



OFFICE OF
CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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INTERNAL REVENUE SERVICE CHIEF COUNSEL ADVICE

MEMORANDUM FOR DISTRICT DIRECTOR,
Attn: Chief, Examination Division

FROM: Assistant Chief, Executive Compensation Branch
Office of the Division Counsel/Associate Chief Counsel (Tax
Exempt and Government Entities), CC:TEBE:EB:EC

SUBJECT: Withdrawal of Section 280G Private Letter Ruling Request

In accordance with section 8.07(2)(b) of Rev. Proc. 2000-1, 2000-1 I.R.B., 4, 33, we are notifying you that a February 2, 2000, ruling request that was submitted to this office, requesting rulings under section 280G of the Internal Revenue Code, was withdrawn in anticipation of adverse rulings. It is our understanding that your office has audit jurisdiction over this Taxpayer.

DISCLOSURE STATEMENT

This memorandum is Chief Counsel Advice and is open to public inspection pursuant to the provisions of section 6110(i). The provisions of section 6110 require the Service to remove taxpayer identifying information and provide the taxpayer with notice of intention to disclose before it is made available for public inspection. Sec. 6110(c) and (i). Section 6110(i)(3)(B) also authorizes the Service to delete information from Chief Counsel Advice that is protected from disclosure under 5 U.S.C. § 552 (b) and (c) before the document is provided to the taxpayer with notice of intention to disclose. Only the National Office function issuing the Chief Counsel Advice is authorized to make such deletions and to make the redacted document available for public inspection. **Accordingly, the Examination, Appeals, or Counsel recipient of this document may not provide a copy of this unredacted document to the taxpayer or their representative.** The recipient of this document may share this unredacted document only with those persons whose official tax administration duties with respect to the case and the issues discussed in the document require inspection or disclosure of the Chief Counsel Advice. Chief Counsel Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be cited as precedent.

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LEGEND:

Taxpayer =

Date B =

Year C =

Year D =

Exchange Index =

ISSUES:

Taxpayer requested that we rule as follows:

1. For purposes of section 280G of the Code, the waiver of market-based exercisability restrictions with respect to stock options held by Taxpayer's executives will not constitute a parachute payment due to the accelerated vesting of nonvested property;
2. For purposes of section 280G of the Code, the calculation of the contingent portion of the Taxpayer's stock options that are vested on account of the merger is performed under the rules of Q&A 24(c) of section 1.280G-1 of Proposed Income Tax Regulations, published in the Federal Register on May 5, 1989 (54 Fed. Reg. 19,390), taking into account only the service-based restriction on the options; and
3. For purposes of section 280G of the Code, Q&A 24(c) of the proposed regulations applies to any lump-sum payments of termination benefits received by Taxpayer's executives on account of a change in ownership or control that served as a substitute for amounts they would have received had they continued to work for Taxpayer.

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CONCLUSIONS:

Prior to Taxpayer's withdrawal of the above-listed ruling requests, we were prepared to rule adversely as follows:

1. The market-based exercisability restrictions caused the options to be unvested in the hands of Taxpayer's executives, and therefore, the waiver of those restrictions resulted in parachute payments on the accelerated vesting of those options when Taxpayer experienced a change of control.
2. The amount contingent on Taxpayer's change of control due to the accelerated vesting of the options may not be reduced using Q&A 24(c) of the proposed regulations.
3. Q&A 24(c) of the proposed regulations does not apply to any lump-sum payments of termination benefits received on account of a change in control that represent severance pay or amounts the executives would have been paid had they continued to perform services.

FACTS:

Taxpayer has or will shortly experience a change of ownership or control.

The Taxpayer Executive Share Option Scheme (Plan) was adopted and approved by shareholders on Date B (and amended in Years C and D). Each February since Plan's adoption, Taxpayer's executives have been granted options under Plan. No options were granted in February of this year. Options granted last February were granted more than a year prior to any change in control.

Under Plan, all options are granted with an option price that is not less than the fair market value of the stock on the date of the option grant. The options granted under Plan may be either nonstatutory stock options or incentive stock options (ISO's) under section 422 of the Code. The option period is not longer than 10 years. If, however, the optionee terminates service without exercising the options before the end of that option period, the options expire either three, twelve, or thirteen months (depending on the executive's age and the timing of special exercisability provisions) after the executive terminates employment.

These options are subject to both service-based vesting conditions and special market-based exercisability limitations. The service-based vesting conditions provide that the options do not vest until the third anniversary of the option grant. If the optionee ceases to be an executive before the end of the three-year vesting period, the optionee forfeits the options.

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The exercisability limitations have been applied to all options granted after Date C. These conditions provide that an option that is otherwise vested cannot be exercised unless the share price of Taxpayer's stock has outperformed the Exchange Index for at least three consecutive months. In the event the share price does not outperform the Exchange Index for three consecutive months, on the tenth anniversary of the grant, the option lapses.

Plan also contains special change in control exceptions to the above-described vesting and exercisability limitations. Under these rules, all outstanding options, whether vested or unvested, become vested and exercisable on any change in control of Taxpayer and remain exercisable for six months thereafter. If, and to the extent, that any options which were originally granted as ISO's are accelerated, the accelerated options must be tested under the \$100,000 limitation of section 422(d) of the Code.

Taxpayer also operates the Corporation Severance Security Plan (Severance Plan) as its severance plan for its regular, full-time, salaried employees who are involuntarily terminated from their jobs as a result of (1) elimination of the employee's position; (2) closing of a work location; (3) business reorganization; and (4) sale of a business (but only if the buyer has not offered the employee a position within two salary grades of the current position). Severance Plan is unfunded, and all benefits paid under Severance Plan are paid from Corporation's general assets.

Severance Plan benefits are based on the terminated employee's service and pre-termination base salary and on the employee's salary grade level. With respect to the senior managers at certain high-level salary grades, two weeks' of pay for each full year of service is provided, plus an additional six months of the executive's pre-termination base salary. For employees below the senior level, two weeks of pay for each full year of service is provided, with a minimum benefit guarantee of 13 weeks of pay and a maximum benefit guarantee of 26 weeks of pay. Both groups of employees may elect to receive these involuntary termination benefits either in a lump sum or over a period correlating to the same number of weeks and months used in calculating the benefit.

LAW AND ANALYSIS:

Section 280G of the Code provides that no deduction will be allowed for any excess parachute payment. Section 280G(b)(1) defines "excess parachute payment" as an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.

Section 280G(b)(2)(A) of the Code defines "parachute payment" as any payment in the nature of compensation to (or for the benefit of) a disqualified individual if (i) such payment is contingent on a change in the ownership or

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effective control of the corporation or in the ownership of a substantial portion of the assets of the corporation and (ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such change equals or exceeds an amount equal to three times the base amount.

Section 4999(a) of the Code imposes on any person who receives an excess parachute payment a tax equal to 20 percent of the amount of the payment.

Ruling Requests 1 and 2

Consistent with legislative history, Q&As 12 and 13 of the proposed regulations generally provide that, under section 280G, a payment in the nature of compensation with regard to property occurs when the property is transferred and becomes substantially vested as defined in section 1.83-3(b) of the regulations and that this rule applies to nonstatutory options if they have an ascertainable fair market value (whether or not readily ascertainable as defined in section 1.83-7(b)) at the time the option becomes substantially vested. According to section 1.83-3(b), property is substantially nonvested when it is subject to a substantial risk of forfeiture, within the meaning of section 1.83-3(c). There, it is provided, in part, that where an employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase, such property is subject to a substantial risk of forfeiture.¹

Also consistent with the legislative history, Q&A 22(c) of the proposed regulations generally provides that, if in fact a payment would have been made had no change in control occurred, it is treated as contingent on the change if the change accelerates the time at which the payment is made. However, the payment that is contingent on the change may be significantly reduced by the rules described in Q&A 24(c), provided that it was substantially certain, at the time of the change, to have been made without regard to the change if the disqualified individual had continued to perform services for the corporation for a specified period of time. If the property may have become, but for the change, substantially vested upon the occurrence of a vesting event other than services, Q&A 24(c) does not apply and the full amount of the payment is contingent on the change. See Q&A 24(e), Example 9.

¹ Q&A 13(c) of the proposed regulations indicates that the issue of whether a statutory option is a payment at the time of grant or at a later time is reserved for future regulations. For purposes of this private letter ruling, we were prepared to advise that, consistent with legislative history, statutory options should be treated the same as nonstatutory options.

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Prior to the withdrawal of ruling requests 1 and 2, we advised Taxpayer's representatives that we were prepared to rule that the exercisability restrictions caused the options granted under Plan (whether statutory or nonstatutory) to be nonvested prior to the change, that the payment in the nature of compensation for purposes of section 280G of the Code occurred when those options received accelerated vesting as a result of the change of control, and that, because vesting was dependent upon an event other than just services, Q&A 24(c) of the proposed regulations did not apply to reduce the contingent portion of the payment.²

Ruling Request 3

Q&A 24(c) was included in the proposed regulations to reduce the contingent portion of a nonvested payment that had been partially earned by the taxpayer with services, but had not been paid. This does not occur with amounts paid under an employment agreement because these amounts are paid as they are earned.

In the case of amounts paid under an employment agreement, the operative Q&A governing those payments is Q&A 42(b) of the proposed regulations. Q&A 42(b) indicates that amounts paid as damages for breach of contract may be reasonable compensation for personal services to be rendered on or after the date of the change of control if certain requirements are met. (See section 280G(b)(4)(A) and (B) of the Code, which concern the treatment to be afforded amounts the taxpayer establishes with clear and convincing evidence represent reasonable compensation for services rendered before and after the change of control.)

Q&A 44 of the proposed regulations also affects the treatment, for purposes of section 280G, of payments for the remaining unearned portions of an employment agreement or amounts paid as severance pay. Q&A 44 provides that severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of a change of control.

Prior to the withdrawal of ruling request 3, we were prepared to rule that all of the amounts paid under the Severance Plan that substituted for compensation that would have been earned had the executives continued to perform services for

² Note that while this ruling would have required that the full value of the options be included for purposes of determining the "three-times-base-amount test" of section 280G(b)(2)(A)(ii), it does not preclude a reduction in an excess parachute payment as provided in section 280G(b)(4)(B) if the Taxpayer can prove by clear and convincing evidence that all or a part of the payment represented reasonable compensation for services actually rendered before the change of ownership or control.

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Taxpayer were parachute payments because (1) they did not qualify for the reduction set out in Q&A 24(c), (2) they did not meet all the requirements of Q&A 42(b), and (3) they were severance pay as discussed in Q&A 44.

We bring this matter to your attention so that you may take whatever action, if any, you deem appropriate. If you have any questions about this matter, please contact us at (202) 622-6030.

Sincerely,

Robert Misner
Robert Misner
Assistant Chief
Executive Compensation Branch
Office of the Division Counsel/
Associate Chief Counsel (Tax
Exempt and Government Entities)