

Client Alert

Latham & Watkins Tax Department

Treasury Issues Final Regulations Under Anti-Morris Trust Legislation

On April 18th the Internal Revenue Service (IRS) issued final regulations addressing the circumstances in which taxpayers must recognize gain on distributions of stock and securities in an otherwise tax-free spin-off, where the spin-off is part of a plan that includes an acquisition. These long-awaited regulations replace the temporary regulations issued in April 2002 and implement the so-called “anti-*Morris Trust*” legislation enacted by Congress in 1997.

Pursuant to that legislation, a corporation (Distributing) that distributes stock or securities of a controlled subsidiary (Controlled) in what would otherwise have been a tax-free spin-off must recognize gain if the distribution is part of a plan in which one or more persons acquire a 50 percent or greater interest in either Distributing or Controlled. The statute provided that a plan was presumed to exist if the acquisition occurred within two years of the spin-off.

The temporary regulations issued in 2002 provided a non-exclusive list of factors relevant to determining whether a distribution and an acquisition were part of a plan. Those regulations also set forth seven safe harbor situations, the satisfaction of any one of which guaranteed that a distribution and an acquisition would not be treated as part of a plan.

The final regulations clarify and, in some cases, modify certain portions of the temporary regulations. Some of the more significant changes are discussed below.

The final regulations retain the safe harbors contained in the 2002 temporary regulations, with some modifications. Significantly, Safe Harbor IV of the 2002 temporary regulations has been expanded. That safe harbor previously provided that a distribution that occurs more than two years *after* an acquisition is not treated as 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. The final regulations provide a more relaxed approach, but only for certain types of acquisitions. Under the new safe harbor, if the pre-distribution acquisition does not involve a public offering, the acquisition and the distribution will not be treated as part of a plan if the acquisition occurs before the first “disclosure event” regarding the distribution (in general, any communication made to the acquirer or any other person by an officer, director, controlling shareholder, or employee of Distributing or Controlled, or an outside advisor, regarding the possibility of the distribution). This safe harbor is not available to acquisitions by controlling shareholders or 10-percent

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shareholders, or acquisitions of 20 percent (or more) of the stock of the acquired corporation (on the theory that, in such cases, the person making the acquisition could participate in the decision to cause the subsequent distribution).

The new regulations also add a safe harbor for *pro rata* distributions that occur after an acquisition, where the acquisition does not involve a public offering. Under this safe harbor (Safe Harbor V of the new regulations), such an acquisition is not treated as part of a plan that includes the distribution if it 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. Similar to Safe Harbor IV, this safe harbor is not available to acquisitions by controlling or 10-percent shareholders of Distributing, or acquisitions of 20 percent (or more) of the stock of the acquired corporation.

The final regulations also add a new safe harbor (Safe Harbor VI) for acquisitions involving a public offering, where the acquisition occurs before the distribution. Such an acquisition will not be treated as part of a plan that includes the distribution if the acquisition occurs before the first disclosure event regarding the distribution (in the case of an acquisition of stock not listed on an established market) or before the date of the first public announcement regarding the distribution (where the stock is

listed on an established market). This safe harbor is based on the IRS's view that a public offering and a distribution are likely not part of a plan where the acquirers in the offering are unaware that the distribution will occur.

In addition to changing the safe harbors, the new regulations make certain clarifying changes to the non-exhaustive list of "plan factors" and "non-plan factors" set forth in the 2002 temporary regulations. For example, under the 2002 temporary regulations, if an acquisition (not involving a public offering) occurred before a distribution, the fact that there were no discussions by Distributing or Controlled with the acquirer about the distribution during the two years prior to the acquisition was considered a factor tending to show the absence of a plan. This provision did not apply, however, if the acquisition occurred after the date of the public announcement of the planned distribution. In drafting the final regulations the IRS recognized that such a public announcement, if made prior to discussion of the acquisition, suggests that the distribution would have been made even in the absence of the acquisition. Thus, the final regulations provide that if an acquisition (not involving a public offering) occurs before a distribution, the fact that there were no discussions by Distributing or Controlled with the acquirer about the distribution during the two-year period ending on the date of the earlier of the date of the acquisition or the date of the first public announcement regarding the distribution tends to show the absence of a plan.

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