

355(d)(5)(C) and paragraph (e)(2) of this section. Accordingly, D may presume that section 355(d) does not apply to the distribution of C to P. This result would not change even if the statistical sampling that involves less than 50 percent of D's outstanding shares indicated that more than 50% of D's shares were acquired by purchase during the five-year period.

Example 4. Non-publicly traded corporation.

D is owned by 20 shareholders and has a single class of stock that is not reporting stock. D knows that A owns 40 percent of the D stock, and D does not know that any other shareholder has owned as much as five percent of the D stock at any time during the five-year period. D may not rely on the presumption in paragraph (f)(3) of this section because its stock is not reporting stock. D may not rely on the presumption in paragraph (f)(4) of this section with respect to A. In addition, D may not rely on the presumption in paragraph (f)(4) of this section for any less-than-five-percent shareholder that, at any time during the five-year period, is related to A under section 355(d)(7)(A), acted pursuant to a plan or arrangement with A under section 355(d)(7)(B) and paragraph (c)(4) of this section with respect to acquisitions of D stock, or holds stock that is attributed to A under section 355(d)(8)(A). D may rely on the presumption in paragraph (f)(4) of this section for less-than-five-percent shareholders that during the five-year period are not related to A, did not act pursuant to a plan or arrangement with A, and do not hold stock attributed to A. Accordingly, under paragraph (f)(1) of this section, to determine whether section 355(d) applies, D must determine: that A is its only shareholder that is (or was at any time during the five-year period) not a less-than-five-percent shareholder; whether A acquired its directly held D stock by purchase under section 355(d)(5) and paragraphs (d) and (e)(2) and (3) of this section during the five-year period; whether A is treated as having purchased any additional D stock under section 355(d)(8) and paragraph (e)(1) of this section during the five-year period; and whether A is related to, or acquired its D stock pursuant to a plan or arrangement with, one or more of D's other shareholders during the five-year period under section 355(d)(7)(A) or (B) and paragraph (c)(4) of this section, and if so, whether those shareholders acquired their D stock by purchase under section 355(d)(5) or (8) and paragraphs (d) and (e) of this section during the five-year period.

(g) *Effective date.* This section applies to distributions occurring after December 20, 2000, except that they do not apply to any distributions occurring pursuant to a written agreement which is (subject to customary conditions)

binding on December 20, 2000, and at all times thereafter.

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§ 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 acquisi-

tion 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 reor-

ganization 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 indi-

rectly 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 offi-

cers, 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.

[T.D. 9198, 70 FR 20283, Apr. 19, 2005]

§ 1.356-1 Receipt of additional consideration in connection with an exchange.

(a) If in any exchange to which the provisions of section 354 or section 355 would apply except for the fact that there is received by the shareholders or security holders other property (in addition to property permitted to be received without recognition of gain by such sections) or money, then—

(1) The gain, if any, to the taxpayer shall be recognized in an amount not in excess of the sum of the money and the fair market value of the other property, but,

(2) The loss, if any, to the taxpayer from the exchange or distribution shall not be recognized to any extent.

(b) For purposes of computing the gain, if any, recognized pursuant to section 356 and paragraph (a)(1) of this section, to the extent the terms of the exchange specify the other property or money that is received in exchange for a particular share of stock or security surrendered or a particular class of stock or securities surrendered, such