MORRIS TRUST REGULATIONS AT LAST

Second of Two Parts

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[In the October issue of the *M&A Tax Report* we covered Proposed Regulation 1.355-7 and its effect on acquisitions after spinoffs, as well as the alternative rebuttal rule. In this issue we complete our analysis with further discussion of the alternative rebuttal rule, acquisitions before spinoffs, and possible safe harbors].

Basically, the alternative rebuttal test cannot be met unless you can show that the spinoff does not make an acquisition of either party more likely to occur compared to the potential for such an acquisition absent the spinoff. This may be an impossible hurdle to surmount. In most cases, taxpayers will surely rely on the general rebuttal rule. Once the regulations are finalized and effective, a six-month embargo on acquisitions following spinoffs may evolve. Moreover, during that same six-month period, it may be imprudent to initiate all but the most innocuous of contacts with the distributing or controlled corporation.

Take Example 5 in the proposed regulations. There, a parent effected a spinoff for a valid business purpose. At the same time, it believed it would become a more attractive acquisition candidate if the spinoff was undertaken. The hoped-for acquisition occurred about a year after the spinoff, and it was not undertaken pursuant to an agreement in place during the six-month period following the spinoff. The example concludes that the presumption can be rebutted, under the general rebuttal rule, if the spinoff was in substantial part motivated by the non-acquisition business purpose. However, the transaction cannot satisfy the alternative rebuttal rule because the distributing corporation cannot establish that, at the time of the spinoff, it did not intend that one or more persons would acquire the requisite 50% interest during the two-year period referred to in Sec. 355(e). Yuck again!

Acquisitions Before Spinoffs

Where an acquisition precedes a spinoff, the presumption can be rebutted only if it can be established that, at the time of the acquisition, the distributing corporation and its controlling shareholders did not intend to effectuate a distribution. A controlling shareholder is a person who possesses voting power representing a "meaningful voice" in corporate governance. For a publicly-traded corporation, a controlling shareholder is a person

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who owns 5% or more of any class of stock and who actively participates in the management or operation of the corporation.

Alternatively, the presumption can be rebutted if it can be established that the distribution would have occurred at approximately the same time and under substantially the same terms (regardless of the acquisition), provided no person acquiring an interest in that acquisition becomes a controlling shareholder before the end of the two year period beginning on the date of distribution. If a new controlling shareholder arises from the acquisition (preceding the distribution) the alternative rebuttal mechanism thus provides no solace.

Safe Harbors?

Suppose an acquisition occurs more than two years after a distribution. The distribution and acquisition are presumed part of a plan only if there was an agreement, understanding or arrangement concerning the acquisition at the time of the distribution, or within the two years thereafter. On the other hand, if an acquisition occurs more than two years before the distribution, the acquisition and distribution are not presumed part of a plan unless the IRS establishes that a person acquiring an interest in that acquisition becomes a controlling shareholder before the end of the two year period beginning on the date of distribution.

Note the burden shift! If an acquisition creates a new controlling shareholder, it is not clear that a subsequent spinoff will ever be safely seen as not undertaken pursuant to the requisite plan or series of related transactions.

The regulations confirm that if the distributing corporation is acquired in a manner that invokes Sec. 355(e) it will be taxed on the distribution of all controlled corporations involved in the transaction. However, if several corporations are distributed in a spinoff, and fewer than all are so acquired, the distributing corporation is not taxed on the distribution of those corporations that remain sufficiently independent. These regulations will affect only distributions that occur subsequent to the time the regulations (now in proposed form), are finalized.

The state of the law during the interim is unclear. Most taxpayers believe that no "plan" can be found to exist if at the time of the spinoff, the parties to the business combination did not contemplate such a transaction and there were no negotiations or discussions regarding a business combination until some time after the spinoff had been consummated. See Rev. Rul. 96-30. What, me worry? If you read the proposed regulations, you'll worry.

THE M&A Tax Report
THE MONTHLY REVIEW OF TAXES, TRENDS & TECHNIQUES

PANEL PUBLISHERS
A Division of Aspen Publishers, Inc.
1185 Avenue of the Americas
New York, NY 10036

First Class
US Postage
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Publishers