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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 8960]

RIN 1545-BA01

Guidance under section 355(e); Recognition of Gain on Certain Distributions of Stock or Securities In Connection with an Acquisition

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations relating to recognition of gain on certain distributions of stock or securities of a controlled corporation in connection with an acquisition. Changes to the applicable law were made by the Taxpayer Relief Act of 1997. These temporary regulations affect corporations and are necessary to provide them with guidance needed to comply with these changes.

EFFECTIVE DATES: These temporary regulations are effective August 3, 2001.

FOR FURTHER INFORMATION CONTACT: Megan R. Fitzsimmons of the Office of Associate Chief Counsel (Corporate), (202) 622-7790 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On January 2, 2001, the IRS and Treasury published in the **Federal Register** (REG-107566-00, 66 FR 66; (2001-3 I.R.B. 346)) a notice of proposed rulemaking (the Proposed Regulations) under section 355(e) of the Internal Revenue Code of 1986. 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.”

The Proposed Regulations provide guidance concerning the interpretation of the phrase “plan (or series of related transactions).” The Proposed Regulations generally provide that whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. They also set forth six safe harbors, the satisfaction of which would confirm that a distribution and an acquisition are not part of a plan.

A public hearing regarding the Proposed Regulations was held on May 15, 2001. In addition, written comments were received. A number of commentators have indicated that the lack of guidance under section 355(e) is hindering the ability to undertake acquisitions and divestitures. These commentators have requested that the IRS and Treasury provide immediate guidance pending the finalization of those regulations. In response to these requests, the IRS and Treasury are promulgating the Proposed Regulations as temporary regulations in this Treasury Decision. The temporary regulations are identical to the Proposed Regulations, except that the temporary regulations reserve section 1.355-7(e)(6) (suspending the running of any time period prescribed in the Proposed Regulations during which there is a substantial diminution of risk of loss under the principles of section 355(d)(6)(B)) and Example 7 of

the Proposed Regulations (interpreting the term “similar acquisition” in the context of a situation involving multiple acquisitions).

The IRS and Treasury continue to study all of the comments received regarding the Proposed Regulations. The IRS and Treasury will continue to devote significant resources to analyzing the comments and, in the near future, expect to issue additional guidance regarding the interpretation of the phrase “plan (or series of related transactions).”

Special Analyses

It has been determined that these temporary regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these temporary regulations, and, because the temporary regulations do not impose a collection of information 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, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these temporary regulations is Brendan P. O’Hara, Office of the Associate Chief Counsel (Corporate). However, other personnel from the Department of the Treasury and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

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

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

Par. 2. Section 1.355-0 is amended by revising the section heading and the introductory text and adding an entry for §1.355-7T to read in part as follows:

§1.355-0 Outline of sections.

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

* * * * *

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

- (a) In general.
- (b) Plan.
- (c) Multiple acquisitions.
- (d) Facts and circumstances.
- (e) Operating rules.
 - (1) Reasonable certainty evidence of business purpose to facilitate an acquisition.
 - (2) Internal discussion evidence of business purpose.
 - (3) Hostile takeover defense.
 - (4) Effect of distribution on trading in stock.
 - (5) Consequences of section 355(e) disregarded for certain purposes.
 - (6) Substantial diminution of risk. [Reserved]
- (f) Safe harbors.
 - (1) Safe Harbor I.

- (2) Safe Harbor II.
- (3) Safe Harbor III.
- (4) Safe Harbor IV.
- (5) Safe Harbor V.
 - (i) In general.
 - (ii) Special rules.
- (6) Safe Harbor VI.
- (g) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests.
 - (1) Treatment of options.
 - (i) General rule.
 - (ii) Agreement, understanding, arrangement, or substantial negotiations to write an option.
 - (2) Instruments treated as options.
 - (3) Instruments generally not treated as options.
 - (i) Escrow, pledge, or other security agreements.
 - (ii) Compensatory options.
 - (iii) Options exercisable only upon death, disability, mental incompetency, or separation from service.
 - (iv) Rights of first refusal.
 - (v) Other enumerated instruments.
 - (h) Multiple controlled corporations.
 - (i) [Reserved]
 - (j) Valuation.
 - (k) Definitions.
 - (1) Agreement, understanding, arrangement, or substantial negotiations.
 - (2) Controlled corporation.
 - (3) Controlling shareholder.
 - (4) Established market.
 - (5) Five-percent shareholder.
 - (l) [Reserved]
 - (m) Examples.
 - (n) Effective date.

Par. 3. Section 1.355-7T is added to read as follows:

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

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

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

(2) That is part of a plan (or series of related transactions) (referred to elsewhere in this section as “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) Whether a distribution and an acquisition are part of a plan is determined based on all the facts and circumstances. In general, in the case of an acquisition after a distribution, the distribution and the acquisition are considered part of a plan if Distributing, Controlled, or any of their respective controlling shareholders intended, on the date of the distribution, that the acquisition or a similar acquisition occur in connection with the distribution. In general, in the case of an acquisition before a distribution, the acquisition and the distribution are considered part of a plan if Distributing, Controlled, or any of their respective controlling shareholders intended, on the date of the acquisition, that a distribution occur in connection with the acquisition.

(2) For purposes of paragraph (b)(1) of this section, the actual acquisition and the intended acquisition may be similar even though the identity of the person acquiring stock of Distributing or Controlled (acquirer), the timing of the acquisition or the terms of the actual acquisition are different from the intended acquisition. For example, in the case of a public offering or auction, the actual acquisition and the intended acquisition may be similar 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 public offering or auction.

(c) 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) Facts and circumstances. (1) 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 specified in paragraphs (d)(2) and (3) of this section. The weight to be given each of the facts and circumstances depends on the particular case. Therefore, whether a distribution and an acquisition are part of a plan does not depend on the relative number of facts and circumstances present under paragraph (d)(2) of this section as compared to paragraph (d)(3) of this section.

(2) 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 or auction) after a distribution, Distributing or Controlled and the acquirer (or any of their respective controlling shareholders) discussed the acquisition or a similar acquisition by the acquirer before the distribution. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions. The existence of an agreement, understanding, arrangement or substantial negotiations at the time of the distribution is given substantial weight.

(ii) In the case of an acquisition (other than involving a public offering or auction) after a distribution, Distributing or Controlled and a potential acquirer (or any of their respective controlling shareholders) discussed an acquisition before the distribution and a similar acquisition by a different person occurred after the distribution. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions and the similarity of the acquisition actually occurring to the acquisition discussed before the distribution.

(iii) In the case of an acquisition involving a public offering or auction after a distribution, Distributing or Controlled (or any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the distribution. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions.

(iv) In the case of an acquisition before a distribution, Distributing or Controlled and the acquirer (or any of their respective controlling shareholders) discussed a distribution before the acquisition. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions.

(v) In the case of an acquisition before a distribution, Distributing or Controlled and a potential acquirer (or any of their respective controlling shareholders) discussed a distribution before the acquisition and a similar acquisition by a different person occurred before the distribution. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions and the similarity of the acquisition actually occurring to the potential acquisition that was discussed.

(vi) In the case of an acquisition involving a public offering or auction before a distribution, Distributing or Controlled (or any of their respective controlling shareholders) discussed a distribution with an investment banker or other outside adviser before the acquisition. The weight to be accorded the discussions depends on the nature, extent and timing of the discussions.

(vii) 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 of Distributing or Controlled.

(viii) In the case of an acquisition either before or after a distribution, the acquisition and the distribution occurred within 6 months of each other or there was an agreement, understanding, arrangement, or substantial negotiations regarding the second transaction within 6 months after the first transaction. Also, in the case of an acquisition occurring after a distribution, there was an agreement, understanding, arrangement, or substantial negotiations regarding a similar acquisition at the time of the distribution or within 6 months thereafter.

(ix) In the case of an acquisition either before or after a distribution, the debt allocation between Distributing and Controlled made an acquisition of Distributing or Controlled likely in order to service the debt.

(3) 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 (other than involving a public offering or auction) after a distribution, neither Distributing nor Controlled and the acquirer or any potential

acquirer (nor any of their respective controlling shareholders) discussed the acquisition or a similar acquisition before the distribution.

(ii) In the case of an acquisition involving a public offering or auction after a distribution, neither Distributing nor Controlled (nor any of their respective controlling shareholders) discussed the acquisition with an investment banker or other outside adviser before the distribution.

(iii) 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.

(iv) In the case of an acquisition (other than involving a public offering or auction) before a distribution, neither Distributing nor Controlled and the acquirer (nor any of their respective controlling shareholders) discussed a distribution before the acquisition. This paragraph (d)(3)(iv) does not apply if the acquisition occurred after the date of the public announcement of the planned distribution.

(v) 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.

(vi) 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 of Distributing or Controlled. The presence of a business purpose to

facilitate the acquisition or a similar acquisition of Distributing or Controlled is relevant in determining the extent to which the distribution was motivated by a corporate business purpose (within the meaning of §1.355-2(b)) other than a business purpose to facilitate the acquisition or a similar acquisition of Distributing or Controlled.

(vii) 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 (including a previously proposed similar acquisition that did not occur).

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

(1) Reasonable certainty evidence of business purpose to facilitate an acquisition.

(i) In the case of an acquisition after a distribution, if, at the time of the distribution, it was reasonably certain that before a date that is 6 months after the distribution an acquisition would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding an acquisition of Distributing or Controlled, the reasonable certainty is evidence of a business purpose to facilitate an acquisition of Distributing or Controlled.

(ii) In the case of an acquisition before a distribution, if the acquisition occurred after the date of the public announcement of the planned distribution, or if, at the time of the acquisition, it was reasonably certain that before a date that is 6 months after the acquisition the distribution would occur, an agreement, understanding, or arrangement would exist, or substantial negotiations would occur regarding the distribution, the

public announcement or reasonable certainty is evidence of a business purpose to facilitate an acquisition of Distributing or Controlled.

(2) Internal discussions evidence of business purpose. The fact that internal discussions regarding an acquisition occurred may be indicative of the business purpose that motivated the distribution.

(3) Hostile takeover defense. If Distributing 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.

(4) 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 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.

(5) 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.

(6) Substantial diminution of risk. [Reserved]

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

(A) The acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution; and

(B) 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 Distributing or Controlled.

(ii) For purposes of paragraph (f)(1)(i)(B) of this section, the presence of a business purpose to facilitate an acquisition of Distributing or Controlled is relevant in determining the extent to which the distribution was motivated by a corporate business purpose (within the meaning of §1.355-2(b)) other than a business purpose to facilitate an acquisition of Distributing or Controlled.

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

(i) The acquisition occurred more than 6 months after the distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition before a date that is 6 months after the distribution; and

(ii) The distribution was motivated in whole or substantial part by a corporate business purpose (within the meaning of §1.355-2(b)) to facilitate an acquisition or acquisitions of no more than 33 percent of the stock of Distributing or Controlled, and no more than 20 percent of the stock of the corporation (whose stock was acquired in

the acquisition or acquisitions that motivated the distribution) was either acquired or the subject of an agreement, understanding, arrangement, or substantial negotiations before a date that is 6 months after the distribution.

(3) Safe Harbor III. If an acquisition occurs more than 2 years after a distribution and there was no agreement, understanding, arrangement, or substantial negotiations concerning the acquisition at the time of the distribution or within 6 months thereafter, the acquisition and the distribution are not part of a plan.

(4) Safe Harbor IV. If an acquisition occurs more than 2 years before a distribution, and there was no agreement, understanding, arrangement, or substantial negotiations concerning the distribution at the time of the acquisition or within 6 months thereafter, the acquisition and the distribution are not part of a plan.

(5) Safe Harbor V--(i) In general. An acquisition of Distributing or Controlled stock that is listed on an established market is not part of a plan if the acquisition is pursuant to a transfer between shareholders of Distributing or Controlled, neither of whom is a 5-percent shareholder. For purposes of the preceding sentence, the term 5-percent shareholder is defined in paragraph (k)(5) of this section, except that the corporation can rely on Schedules 13D and 13G (or any similar schedules) filed with the Securities and Exchange Commission to identify its 5-percent shareholders.

(ii) Special rules. (A) This paragraph (f)(5) does not apply to public offerings or redemptions.

(B) This paragraph (f)(5) does not apply to a transfer of stock by or to a person who, pursuant to a formal or informal understanding with other persons (the coordinating

group), has joined in coordinated transfers of stock if, at any time during the period the understanding exists, the coordinating group owns, in the aggregate, 5 percent or more of the stock of the corporation whose stock is transferred (determined by vote or value) immediately before or after each transfer or at the time of the distribution. 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 1 or more other existing or prospective shareholders.

(C) This paragraph (f)(5) does not apply to a transfer of stock by or to a person if the corporation the stock of which is being transferred knows, or has reason to know, that the person (or a coordinating group, treating it as a single person) intends to become a 5-percent shareholder at any time during the 4-year period beginning 2 years before the distribution.

(6) Safe Harbor VI. If stock of Distributing or Controlled is acquired by an employee or director of Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A), in connection with the performance of services as an employee or director for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) in a transaction to which section 83 applies, the acquisition is not an acquisition that is part of a plan as described in paragraph (b)(1) of this section.

(g) Stock acquired by exercise of options, warrants, convertible obligations, and other similar interests--(1) Treatment of options--(i) General rule. For purposes of this section, if stock of Distributing or Controlled is acquired pursuant to an option, the

option will be treated as an agreement to acquire the stock on the date the option is written unless Distributing establishes that on the later of the date of the stock distribution or the writing of the option, the option was not more likely than not to be exercised. 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, arrangement, or substantial negotiations to write an option. If there is an agreement, understanding, or arrangement to write an option, the option will be treated as written on the date of the agreement, understanding, or arrangement. If an agreement, understanding, or arrangement to write an option is reached, or an option is written, more than 6 months but not more than 2 years after the distribution, and there were substantial negotiations regarding the writing of the option or the acquisition of the stock underlying the option before the end of the 6-month period beginning on the date of the distribution, the option will be treated as written within 6 months after the distribution.

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

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

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

(ii) Compensatory options. An option to acquire stock in Distributing or Controlled with customary terms and conditions provided to an employee or director of Distributing, Controlled, or a person related to Distributing or Controlled under section 355(d)(7)(A), in connection with the performance of services as an employee or director for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed) and that immediately after the distribution and within 6 months thereafter--

(A) Is nontransferable within the meaning of §1.83-3(d); and

(B) Does not have a readily ascertainable fair market value as defined in §1.83-7(b).

(iii) Options exercisable only upon death, disability, mental incompetency, or separation from service. Any option entered into between shareholders of a corporation (or a shareholder and the corporation) that is exercisable only upon the

death, disability, or mental incompetency of the shareholder, or, in the case of stock acquired in connection with the performance of services for the corporation or a person related to it under section 355(d)(7)(A) (and that is not excessive by reference to the services performed), the shareholder's separation from service.

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

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

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

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

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

(i) [Reserved]

(j) Valuation. Except as provided in paragraph (g)(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.

(k) Definitions--(1) Agreement, understanding, arrangement, or substantial negotiations. 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 terms to have an agreement, understanding, or arrangement. However, an agreement, understanding, or arrangement clearly exists if enforceable rights to acquire stock exist. In public offerings or auctions by Distributing or Controlled of Distributing or Controlled's stock, an agreement, understanding, arrangement, or substantial negotiations can exist even if the acquirer has not been specifically identified. The existence of such an agreement, understanding, arrangement, or substantial negotiations will be based on discussions with an investment banker or other outside adviser.

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

(3) Controlling shareholder. (i) A controlling shareholder of a corporation the stock of which is not listed on an established market is any person who, directly or indirectly, or together with related persons (as described in sections 267(b) and 707(b)),

possesses voting power in Distributing or Controlled representing a meaningful voice in the governance of the corporation.

(ii) A controlling shareholder of a corporation the stock of which is listed on an established market is a 5-percent shareholder who actively participates in the management or operation of the corporation.

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

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

(4) 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).

(5) Five-percent shareholder. A person will be considered a 5-percent shareholder of a corporation the stock of which is listed on an established market if the person owns, directly or indirectly, or together with related persons (as described in sections

267(b) and 707(b)) 5 percent or more of any class of stock of the corporation whose stock is transferred. A person is a 5-percent shareholder if the person meets the requirements of the preceding sentence immediately before or after each transfer. All options are treated as exercised for the purpose of determining whether the shareholder is a 5-percent shareholder.

(l) [Reserved]

(m) Examples. The following examples illustrate paragraphs (a) through (k) 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. D and X enter into a binding contract for D to merge into X subject to several conditions. D distributes C and D merges into X one month later. As a result of the merger, D's former shareholders own less than 50 percent of the stock of X.

(ii) No Safe Harbor applies to this acquisition.

(iii) The issue is whether the distribution of C and the merger of D into X are part of a plan. 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 (d) of this section.

(iv) 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 discussed the acquisition before the distribution (paragraph (d)(2)(i) of this section), D was motivated by a business purpose to facilitate the merger (paragraph (d)(2)(vii) of this section), and the distribution and the merger occurred within 6 months of each other (paragraph (d)(2)(viii) of this section). Because the merger was not only discussed, but was agreed to, before the distribution, the fact described in paragraph (d)(2)(i) of this section is given substantial weight.

(v) None of the facts and circumstances listed in paragraph (d)(3) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(vi) The distribution of C and the merger of D into X are part of a plan under paragraph (b)(1) of this section.

Example 2. Substituted acquirer. (i) The facts are the same as in Example 1, except that after D distributes C, X is unable to fulfill one of the conditions of the merger agreement and the merger of D into X does not occur. Y, one of X's competitors, perceives this as an opportunity and begins discussing with D a merger into Y. Five months after D distributes C, D merges into Y. As a result of the merger, the D shareholders own less than 50 percent of the outstanding Y stock.

(ii) No Safe Harbor applies to this acquisition.

(iii) The issue is whether the distribution of C and the merger of D into Y are part of a plan. To determine whether the distribution of C and the merger of D into Y are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(iv) The following tends to show that the distribution of C and the merger of D into Y are part of a plan: X, a potential acquirer, and D discussed an acquisition before the distribution and a similar acquisition by Y occurred (paragraph (d)(2)(ii) of this section), D was motivated by a business purpose to facilitate an acquisition similar to the merger with Y (paragraph (d)(2)(vii) of this section), and the distribution and the merger occurred within 6 months of each other (paragraph (d)(2)(viii) of this section).

(v) As in Example 1, none of the facts and circumstances listed in paragraph (d)(3) of this section exist in this case. Although a substituted acquirer acquired D, the merger of D into Y was similar to the negotiated merger of D into X.

(vi) The distribution of C and the merger of D into Y are part of a plan under paragraph (b)(1) of this section.

Example 3. 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 50 percent of D's stock with D as a stand alone corporation would be in D's best interest. To facilitate a stock offering by D of 50 percent of its stock, D distributes all the stock of C pro rata to D's shareholders. D issues new shares amounting to 50 percent of its stock to the public in a public offering 7 months after the distribution.

(ii) No Safe Harbor applies to this acquisition. Safe Harbor V, relating to public trading, does not apply to public offerings (paragraph (f)(5)(ii)(A) of this section).

(iii) The issue is whether the distribution of C and the public offering by D are part of a plan. 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 (d) of this section.

(iv) 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 before the distribution (paragraph (d)(2)(iii) of this section), D was motivated by a business purpose to facilitate the public offering (paragraph (d)(2)(vii) of this section), and there were substantial negotiations regarding the public offering within 6 months after the distribution (paragraph (d)(2)(viii) of this section).

(v) None of the facts and circumstances listed in paragraph (d)(3) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(vi) The distribution of C and the public offering by D are part of a plan under paragraph (b)(1) of this section.

Example 4. Public offering followed by unexpected opportunity. (i) Facts. D's managers, directors, and investment banker discuss the possibility of offering C stock to the public. D decides to distribute C pro rata to D's shareholders solely to facilitate a 20 percent stock offering by C. To take advantage of favorable market conditions, C issues new shares amounting to 20 percent of its stock in a public offering 1 month before D distributes its remaining 80 percent of the C stock. The public offering documents disclose the intended distribution of C, which is expected to occur shortly after the public offering. At the time of the distribution, it is not reasonably certain that an acquisition will occur, an agreement, understanding, or arrangement concerning an acquisition will exist, or substantial negotiations concerning an acquisition will occur within 6 months. Two months after the distribution, C is approached unexpectedly regarding an opportunity to acquire X. Five months after the distribution, C acquires X in exchange for 40 percent of the C stock.

(ii) Public offering. (A) No Safe Harbor applies to the public offering. Safe Harbor V, related to public trading, does not apply to public offerings (paragraph (f)(5)(ii)(A) of this section).

(B) The issue is whether the 20 percent public offering by C and the distribution by D of the remaining C stock are part of a plan. To determine whether the distribution and the public offering are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(C) Under paragraph (d)(2) of this section, the following tends to show that the distribution of C and the public offering are part of a plan: D discussed the distribution with its investment banker before the public offering (paragraph (d)(2)(vi) of this section), D was motivated by a business purpose to facilitate the public offering (paragraph (d)(2)(vii) of this section), and the public offering and the distribution occurred within 6 months of each other (paragraph (d)(2)(viii) of this section).

(D) None of the facts and circumstances listed in paragraph (d)(3) of this section, tending to show that a distribution and an acquisition are not part of a plan, exist in this case.

(E) The public offering of C and the distribution of C are part of a plan under paragraph (b)(1) of this section.

(iii) X acquisition. (A) No Safe Harbor applies to the X acquisition.

(B) The issue is whether the distribution of C and the acquisition by C of X are part of a plan. To determine whether the distribution of C and the acquisition by C of X are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(C) Under paragraph (d)(2) of this section, the following tends to show that the distribution of C and acquisition by C of X are part of a plan: The distribution and the acquisition occurred within 6 months of each other (paragraph (d)(2)(viii) of this section). The fact described in paragraph (d)(2)(vii) of this section does not exist in this case because D's business purpose was to facilitate the public offering and C's acquisition of X is not similar to that acquisition.

(D) Under paragraph (d)(3) of this section, the following tends to show that the distribution of C and the acquisition by C of X are not part of a plan: Neither D, C, nor their respective controlling shareholders discussed the acquisition of X or a similar acquisition with potential acquirers before the distribution (paragraph (d)(3)(i) of this section), D had a substantial business purpose for the distribution other than a business purpose to facilitate the acquisition of X or a similar acquisition (paragraph (d)(3)(vi) of this section), and the distribution would have occurred at approximately the

same time and in similar form regardless of the acquisition of X (paragraph (d)(3)(vii) of this section). The distribution was announced and accomplished to facilitate the 20 percent public offering by C. D and C were unaware of the opportunity to acquire X at the time of the distribution.

(E) Weighing the facts and circumstances, the acquisition by C of X and the distribution of C by D are not part of a plan under paragraph (b)(1) of this section.

(F) If C's acquisition of X had occurred more than 6 months after the distribution and had not been the subject of an agreement, understanding, arrangement, or substantial negotiations before the date that is 6 months after the distribution, Safe Harbor II would have applied to C's acquisition of X.

Example 5. 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 D has not been approached by any potential acquirer of C, it is reasonably certain that within 6 months after the distribution either an acquisition of C will occur or there will be an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition of C. Corporation Y acquires C in a merger described in section 368(a)(2)(E) within 6 months after the distribution. The C shareholders receive less than 50 percent of the stock of Y in the exchange.

(ii) No Safe Harbor applies to this acquisition.

(iii) The issue is whether the distribution of C and the acquisition of C by Y are part of a plan. To determine whether the distribution of C and the acquisition of C by Y are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(iv) Under paragraph (d)(2) of this section, the following tends to show that the distribution of C and the acquisition of C by Y are part of a plan: The acquisition and the distribution occurred within 6 months of each other (paragraph (d)(2)(viii) of this section). In addition, the distribution may be motivated by a business purpose to facilitate the acquisition or a similar acquisition because there is evidence of a business purpose to facilitate an acquisition by reason of the fact that at the time of the distribution it was reasonably certain that an acquisition of C would occur or there would be an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition of C within 6 months after the distribution (paragraphs (d)(2)(vii) and (e)(1)(i) of this section).

(v) Under paragraph (d)(3) of this section, the following tends to show that the distribution of C and the acquisition of C by Y are not part of a plan: Neither D, C, nor their respective controlling shareholders discussed the acquisition or a similar acquisition with Y or any other potential acquirers before the distribution (paragraph (d)(3)(i) of this section). Furthermore, D may be able to demonstrate that the distribution was motivated in whole or substantial part by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition (paragraph (d)(3)(vi) of this section). D's stated purpose for the distribution (facilitating D's access to favorable financing) must be evaluated in light of the evidence of a business purpose to facilitate an acquisition. D also may be able to demonstrate that the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition (paragraph (d)(3)(vii) of this section).

(vi) Under paragraph (e)(5) of this section, the existence of the indemnity is irrelevant in analyzing whether the distribution and acquisition of C are part of a plan.

(vii) In determining whether the distribution of C and the acquisition of C by Y are part of a plan, one should consider the importance of D's stated business purpose for the distribution in light of the reasonable certainty that C would be acquired or there would be an agreement, understanding, arrangement, or substantial negotiations regarding an acquisition of C within 6 months after the distribution. If D's stated business purpose for the distribution is substantial even though the reasonable certainty that C would be acquired is evidence of a business purpose to facilitate an acquisition, and if D would have distributed C regardless of Y's acquisition of C, Y's acquisition of C and D's distribution of C are not part of a plan.

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

(ii) No Safe Harbor applies to this acquisition.

(iii) The issue is whether the acquisition of X by D and the distribution of C are part of a plan. To determine whether the distribution of C and the acquisition of X by D are part of a plan, D must consider all the facts and circumstances, including those described in paragraph (d) of this section.

(iv) Under paragraph (d)(2) of this section, the following tends to show that the acquisition of X by D and the distribution of C are part of a plan: The acquisition and the distribution occurred within 6 months of each other (paragraph (d)(2)(viii) of this section). Also, the distribution may be motivated by a business purpose to facilitate the acquisition or a similar acquisition because there is evidence of a business purpose to facilitate an acquisition by reason of the fact that the acquisition occurred after the public announcement of the planned distribution (paragraphs (d)(2)(vii) and (e)(1)(ii) of this section).

(v) Under paragraph (d)(3) of this section, D would assert that the following tends to show that the distribution of C and the acquisition of X by D are not part of a plan: The distribution was motivated by a corporate business purpose other than a business purpose to facilitate the acquisition or a similar acquisition (paragraph (d)(3)(vi) of this section), and the distribution would have occurred at approximately the same time and in similar form regardless of the acquisition (paragraph (d)(3)(vii) of this section). That D decided to distribute C and announced that decision before it became aware of the opportunity to acquire X suggests that the distribution would have occurred at approximately the same time and in similar form regardless of D's acquisition of X. X's lack of participation in the decision also helps establish that fact.

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

Example 7. Multiple acquisitions. [Reserved]

(n) Effective date. This section applies to distributions occurring after August 3, 2001.

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