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 is 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. The ultimate owners of Y are substantially different from the ultimate owners of X.

(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, and because the ultimate owners of Y are substantially different from the ultimate owners of X, 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 not involving a public offering 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.

**Example 8. Acquisitions involving public offerings with different purposes.** (i) D's managers, directors, and investment banker discuss the possibility of offering D stock to the public for the purpose of funding the acquisition of the assets of X. They decide a public offering of 20 percent of D's stock with D as a stand-alone corporation would allow D to raise the capital needed to effect the acquisition of X's assets. 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. Two months after the distribution, D issues new shares amounting to 20 percent of its stock to the public in a public offering (the first public offering). Four months after the distribution, D acquires the assets of X. Seven months after the distribution, D's managers, directors, and investment banker discuss the possibility of offering D stock to the public solely for the purpose of funding the acquisition of the assets of Y, a corporation unrelated to X. One year after the distribution, D issues new shares amounting to 40 percent of its stock to the public in a public offering (the second public offering). One month after the second public offering, D acquires the assets of Y.

(ii) The first public offering is the same as the potential acquisition that D's managers, directors, and investment banker discussed prior to the distribution. The purpose of the second public offering (funding the

acquisition of the assets of Y) is not similar to that of the potential acquisition (funding the acquisition of the assets of X). Therefore, the second public offering is not similar to the potential acquisition.

*Example 9. Acquisitions involving public offerings that are close in time.* (i) D's managers, directors, and investment banker discuss the possibility of offering D stock to the public for the purpose of raising funds for general corporate purposes. They decide a public offering of 20 percent of D's stock with D as a stand-alone corporation would allow D to raise such funds. 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. Two months after the distribution, D issues new shares amounting to 20 percent of its stock to the public in a public offering (the first public offering). After the first public offering, D's managers, directors, and investment banker discuss the possibility of another offering of D stock to the public for the purpose of raising additional funds for general corporate purposes. Eight months after the distribution, D issues new shares amounting to ten percent of its stock to the public in a public offering (the second public offering).

(ii) The first public offering is the same as the potential acquisition that D's managers, directors, and investment banker discussed prior to the distribution. The purpose of the second public offering (raising funds for general corporate purposes) is the same as that of the potential acquisition. In addition, the second public offering is close in time to the first public offering. Therefore, the second public offering is similar to the potential acquisition.

*Example 10. Acquisitions involving public offerings that are not close in time.* The facts are the same as those in *Example 9*, except that the second public offering occurs fourteen months after the distribution. Although the purpose of the second public offering is the same as that of the potential acquisition, the second public offering is not close in time to the first public offering. Therefore, the second public offering is not similar to the potential acquisition.

(k) *Effective dates.* This section applies to distributions occurring after April 19, 2005. For distributions occurring on or before April 19, 2005, and after April 26, 2002, see § 1.355-7T as contained in 26 CFR part 1 revised as of April 1, 2003; however, taxpayers may apply these regulations, in whole, but not in part, to such distributions. For distributions occurring on or before April 26, 2002, and after August 3, 2001, see § 1.355-7T as contained in 26 CFR part 1 revised as of April 1, 2002; however, taxpayers may apply, in whole, but not in part, either these regulations or § 1.355-7T as contained in 26 CFR part 1 revised as of April 1, 2003, to such distributions. For distributions occurring on or before August 3, 2001, and after April 16, 1997, taxpayers may apply, in whole, but not in part, either these regulations or

§ 1.355-7T as contained in 26 CFR part 1 revised as of April 1, 2003, to such distributions.

#### § 1.355-7T [Removed]

■ **Par. 4.** Section 1.355-7T is removed.

**Cono R. Namorato,**

*Acting Deputy Commissioner for Services and Enforcement.*

Approved: April 13, 2005.

**Eric Solomon,**

*Acting Deputy Assistant Secretary of the Treasury.*

[FR Doc. 05-7811 Filed 4-18-05; 8:45 am]

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## POSTAL SERVICE

### 39 CFR Parts 211 and 601

#### Purchasing of Property and Services

**AGENCY:** Postal Service.

**ACTION:** Final rule.

**SUMMARY:** The Postal Service™ is amending its regulations in order to implement the acquisition portions of its *Transformation Plan* (April 2002) and the similar recommendations of the President's Commission on the United States Postal Service (July 2003) as they relate to the acquisition of property, goods and services in accordance with 39 U.S.C. §§ 101, 401, 403, 404, and 410.

**DATES:** *Effective Date:* May 19, 2005.

**FOR FURTHER INFORMATION, CONTACT:** Michael J. Harris, (202) 268-5653.

#### SUPPLEMENTARY INFORMATION:

##### Background

The Board of Governors of the Postal Service has determined in the *Transformation Plan* that challenging times require the Postal Service to continually improve its business practices to meet the challenge of the future in order to fulfill its charter to serve the American public. As part of that challenge, the Postal Service determined to "revise purchasing regulations [where possible] to allow for the acquisition of goods and services in a manner similar to that followed by businesses." *Transformation Plan* (April 2002), p. v.

The President's Commission on the Postal Service also has recommended that the Postal Service exercise the "latitude to conduct its procurement with fewer substanti[ve] regulations" pursuant to authority granted by Congress in the Postal Reorganization Act Report (July 2003), p. 94. The Commission expressed its view that "it is inappropriate to apply regulations \* \* \* aimed at traditional agencies to a

Federal entity required to finance its own multi-billion dollar operations." Rather, the public will benefit greatly if the Postal Service applies purchasing practices used by leading corporate enterprises. In accordance with the *Transformation Plan* and the Commission's recommendations, the Postal Service is replacing all of its current purchasing regulations with those discussed here.

The Postal Service published in the **Federal Register** on March 24, 2004 [Vol. 69, No. 57, pages 13786-13793], proposed rules, invited comments by members of the public on or before April 23, 2004, and received 20 responses and comments, some of which were by membership associations or organizations.

#### Discussion of Comments

Given that the Postal Service does business with approximately 25,000 suppliers per annum, very few commented on the proposed regulations. We view that as an indication that the supplier community is satisfied with the proposed regulations and did not have serious reservations about the proposed regulations. Some responders expressed positive views of the proposed regulations. The critical comments may generally be placed in three categories, as follows:

1. Revocation of previous purchasing regulations. Several responders expressed a view that revocation of the previous regulations would lead to a lack of transparency and also expressed a view that the Postal Service's non-binding guidelines should be made available to the public, so the public will know more about the Postal Service's acquisition policies and practices.

When Congress passed the Postal Reorganization Act it exempted the Postal Service from most governmental purchasing regulations in order to give it the flexibility to operate in a manner akin to those in the private sector. The Postal Service, in its transformed purchasing regulations, seeks to fulfill that Congressional policy by adopting regulations which will allow it to obtain the best products or services to meet its needs at fair and reasonable prices. In other words, the Postal Service seeks to focus upon and to obtain the best value in its acquisitions. The new regulations, as well as Supplying Principles and Practices now under development, are designed to permit flexibility to the Postal Service so it may respond to market conditions in acquiring the best property, goods and services it believes meet its needs at a fair and reasonable