COMMENTS ON PROPOSED RULEMAKING AND OTHER GUIDANCE REGARDING GOLDEN PARACHUTE PAYMENTS

The following comments regarding the proposed regulations on golden parachute rules of Sections 280G and 4999 of the Internal Revenue Code of 1986, as amended, published by the U.S. Department of Treasury ("Treasury") on February 20, 2002, with corrections issued June 20, 2002, represent the individual views of the members of the Executive Compensation Subcommittee, Employee Benefits Committee, Section of Taxation, who prepared them. These comments do not represent the position of the American Bar Association or any of its Sections.

Individual members of the Executive Compensation Subcommittee prepared these comments. Not all members of the subcommittee who participated in the development of the comments paper agreed with all of the comments contained herein. Participating in the preparation of the comments were John E. Aguirre, Dennis E. Drapkin, Richard A. Grimm, Russell E. Hall, Richard M. Harter, Jennifer A. Henrikson, R. Scott Kilgore, Andrew C. Liazos, Wayne R. Luepker, Keith Mong, Donald L. Norman, Michael E. Pietzsch, Melissa K. McGrory, Priscilla E. Ryan, Max J. Schwartz, Steven H. Sholk, Marvin S. Swift, Linda A. Wilkins, and Mark Wintner.

These comments were reviewed by Priscilla Ryan, a Vice Chair of the Employee Benefits Committee of the Tax Section of the American Bar Association, Pamela Baker, of the Section’s Committee on Government Submissions and by Stuart M. Lewis, Council Director for the Committee on Government Submissions.

Although members who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments.

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I. EXECUTIVE SUMMARY

Our recommendations regarding the proposed regulations are as follows:

A. Exempt Payments Made by Certain Tax-exempt Entities

1. We recommend that the final regulations eliminate the requirement that a parachute payment to a disqualified individual who provides services to a tax-exempt organization must be made by the tax-exempt organization in order for the payment to be exempt under section 280G. Instead, we recommend that either (i) the tax-exempt organization must make the payment or (ii) the tax-exempt organization must approve the parachute payment in compliance with federal and state law requirements governing its tax-exempt status, including when applicable the intermediate sanctions rules of section 4958, and that the services be rendered to the tax-exempt entity.

2. We recommend that the final regulations provide that a tax-exempt organization with taxable affiliates be eligible to qualify for the exemption, so long as the disqualified individual is employed by the tax-exempt organization that makes or approves the parachute payments to such individual.

B. The Private Company Exemption

1. We recommend that the final regulations clarify for purposes of determining whether the shareholder approval requirements are met whether the stock option attribution rules of section 318(a) apply in determining the number of outstanding shares of stock of a corporation.

2. We recommend that in determining the number of shares of stock outstanding for purposes of the entity shareholder approval requirement that the provision disregarding shares held by a partnership which has a partner who is a disqualified individual be modified in the final regulations to exclude shares held by such partnership only if the disqualified individual or one of his or her partners is eligible for a payment subject to the shareholder vote.

3. We recommend that the final regulations include a safe harbor setting forth information which would constitute adequate disclosure of material facts to the shareholders.

1 All section references are references to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
C. **Definition of Disqualified Individuals**

1. We recommend that the method of determining the identity of 1% shareholders be modified in the final regulations to permit methods comparable to those used for testing qualified plans.

2. We recommend that the application of the constructive ownership rules in Q&A-17 be modified in the final regulations so that the exercise price for options is subtracted, and so that payments that do not give rise to voting rights until after the change of control are excluded.

3. We recommend that the final regulations clarify the calculation of the number of outstanding shares for purposes of applying the 1% test.

4. We recommend that the 1% test be modified to exclude holdings that do not reflect an ability significantly to influence the corporation.

5. We recommend that the final regulations define the term “officer” by reference to the definition of “executive officer” under section 16 of the Securities Exchange Act of 1934.

6. We recommend that the final regulations include a rule of administrative convenience that may be used to determine officer status.

D. **Amounts Contingent on Change**

We recommend that the final regulations clarify the application of section 280G to agreements made after a change of control.

E. **Change in Ownership of Assets**

We recommend that the final regulations explain the significance of the addition of the word “gross” to the phrase “total fair market value” used in Q&A-29 of the 1989 Proposed Regulations. We also recommend that the final regulations explain how to measure the total gross fair market value of assets of a corporation in situations involving the sale of the stock of a subsidiary (including, without limitation, the sale of the stock of a subsidiary that is treated for federal income tax purposes as an asset sale pursuant to an election under section 338(h)(10)) when the purchase price of the stock of the subsidiary is less than one third of the value of the assets of an affiliated group, but the value of the underlying assets of the subsidiary (without taking into consideration the liabilities of the subsidiary) is more than one third of the value of the assets of the affiliated group.

F. **Merger of Equals**

1. We recommend that the new overlapping ownership rules apply no earlier than the permanent effective date for the Proposed Regulations. In addition, we recommend that the final regulations state that no inference is intended as to the
meaning of the 1989 Proposed Regulations by the new language in the Proposed Regulations regarding overlapping ownership.

2. We recommend that the final regulations formalize the rulings set forth in a number of private letter rulings regarding Q&As-27, 28, and 29.

G. **Determination of Present Value**

1. We recommend that the final regulations clarify that the applicable Federal rate to be used to determine the present value of payments to be made under an agreement entered into before a change of control be based upon the time between the date of the change and the date(s) on which payments would have been made in the absence of a change of control.

2. We recommend that the final regulations clarify that the applicable Federal rate that is to be used in determining the present value of future payments is the applicable Federal rate on the date of the change of control, unless the agreement between the corporation and the disqualified individual specifies that the applicable Federal rate in effect on the date the agreement is entered into is to apply for purposes of calculating such present value.

H. **Reasonable Compensation**

We recommend that the final regulations eliminate the condition that a disqualified individual whose employment has been involuntarily terminated by his or her employer must offer to provide personal services to the employer, which the employer rejects, in order for the disqualified individual to demonstrate that the contractual damages he or she receives is reasonable compensation.

I. **International**

1. We recommend that the final regulations provide that a disqualified individual who, during the disqualified individual determination period, was a nonresident alien and was not subject to income tax in the United States on wages earned from the affiliated group, not be subject to the excise tax. This rule would apply regardless of which entity inside the affiliated group employs the disqualified individual and regardless of the amount of time the disqualified individual has been present within the United States.

2. We recommend that the final regulations provide that a corporation domiciled outside the United States can qualify for both the small business corporation exception and the shareholder approval exception for payments made to disqualified individuals subject to tax on compensation for services performed in the United States.

3. We recommend that the final regulations clarify that the deduction denied to foreign subsidiaries of U.S. corporations for golden parachute payments reduces the earnings and profits of the foreign subsidiaries, thus having an impact on the
U.S. parent corporation’s dividends, foreign tax credits, and liquidations. Our recommendation is similar to the rule that applies for nondeductible political contributions (see Rev. Rul. 77-442).

J. Bankruptcy

Several private letter rulings address the application of section 280G to financially distressed corporations undergoing corporate reorganizations. In some instances, the corporations are in a reorganization proceeding in the United States Bankruptcy Courts. In other situations, however, the corporations are engaged in reorganizations outside of a bankruptcy filing. We recommend that rulings set forth in the private letter rulings discussed below be incorporated into the final regulations.

II. BACKGROUND


III. COMMENTS

EXEMPT PAYMENTS MADE BY CERTAIN TAX-EXEMPT ENTITIES

1. Summary

The Proposed Regulations clarify when a payment made by a tax-exempt entity that would otherwise be a “parachute payment” is not a “parachute payment.” Q&A-6(a)(3) provides that this exemption is available if the payment is made by a tax-exempt entity that is a “tax-exempt organization.” The Proposed Regulations define a “tax-exempt organization” as any organization subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, an organization described in subsection 501(c)(1) or 501(c)(21), a religious or apostolic organization described in section 501(d), or any qualified tuition program described in section 529. The organization must satisfy the definition of a “tax-exempt organization” both immediately before and immediately after the change in ownership or control.
2. **Identity of Payor.**

   **Recommendation.**

   We recommend that the final regulations eliminate the requirement that a parachute payment to a disqualified individual who provides services to a tax-exempt organization must be made by the tax-exempt organization. Instead, we recommend that the tax-exempt organization either must make the payment or must approve the parachute payment in compliance with federal and state law requirements governing its tax-exempt status, including when applicable the intermediate sanctions rules of section 4958, and that the disqualified individual’s services must be rendered to the tax-exempt organization.

   **Explanation.**

   Payment is not always made by the tax-exempt organization for whom services are being performed. For example, assume that a tax-exempt organization has a taxable subsidiary. Payment may be made by the taxable subsidiary for services performed by an employee of such subsidiary for the tax-exempt organization. We believe that where services are being performed for a tax-exempt organization, regardless of which entity actually makes the payment, it is appropriate that these payments not be parachute payments for purposes of the excise tax under section 4999.

   The approval process for a parachute payment provides, by itself, adequate assurance that the payment is reasonable compensation that should be exempt from the excise tax. As part of approving a contract providing parachute payments, tax-exempt organizations subject to the private inurement prohibition cannot provide unreasonable compensation, and disqualified individuals who receive and organizational managers who approve unreasonable compensation packages may be subject to excise taxes under the intermediate sanctions rules. In enacting intermediate sanctions for section 501(c)(3) organizations, Congress provided for a rebuttable presumption of reasonableness if compensation is approved in the manner prescribed in regulations promulgated under section 4958.

   Furthermore, we believe payments made by a taxable organization upon acquiring tax-exempt organization assets will be improperly excluded from the exemption for purposes of the excise tax under section 4999 as the exemption is currently formulated. For example, assume that a section 501(c)(3) organization enters into an employment agreement with a disqualified individual. The agreement provides a right to severance benefits upon termination of employment following a change of control. Subsequently, the organization transfers substantially all of its assets to a taxable entity, thereby triggering a change of control under the agreement. After being employed by the taxable successor entity for eighteen months, the disqualified individual’s employment is terminated, and he or she becomes entitled to severance payments. The severance benefit was part of an employment contract approved by the tax-exempt organization prior to the disqualified individual determination period, consistent with applicable federal and state law, and the employment contract was assumed by the taxable buyer. We recommend that, under these circumstances, the severance payments made by the successor not be considered parachute payments for purposes of the excise tax under section 4999, because the tax-exempt organization was required to determine if the parachute payments were
reasonable compensation and to determine if the sale of assets complied with applicable federal and state law governing tax-exempt or nonprofit organizations.

As discussed above, we believe that if a change of control is the result of a change from a tax-exempt entity to a taxable entity, the payment from the taxable entity should be exempt from the excise tax under section 4999. We do not believe, however, that the exemption should apply if the payment is made under other circumstances. For example, if (i) an individual enters into an employment agreement with a tax-exempt entity, (ii) a successor taxable employer replaces the tax-exempt employer in a change of control, (iii) a subsequent change of control occurs with respect to the successor entity, and (iv) payments are made to the individual in connection with the second change of control, then the exemption should not apply.

Generally, the exclusion of amounts paid by a tax-exempt organization will result in the individual not being subject to the excise tax under section 4999, but the presence or absence of an exemption from the deduction provisions of section 280G will have no effect on the tax-exempt organization. We believe that excluding payments earned by an individual while providing services to a tax-exempt organization for purposes of the excise tax under section 4999 reflects sound tax policy. However, we believe that an exclusion from the deduction limits of section 280G for payors that are taxable entities represents a more difficult policy question, and those participating in this comment were divided as to whether payments approved by a tax-exempt organization, but made by a taxable entity, should be exempt from section 280G. In support of the exemption from section 280G for payments made by a taxable entity is the fact that the commitment to payment was made while the person was performing services for the tax-exempt organization. In opposition to the exemption is the fact that it would seem an odd result that a taxable organization would be exempt from section 280G.

3. Affiliates.

Recommendation.

We recommend that the final regulations provide that a tax-exempt organization with taxable affiliates be eligible to qualify for the exemption, so long as the disqualified individual is employed by the tax-exempt organization that approves the parachute payments to such individual.

Explanation.

It is common for a tax-exempt organization to own or have a participating interest in a taxable entity. Q&A-46 provides that all members of the same “affiliated group,” as defined under section 1504(a), are treated as a single corporation. Strict application of this rule might suggest that a tax-exempt organization that has taxable affiliates cannot qualify for the exemption. The existence of a taxable affiliate has no bearing on the policy reasons for the exemption or the process by which a tax-exempt organization approves parachute payments for a disqualified individual.
THE PRIVATE COMPANY EXEMPTION

1. Summary.

Q&A-6(a)(2)(ii) of the Proposed Regulations exempts from the definition of the term “parachute payment” any payment made by a corporation for which, immediately before the change in ownership or control, no stock is readily tradable on an established securities market or otherwise, if the shareholder approval requirements described in Q&A-7 are met.

2. Stock Taken into Account.

Recommendation.

We recommend that the final regulations clarify whether the stock option attribution rules of section 318(a) apply in determining the number of outstanding shares of stock of a corporation for purposes of determining whether the shareholder approval requirements are met.

Explanation.

The Proposed Regulations provide that all the outstanding stock is taken into account for determining whether the shareholder approval requirements are met. There is an express exception for stock owned by disqualified individuals, which is discussed further below. In determining the number of shares owned by disqualified persons that must be excluded from the number of shares outstanding, Q&A-7 provides that the attribution rules of section 318(a) apply. Under those attribution rules, inter alia, a person is generally considered to own the stock that could be acquired on the exercise of vested stock options (the “deemed exercise rule”). It is unclear whether the deemed exercise rule also applies in determining the number of outstanding shares of a corporation.

3. Entity Shareholders.

Q&A-7 of the Proposed Regulations provides that if a substantial portion of assets of an entity shareholder consists of stock in the corporation undergoing the change of control then a separate approval of the payment must be passed through to the entity shareholders if the entity owns at least one-third of the corporation’s shares. The approval generally must be obtained by more than 75% of the voting power of the entity shareholder.

Explanation.

If a shareholder is not an individual (i.e., an “entity shareholder”), approval must generally be made by the person authorized by the entity shareholder to approve the payment. There are two exceptions.

When a partner authorized by a partnership to approve a payment is a disqualified individual none of the stock held by the partnership is taken into account for purposes of determining whether the shareholder approval requirements are met. We believe that this provision is broader than necessary to address potential abuse and recommend that the exclusion
of partnership stock apply only if the partner who is a disqualified individual or one of his or her partners is eligible for a payment that will be subject to a shareholder vote.


   Recommendation.

   We recommend that the final regulations include a safe harbor setting forth information which would constitute adequate disclosure of material facts to the shareholders.

   Explanation.

   Section 280G(b)(5)(B)(ii) provides that the shareholder approval requirement is met if there is adequate disclosure to shareholders of all material facts concerning all payments that would be parachute payments (but for the shareholder approval exception) with respect to a disqualified individual. Q&A-7 provides that there must be a full and truthful disclosure of the material facts and such additional information must be given as necessary to make the disclosure not materially misleading when made. Q&A-7 also provides that the following two pieces of information must be disclosed to shareholders: (1) the total amount of the parachute payments made to each disqualified individual, and (2) a brief description of each payment.

   We believe that the general standard set forth in Q&A-7(a)(2) and (c) is sound. Nevertheless, because in practice there has been disagreement regarding what disclosure would be required, we recommend that the final regulations include a safe harbor that sets the minimum information to be disclosed. For example, the final regulations might provide that the full disclosure requirement would be satisfied if a description of the following was provided:

   (a) the change of control transaction;
   (b) the tax consequences to the corporation and the disqualified individual resulting from the payment of excess parachute payments;
   (c) the shareholder approval exception to section 280G; and
   (d) the fact that the payment will not occur (or if it has occurred will be returned) if the requisite shareholder approval is not obtained.

   DEFINITION OF DISQUALIFIED INDIVIDUALS

1. Explanation.

   Q&A-2 provides that “parachute payments” are payments made to or for the benefit of disqualified individuals. Q&As-15 through 21 provide rules for determining who is a disqualified individual.
2. Shareholder Test.

2.1. Summary.

Q&A-17 provides that an individual is a disqualified individual due to share ownership during the “disqualified individual determination period” (defined in Q&A-20) only if the individual’s share ownership exceeds 1% of the total fair market value of the outstanding shares of all classes of stock of the corporation undergoing a change of control. We welcome the elimination of the alternative $1 million dollar value test set forth in the 1989 Proposed Regulations which would have been difficult to apply due to valuation problems caused by stock price volatility. However, we recommend that the final regulations address the other issues noted below.

2.2. Fair Market Value Determination.

Recommendation.

We recommend that the method of determining the identity of 1% shareholders be modified to permit methods comparable to those used for testing qualified plans.

Explanation.

In determining whether an individual is a disqualified individual due to share ownership, an employer must calculate whether the individual’s share ownership exceeds 1% of the fair market value of all outstanding classes of stock. Although the Proposed Regulations do not explicitly state when an employer must perform this test, the Proposed Regulations can be read as implying that testing is required each day during the disqualified individual determination period. Such a requirement would be impractical for employers to apply and would make it difficult for them to identify disqualified individuals with reasonable certainty prior to a change of control. With respect to qualified plans, employers may substantiate compliance with the nondiscrimination rules on the basis of the employer’s work force on a single day during the plan year (a “snapshot day”), provided that such day is reasonably representative of the employer’s workforce and the plan’s coverage throughout the plan year. Rev. Proc. 93-42, § 3.01, 1993-2 C.B. 540. We recommend that a comparable approach be permitted in determining shareholder status for purposes of Q&A-17.

2.3. Constructive Ownership Rules of Section 318.

Recommendation.

We recommend that the application of the constructive ownership rules in Q&A-17 be modified in the final regulations so that the exercise price for options is subtracted, and so that payments that do not give rise to voting rights until after the change of control are excluded.

Explanation.

The Proposed Regulations state that the constructive ownership rules of section 318(a) apply when determining stock ownership for purposes of the 1% test. Revenue rulings
interpreting section 318 have consistently held that the right to acquire stock which is subject to
the conditions beyond the control of the holder is not an “option” for purposes of the section 318
individual holding vested options is treated as constructively owning the stock acquired on
exercise. The application of the section 318 rules has the effect of overstating the ownership
interest. To address this, we recommend that the final regulations permit employers to subtract
the exercise price when determining the value of shares constructively owned through deemed
exercise. We believe that the test should be applied to the net shareholder ownership conferred
by the option.

We recommend that the final regulations clarify that individuals who do not own stock
options, but have certain contingent rights to receive payments upon a change of control, not be
considered shareholders. One example is a right under a bonus or retention plan to receive a
payment equal to 2% of the proceeds upon the sale of the company. If such contractual rights do
not create voting rights, particularly before the change in ownership occurs, then we recommend
that such rights not be treated as voting stock.

**Recommendation.**

We recommend that the final regulations clarify the calculation of the number of
outstanding shares for purposes of applying the 1% test.

**Explanation.**

Section 318(a) attributes ownership of shares subject to options to disqualified
individuals. We believe that if option shares, which are not issued and outstanding, are to be
attributed to a disqualified person, option shares should also be attributed to all shareholders who
hold options. Under this approach, like ownership interests would be taken into account for both
the numerator and the denominator in determining whether a disqualified individual owns more
than 1% of the voting power of a corporation. We recommend that the final regulations provide
that in determining whether an individual owns more than 1% of the voting power of a
corporation’s outstanding shares that all shares subject to options attributed under section 318(a)
to any shareholder (using whatever the 1% test uses, such as vested options only), regardless of
whether the holder is a disqualified individual, be included in the denominator. An example (or
a modification of A-17(b), example 2) to this effect would be helpful.

**Recommendation.**

We recommend that the 1% test be modified to exclude holdings that do not reflect an
ability significantly to influence the corporation.

**Explanation.**

The preamble to the Proposed Regulations, at 67 Fed. Reg. 7631, states that, in regard to
the $1 million/1% rule that “it has become apparent that this rule may include individuals who do
not possess significant influence over the corporation.” As a result, the Service eliminated the $1
million test. If a corporation is not a widely held public company, it is unlikely that shareholders
with only 1% of total fair market value of the corporation’s shares have “significant influence
over the corporation.” If “influence” is the relevant factor, we recommend that the percentage apply to voting power, not fair market value and that the percentage be increased. We recommend that the final regulations provide a presumption that ownership of stock representing less than 5% of the aggregate voting power of a corporation is not “significant influence” and, therefore, does not establish disqualified individual status. We also recommend that if one shareholder holds stock representing at least 50% of the voting power, no other unrelated shareholder be a disqualified individual by reason of the 1% test.

3. Officer Test

3.1. Definition of “Officer”.

**Recommendation.**

We recommend that the final regulations define the term “officer” by reference to the definition of “executive officer” under section 16 of the Securities Exchange Act of 1934 (“SEA”).

**Explanation**

Q&A-18 provides that the determination of who is an officer is to be made upon the basis of all the facts and circumstances. We believe that it would be useful in determining the relevant facts and circumstances to draw upon the existing body of law that has been developed over the years regarding who is an executive officer for SEA purposes.

3.2. Time of Officer Determination.

**Recommendation.**

We recommend that the final regulations include a rule of administrative convenience that may be used to determine officer status.

**Explanation.**

As noted above, the disqualified individual determination period creates issues in identifying disqualified individuals prior to a change in ownership. For example, in applying the 1% test, the number of employees must be determined based on the greatest number of employees during the disqualified individual determination period. We recommend that the final regulations permit alternative methods for determining “officer” status, e.g., permit an employer to determine the greatest number of employees within a specified period ending before the change in control or determine the number based on the number of forms W-2 for the calendar year before the change in control).

**AMOUNTS CONTINGENT ON CHANGE**

1. **Summary.**
Q&A-23 of the Proposed Regulations (like the 1989 Proposed Regulations) generally provides that a payment is not “contingent on a change in ownership or control” if the payment is made under an agreement entered into after the change (called a “post-change agreement”), provided that the agreement was not entered into pursuant to a legally enforceable agreement that was entered into before the change of control.

The Proposed Regulations added to Q&A-23 that “[i]f an individual has a right to receive a parachute payment under an agreement entered into prior to a change in ownership or control (pre-change agreement) and gives up that right as bargained-for consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement” (emphasis supplied). Accordingly, the Proposed Regulations cast the parachute payment net wider than the 1989 Proposed Regulations, which did not necessarily cover compensation arrangements entered into after a change of control and were not entered into pursuant to a legally enforceable agreement in effect before the change. This extension of the parachute payment concept is generally consistent with a 1993 Tax Court decision in which the Tax Court determined that section 280G could not be avoided by a post-change bonus orally agreed to and paid by an acquirer to a target company executive to make up for a reduction in severance pay amount subject to section 280G. John N. Balch, et al. v. Commissioner, 100 T.C. 331 (1993); see also Cline v. Commissioner, 34 F.3d 480 (7th Cir. 1994). This amendment to the Proposed Regulations is also consistent with a 1995 private letter ruling that section 280G applied to an acquirer’s substitution of a post-change agreement with a pre-change agreement. PLR 9608020 (Nov. 21, 1995).

Recommendation.

We recommend that the final regulations clarify the application of section 280G to post-change agreements.

Explanation.

As described above, the Proposed Regulations treat payments in connection with post-change agreements as not contingent on a change of ownership or control “to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement.” In other words, the Proposed Regulations provide that payments under post-change agreements that are at least equal to but not in excess of those under pre-change agreements will be treated as contingent on a change of ownership or control and tested as parachute payments, but post-change agreement payments in excess of those under pre-change agreements will not. We recommend that the final regulations make it clear how to value post-change agreements and their pre-change counterparts, especially when the nature and terms of the post-change agreement are substantially different from its pre-change counterpart.

We recommend that the final regulations provide that when a disqualified individual is required to surrender a pre-change agreement in return for a new agreement entered into within a specified period after the change of control the compensation under the post-change agreement be presumed to have been entered into prior to the change with respect to amounts not exceeding the pre-change parachute payments, but that the presumption can be rebutted by clear and
convincing evidence. We recommend that the final regulations provide criteria for permitting taxpayers to show that post-change agreements are not entered into in exchange for releasing rights under pre-change agreements.

Further, we recommend that the final regulations clarify (i) how the pre-change parachute amounts are to be allocated to the payments made pursuant to the post-change agreement and (ii) the extent to which post-change amounts can be excluded by reason of being reasonable compensation for services actually rendered. We also recommend that the final regulations provide guidance for determining how to value payments that would have been made pursuant to the pre-change agreement and payments that are made pursuant to the post-change agreement. The following example illustrates some areas of uncertainty:

A target company’s pre-change severance arrangement provided that executive A, who had a $100,000 base amount, would receive $400,000 if he was terminated in connection with a change of control. In these circumstances, $300,000 of A’s pre-change agreement would be an excess parachute payment. In agreeing to purchase target, acquirer (a publicly traded company) enters into an agreement to employ executive A at a base salary equal to his base pay at target, and also enters into an agreement with executive A post-change to provide him with a $200,000 sign-on bonus, and an opportunity to receive a bonus at the second anniversary of the change of control of between $0 and $400,000 based on achievement of performance objectives. He will receive another $100,000 at the time of signing the agreement if, at that time, he agrees to a non-competition restriction that will apply for one year following his termination of employment. Assume the same example, but the executive retains the right to receive some or all of the severance payment if his employment is terminated without cause. If the executive, in fact, never receives the severance payment (for example, because he voluntarily resigns), does that affect the allocation?

The Staff of the Joint Committee on Taxation suggests that post-change agreements with acquiring companies that were contingent on the change of control should be valued “as of the date the contract becomes operative.” See the General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (Division A of the Deficit Reduction Act of 1984, P.L. 98-369), at 202, prepared by the Staff of the Joint Committee on Taxation (the “General Explanation”).

The Proposed Regulations assume the situation in which a disqualified individual is employed in exactly the same capacity with a corporation after the change of control as prior to the change of control. In these circumstances, comparing the value of post-change compensation of a disqualified individual to pre-change compensation is more likely to represent an “apples-to-apples” comparison. The Proposed Regulations appear to assume that any additional payment made pursuant to a post-change agreement constitutes a replacement of parachute payments which may have become due under the pre-change agreement, and so must be treated to the same extent as other payments made on a change of control. However, there are circumstances where additional payments are not the result of a change of control. For example, in many situations, after the change, the disqualified individual will have new duties or obligations, a new peer group, a new title, or a new position. In these situations, it is inequitable to compare the value of the new compensation arrangement to the old compensation arrangement. We believe that when a disqualified individual surrenders rights under a pre-change agreement, and obtains different
rights under a post-change agreement, payments under the post-change agreement should not be treated as contingent on a change of control to the extent that it is shown by clear and convincing evidence that the rights under the post-change agreement are attributable to factors other than the surrender of rights under the pre-change agreement.

**CHANGE IN OWNERSHIP OF ASSETS**

1. **Background.**

   The Proposed Regulations revise Q&A-29, which addresses the issue of when a change in the ownership of a substantial portion of the assets of a corporation occurs for purposes of section 280G, to state as follows:

   For purposes of this section, a change in the ownership of a substantial portion of a corporation’s assets occurs on the date than any one person, or more than one person acting as a group acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than one third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. Prop. Reg. § 1.280G-1, Q&A-29 (emphasis added).

   Q&A-29 of the 1989 Proposed Regulations used the term “total fair market value” rather than “total gross fair market value.”

   **Recommendation.**

   We recommend that the final regulations explain the significance of the addition of the word “gross” to the phrase “total fair market value” used in Q&A-29 of the 1989 Proposed Regulations. We also recommend that the final regulations explain how to measure the total gross fair market value of assets of a corporation in situations involving the sale of the stock of a subsidiary (including, without limitation, the sale of the stock of a subsidiary that is treated for federal income tax purposes as an asset sale pursuant to an election under section 338(h)(10)) when the purchase price of the stock of the subsidiary is less than one third of the value of the assets of an affiliated group, but the value of the underlying assets of the subsidiary (without taking into consideration the liabilities of the subsidiary) is more than one third of the value of the assets of the affiliated group.

   **Explanation.**

   Under the 1989 Proposed Regulations, a change in the ownership of a substantial portion of a corporation’s assets is deemed to occur on the date than any one person or group acquires assets from the corporation having a total fair market value equal to one third or more of the total fair market value of all the assets of the corporation. The phrase “total fair market value” is not defined in the 1989 Proposed Regulations.
Under the Proposed Regulations, a change in the ownership of a substantial portion of a corporation’s assets is deemed to occur on the date that any one person or group acquires assets from the corporation having a total gross fair market value equal to one third or more of the total gross fair market value of all the assets of the corporation. Prop. Reg. § 1.280G-1, Q&A-29. The phrase “total gross fair market value” is not defined in the Proposed Regulations. In fact, the Preamble to the Proposed Regulations makes no mention of such change and goes on to state that the Proposed Regulations follow the same approach as the 1989 Proposed Regulations for determining when a change in ownership or control occurs.

We believe that the addition of the word “gross” in the Proposed Regulations creates ambiguity because it can be interpreted in more than one manner. One interpretation of the phrase “total gross fair market value” is that it means the assets of the corporation without taking into account its liabilities. However, another interpretation of the phrase “total gross fair market value” is that it means the gross proceeds received by the seller. If such phrase is intended to signify that only the underlying assets of a corporation are to be taken into account when determining the “total gross fair market value” of its assets, we recommend that the final regulations clarify this point and that they provide examples.

Additionally, we recommend that the final regulations clarify, in the case of a corporation’s sale of the stock of its subsidiary, whether the value of the corporation’s assets is (i) the purchase price of the stock sold (which would take into account the subsidiary’s liabilities) or (ii) the value of the subsidiary’s underlying assets (which likely would not take into account the subsidiary’s liabilities).

**MERGER OF EQUALS**

1. **Background.**

For section 280G to apply, a change in the ownership of a corporation, a change in effective control of a corporation, or a change in the ownership of a substantial portion of a corporation’s assets must occur. The legislative history of section 280G provides that whether a particular transaction constitutes a change of control “is to be determined under all of the facts and circumstances.” H. Rep. No. 861, 98th Cong. 2d Sess., 851 (1984). Neither the statute nor the legislative history provides any further guidance.

The 1989 Proposed Regulations provide that a change in ownership of a corporation occurs when any one person, or more than one person acting as a group, acquires ownership of stock that, when aggregated with stock already held by such person or group, represents more than 50% of the total fair market value of the total voting power of the stock of the corporation. 1989 Proposed Regulations § 1.280G-1, Q&A-27(a). Persons are not considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. Persons are considered to act as a group, however, if they own an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. 1989 Proposed Regulations § 1.280G-1, Q&A-27(b). All the shareholders of a target corporation are considered to act as a group when they obtain ownership of the acquiring corporation’s stock. 1989 Proposed
Regulations § 1.280G-1, Q&A- 27(d), Example (3). The constructive ownership rules of section 318(a) apply in determining stock ownership.

Under the 1989 Proposed Regulations, a change in effective control of a corporation is presumed to occur if, within any twelve-month period, (i) a person or a group of persons acquires ownership of stock possessing 20% or more of the total voting power of the stock of the corporation, or (ii) a majority of the board is replaced by directors whose appointment or election was not endorsed by a majority of the members of the board prior to the date of the appointment or election. If neither of these events occurs, a change in the effective control of a corporation is presumed not to occur. 1989 Proposed Regulations § 1.280G-1, Q&A-28(a). Whether persons are considered to act as a group is determined in the same manner as determining a change in ownership. The constructive ownership rules of section 318(a) apply in determining stock ownership.

As stated above, under the 1989 Proposed Regulations § 1.280G-1, Q&A-29(a), a change in ownership of a substantial portion of a corporation’s assets occurs on the date any one person, or more than one person acting as a group, acquires assets from the corporation that have a total fair market value of at least one-third of the total fair market value of all the assets of the corporation immediately prior to the acquisition. A transfer of assets of the corporation is not treated as a change of ownership of a substantial portion of the corporation’s assets if, among other exceptions, the corporation transfers the assets to an entity in which, immediately after the transfer, the shareholders of the transferor corporation own at least a 50% interest (by value or voting power). 1989 Proposed Regulations § 1.280G-1, Q&A- 29(b)(4) and 29(d), Example (3). The constructive ownership rules of section 318(a) apply in determining stock ownership.

2. Overlapping Ownership Issue.

The Proposed Regulations restate Q&As-27, 28, and 29 with minor changes, except that the following language has been added to each Q&A:

If a person, including an entity shareholder, owns stock in both entities that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in an entity only to the extent of his ownership in that entity prior to the transaction giving rise to the change and not with respect to his ownership interest in the other entity.

Proposed Regulations § 1.280G-1, Q&A-27(b), 28(d), and 29(d). In addition, Example 4 has been added to Q&A-27(d) to illustrate the operation of the new language. Proposed Regulations § 1.280G-1.2 In the example, Corporation P merges into Corporation O, and P shareholders receive O stock in exchange for their P stock. After the merger, the former shareholders of P own stock representing 51% of the value of Corporation O stock, and the former shareholders of O own stock representing 49% of the value of Corporation O stock. Prior to the merger, three O

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2 The example was revised in important respects by corrections published on June 20, 2002. 67 Fed. Reg. 42210.
shareholders owned P stock that was exchanged for O stock representing 5% of the pre-merger value of the O stock. The example concludes that the three overlapping shareholders are not treated as “acting as a group” with the P shareholders with respect to the O stock each such shareholder owned prior to the merger, and that the three overlapping shareholders are “acting as a group” with the O shareholders only to the extent of their interest in O before the merger.\(^3\)

The preamble to the Proposed Regulations states that the new language and example “clarify” the 1989 Proposed Regulations. 67 Fed. Reg. at 7633 (Feb. 20, 2002). The preamble illustrates the application of the new language with an example. Individual A owns stock in corporations X and Y; X acquires Y stock in exchange for X stock. In determining whether a change in ownership has occurred with respect to Y, the example concludes that A is acting as a group with other Y shareholders only to the extent of A’s pre-transaction interest in Y, and without regard to A’s interest in X. A parallel conclusion applies to the analysis of whether a change in ownership has occurred with respect to X. The preamble notes that the result is the same regardless of whether A is an individual or any other type of shareholder.

Although the effect of the changes made by the Proposed Regulations is not completely clear, the intent appears to be that in applying Q&A-27, 28, and 29 to specific facts, if a shareholder owns stock in both corporations participating in a transaction, such shareholder is to be treated as if it were two distinct shareholders, each of which owns the corresponding number of shares in each of the corporations. Assume, for example, that (i) individual A owns 80% of the stock of each of two public corporations X and Y, (ii) the fair market value of corporation X is equal to N, and the fair market value of corporation Y is equal to 3N, and (iii) X merges into Y solely in exchange for Y stock. Individual A will own 80% of the stock of Y after the merger, 60% of the value of such stock attributable to A’s status as a Y shareholder and 20% of its value attributable to A’s status as an X shareholder. Under the Proposed Regulations, there will be a change in ownership as to corporation X (the former X shareholders will obtain only 25% of the shares of Y by reason of the merger; A is considered to be “acting as a group” with the corporation X shareholders only to the extent of A’s former interest in corporation X, and without regard to A’s interest in corporation Y). Yet it is clear that economically, taking the beneficial interests in both corporations into account, there should not be a change in ownership as to either corporation due to A’s overlapping ownership of both corporations. Furthermore, the

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\(^3\) Presumably, the example is intended to illustrate whether a change in ownership occurred with respect to Corporation O. Therefore, the question is whether the former shareholders of Corporation P own, after the merger, stock of Corporation O representing more than 50% of the total fair market value or total voting power represented by the O stock after the merger. Since the example begins by stating that after the merger, the former P shareholders own 51% of the fair market value of the O stock, a change in ownership of Corporation O has occurred. The overlapping interest that the pre-merger O shareholders owned in P is irrelevant in reaching this conclusion. Furthermore, since the transaction is a merger, the possible use of overlapping ownership by O to prove that a change in ownership or control occurred as to P (which, presumably, the example would contradict) would arise under Q&A-29, not Q&A-27. Under Q&A-29, O would argue that it acquired 100% of P’s assets, and that none of the exceptions in Q&A-29(b) applies.
result should not be different if instead of a single overlapping shareholder, there were multiple overlapping shareholders.

The unstated premise in the Proposed Regulations appears to be that in any combination of two corporations, there must always be a change in ownership as to one of the corporations. As the preceding example shows, there is no policy reason why this should be the case. The “facts and circumstances” referenced in the legislative history should be applied to reflect the economic reality of the absence of a change in beneficial interest when there are significant overlapping shareholder interests. This conclusion is entirely consistent with the Congressional purpose of section 280G to protect the value of shareholder interests:


It is difficult to see how the disallowance of the deduction for excess parachute payments serves to “protect equity shareholders” with overlapping interests in both corporations and who consent to the transaction fully aware of the economic effect of the payments on each corporation that is party to the transaction and the corresponding reduction in the value of their shares in either corporation.

Applying the tax law to reflect the economic substance of overlapping ownership of corporations is not new.\(^4\) Section 382 imposes a limitation on a corporation’s use of net operating loss carryforwards and other tax attributes if an ownership change of more than 50% occurs within any three-year period. The determination of whether an ownership change occurs is based upon changes in the ultimate beneficial ownership of the corporation’s shares. Accordingly, with sufficient overlapping ownership, a combination of two corporations does not mean that an ownership change occurs with respect to either corporation.\(^5\)

Section 355(e) imposes adverse tax consequences on a distributing corporation in a spin-off if, pursuant to a plan, one or more persons acquire stock representing a 50% or greater interest in either the distributing corporation or the controlled corporation. Section 355(e) does not take into account the acquisition of stock in either the acquiring or the distributing corporation to the extent that the direct or indirect percentage ownership interest before the acquisition does not decrease. Section 355(e)(3)(A)(iv). Regulations interpreting this provision have not yet been published. The applicable legislative history clearly states that in applying this rule, the decrease in a shareholder’s interest as a result of a post-spin-off transaction is measured

\(^4\) The points below regarding Sections 382 and 355(e) are made in greater detail in an earlier comment on the Proposed Regulations. See F. Ferrante, Letter to Internal Revenue Service dated April 25, 2002, at 6-10.

by taking into account the shareholder’s pre-transaction interest in both corporations. S. Rep. No. 105-174, 105th Cong. 2d Sess. 174-175.  

Another issue arises when an overlapping shareholder owns different proportionate interests in the two corporations. If a shareholder owns a single share in the target corporation representing an insignificant economic interest, it is difficult to justify taking into account an entire and much larger interest owned by the same shareholder in the acquiring corporation. We recommend that the overlapping interests taken into account be the smaller of the two interests, as illustrated by the following example.

Assume that (i) shareholders A and B own 60% and 40%, respectively, of the stock of corporation X, and 40% and 60%, respectively, of the stock of corporation Y, (ii) the fair market value of corporation X is equal to N, and the fair market value of corporation Y is equal to 3N, and (iii) X merges into Y solely in exchange for Y stock. A and B collectively own 100% of each of X, Y, and the survivor corporation Y. However, A and B overlapping interests should be limited to 40%, the smaller of the two percentage interests that A and B own in each of the two participating corporations. Therefore, the former shareholders of X own 85% of Y, determined as follows: (i) 25% of Y, based solely on their pre-merger interests in X, plus (ii) 60% of Y, based solely on their pre-merger overlapping interests in Y. As a result, a change in ownership does not occur with respect to either X or Y upon the merger of X into Y.

If a shareholder owns stock in both corporations participating in a change in ownership, we recommend that the portion of the stock exchanged for cash not be taken into account in determining an overlapping interest. For example, assume that shareholder A owns a 20% interest in corporation X and an 8% interest in corporation Y. As a result of the merger of X into Y, A receives in exchange for A’s stock in X consideration consisting of 50% Y stock and 50% cash. We recommend that for purposes of determining A’s pre-merger interest in X, only 50% of the stock exchanged for cash is taken into account.

6 In the example in the legislative history, each shareholder of the distributing corporation owns a 10% interest in such corporation after the spin-off. One of the shareholders owns 100% of another corporation with a value nine times that of the distributing corporation. The smaller corporation is merged into the larger corporation. As a result, each non-overlapping shareholder owns 1% of the surviving corporation (a nine percentage point decrease for each shareholder). The overlapping shareholder owns 91% of the surviving corporation. In the example, the amount of the overlapping shareholder’s decrease in ownership of the distributing corporation as a result of the merger is measured by reference to the smaller of such shareholder’s percentage interest in the two merging corporations, i.e., his 10% in the smaller corporation, rather than by reference to the overlapping shareholder’s 1% interest in the surviving corporation that resulted solely from such shareholder’s pre-merger interest in the distributing corporation.

7 As noted below, however, the 1989 Proposed Regulations, read literally, support this interpretation.

8 Or receives any other consideration that would not count for purposes of determining continuity of shareholder interest under Treas. Reg. § 1.368-1(e).
of A’s 20% pre-merger interest be taken into account because only 50% was owned after the change of control is consummated.

This analysis is consistent with the controlled group rules of section 414(b) and (c). In determining a brother-sister controlled group, the same five or fewer persons who are individuals, estates, or trusts must own a controlling interest in each organization, and taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons must be in effective control of each organization. Treas. Reg. § 1.414(c)-2(c)(1). Thus, in determining effective control, only the lowest common interest in each organization is taken into account.

3. Effective Date.

Q&A-48 provides that the rules set forth in Proposed Regulations apply to a change of ownership that occurs on or after January 1, 2004.9 Taxpayers may rely on the Proposed Regulations for the treatment of any parachute payment after February 20, 2002. Id. For a change in ownership that occurs prior to January 1, 2004, taxpayers may also rely on the 1989 Proposed Regulations. See the preamble to the Proposed Regulations, 67 Fed. Reg. 7635 (Feb. 20, 2002).

The preamble to the Proposed Regulations suggests that the new language and the new example on the effect of overlapping ownership clarify the 1989 Proposed Regulations. 67 Fed. Reg. 7633 (Feb. 20, 2002). Yet we believe that the language of the 1989 Proposed Regulations supports the favorable treatment of overlapping ownership recommended above.10 The 1989 Proposed Regulations do not require or suggest that an ownership interest in the acquiring corporation must be acquired solely as a result of the transaction, nor do the 1989 Proposed Regulations limit the amount of the overlapping ownership that may be taken into account.11

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10 See 1989 Proposed Regulation § 1.280G-1, Q&A-27(d), Example (3) (“Immediately after the merger, the former shareholders of Corporation P own stock having a fair market value equal to 60 percent of the value of the stock of Corporation O, . . .”); 1989 Proposed Regulations § 1.280G-1, Q&A-29(d), Example (3) (“Immediately after the transfer, the former shareholders of Corporation P own 60 percent of the fair market value of the outstanding stock of Corporation O . . . Because Corporation O is an entity more than 50 percent of the fair market value of outstanding stock of which is owned by the former shareholders of Corporation P, . . .”) (emphasis added). The ordinary meaning of “own” and “owned” does not call for any distinction between previously owned and newly acquired shares.

11 The “reverse acquisition” rules, which predate the 1989 Proposed Regulations and which determine when a consolidated group remains in existence, demonstrate that when the Service seeks to identify shares of stock in one corporation acquired solely by reason of owning shares of stock in another corporation, the Service will do so. See Treas. Reg. § 1.1502-75(d)(3)(i).
Indeed, the language of the 1989 Proposed Regulations would permit any acquiring corporation shares owned by a pre-transaction target corporation shareholder, and not just the common ownership by percentage, to be taken into account. Accordingly, if this provision of the Proposed Regulations is included in the final regulations, we recommend that the new overlapping ownership rules apply no earlier than the permanent effective date for the Proposed Regulations. In addition, we recommend that the final regulations state that no inference is intended by the new language in the Proposed Regulations regarding overlapping ownership as to the meaning of the 1989 Proposed Regulations.


Recommendation.

We recommend that the final regulations formalize the rulings set forth in a number of private letter rulings regarding Q&As-27, 28, and 29.

Explanation.

The Service has issued several private letter rulings indicating how various transaction structures should be analyzed under Q&A-27, 28 and 29. For example, in a number of private letter rulings, the Service has applied section 280G to the target company in a forward merger as if the transaction were a transfer of target company assets to be analyzed under Q&A-29. See, e.g., PLR 199914032 (Jan. 13, 1999); PLR 9719003 (Dec. 24, 1996; technical advice); PLR 9610022 (Dec. 11, 1995); PLR 9536014 (June 8, 1995); but see PLR 199920009 (Feb. 9, 1999) (forward subsidiary merger described, in part, as a stock acquisition). For corporate tax purposes, a merger is treated as an asset transfer, not a stock acquisition. See sections 368(a)(1)(A), 368(a)(2)(D), 381(a). We recommend that the final regulations adopt the approach taken in PLRs 199914032, 9719003, 9610022 and 9536014.

DETERMINATION OF PRESENT VALUE

1. Payment Term.

Recommendation.

We recommend that the final regulations clarify that the determination of the applicable Federal rate to be used to determine the present value of future payments to be made under an agreement that was entered into before the change of control should be based on the time between the date on which present value is being determined (i.e., the date of the change of control) and the date(s) on which the payment(s) would have been made in the absence of a change of control, rather than the time between the date on which the agreement was originally entered into or became effective and the date(s) on which the payment(s) would have been made in the absence of a change of control.

Explanation.

Q&A-32 states that the applicable Federal rate to be used to determine the present value of future payments is to be determined under section 1274(d) and the regulations thereunder.
Under section 1274(d) and the regulations thereunder, the applicable Federal rate is based on the term of a debt instrument. Nothing in section 1274(d) or the regulations thereunder explains how this concept is to be applied where a change of control occurs some time after an agreement was entered into providing for the payment of certain amounts at future dates and the payment of such amounts is accelerated by the change of control. For purposes of the golden parachute rules, the amount of time by which a payment is accelerated by the change of control would seem to be the relevant calculation and this would presumably be determined by using the applicable Federal rate appropriate for the time between the date on which present value is being determined and the date on which the payment would otherwise have been paid. In other words, the value of the acceleration of a payment that would have been made in three years should be based on the Federal short-term rate, regardless of whether the agreement providing for such payment was entered into on the day before the change of control or ten years before the change of control. Alternatively, the final regulations could apply the principles of section 7872 (regarding the Federal rate to apply to below-market interest loans). Under section 7872(f)(5), a “demand loan” is any loan that is payable in full on the demand of the lender and a “term loan” is any loan that is not a demand loan. The applicable Federal interest rate for demand loans is the Federal short-term rate in effect under section 1274(d), compounded annually. An acceleration of a payment upon a change of control is similar to a demand loan because regardless of the time the payment would ordinarily be made under the contract, it could be accelerated at any time upon the occurrence of a change of control.

Recommendation.

We recommend that the final regulations clarify that the present value of a payment is to be calculated using the applicable Federal rate in effect on the date as of which such present value is determined (i.e., the date of the change of control), unless the corporation and disqualified individual agree in the contract providing for such payment that the applicable Federal rate in effect on the date that the contract is entered into is expressly to apply for purposes of calculating present value under section 280G.

Explanation.

Many existing contracts between corporations and disqualified individuals currently provide that the applicable Federal rate in effect at the time the contract was entered into is to be used to calculate a present value payment in the event that payment of amounts payable under the contract are accelerated in certain circumstances. The applicable Federal rate so specified in such contracts was agreed upon between the parties solely for purposes of determining the economic consequences on the parties of a contingent future event. Unless the parties expressly agree that such applicable Federal rate should be used for purposes of section 280G, it is likely that the parties intended only to address the economics of their arrangement and not the possible application of section 280G to the arrangement at a future date. For purposes of the golden parachute rules, Q&A-32 provides that the value of the acceleration of a payment is to be determined using the applicable Federal rate in effect when such determination is made, unless the parties elect in the contract to use the applicable Federal rate in effect on the date the contract was entered into. We believe that it is appropriate for the regulations to permit the corporation and disqualified individual expressly to agree to use the rate in effect at the time the contract
providing for a payment is entered into, but only if it is absolutely clear that the parties intended such rate to be applicable for purposes of section 280G.

**REASONABLE COMPENSATION**

**Recommendation.**

We recommend that the final regulations eliminate the condition that a disqualified individual whose employment has been involuntarily terminated by his or her employer must offer to provide personal services to the employer, which the employer rejects, in order to demonstrate that the contractual damages the disqualified individual receives is reasonable compensation.

**Explanation.**

Q&A-42(c) sets forth the conditions for showing reasonable compensation from damages for breach of contract resulting from involuntary termination. Subsection (c)(4) provides that the disqualified individual must receive damages because the disqualified individual made an offer to provide personal services, which the employer rejected. We recommend that this requirement be eliminated. When a person’s employment is involuntarily terminated, whether the person is a disqualified individual or a rank-and-file employee, an offer to perform services is likely a futile act.

**INTERNATIONAL**

1. **Non-resident alien.**

**Recommendation.**

We recommend that the final regulations provide that a disqualified individual who, during the disqualified individual determination period, was a nonresident alien and was not subject to income tax in the United States on wages earned from the affiliated group, not be subject to the excise tax. This rule would apply regardless of which entity inside the affiliated group employs the disqualified individual and regardless of the amount of time the disqualified individual has been present within the United States.

**Explanation.**

Assuming a disqualified individual has neither U.S. effectively connected income nor U.S. source income (i.e., is not paid compensation for services performed in the U.S.), the compensation paid is not subject to U.S. income tax. We recommend that the excise tax treatment be consistent with the income tax treatment, and that the excise tax not be imposed when the nonresident alien has not been paid compensation for services performed in the U.S. during the disqualified individual determination period.

We also recommend that if the disqualified individual was a U.S. resident for a portion but not all of the disqualified individual determination period, the excise tax apply based on a time-oriented fraction of service within and without the U.S. Further, we recommend that, if a
treaty contains an exemption for compensation for services performed in the U.S. during the disqualified individual determination period, the disqualified individual not be subject to the portion of the excise tax allocated to the taxable year in which the compensation is exempt from tax.

2. Small Businesses and Companies with No Readily Tradeable Stock.

   Recommendation.

   We recommend that the final regulations provide that a corporation domiciled outside the United States can qualify for both the small business corporation exception and the shareholder approval exception for payments made to disqualified individuals subject to tax on compensation for services performed in the United States.

   Explanation.

   There is nothing in the legislative history to sections 280G and 4999 that suggests that non-United States corporations cannot qualify for the small business corporation and the shareholder approval exceptions. It is not uncommon for a non-U.S. corporation to employ a U.S. citizen or resident alien. Unless the final regulations allow non-U.S. corporations to qualify for these important exceptions, a disqualified individual will be subject to different tax liabilities depending upon whether the individual chooses to work for a U.S. corporation or a non-U.S. corporation. Furthermore, similar to the rulings regarding application of the equal rights and privileges provision to employee stock purchase plans, we recommend that the final regulations disregard noncompliance with those provisions of the exceptions to the extent that compliance would violate applicable non-U.S. law. See G.C.M. 34260 (January 23, 1970). As long as the non-U.S. corporation would otherwise comply with the applicable provision, excusing noncompliance because of illegality under the foreign law does not undermine the integrity of the exceptions.

3. Controlled Foreign Corporations.

   Recommendation.

   We recommend that the final regulations clarify that the deduction denied to foreign subsidiaries of U.S. corporations for golden parachute payments reduce the earnings and profits of the foreign subsidiaries, thus having an impact on the U.S. parent corporation’s dividends, foreign tax credits, and liquidations. Our recommendation is similar to the rule that applies for nondeductible political contributions. See Rev. Rul. 77-442.

   Explanation.

   The legislative history of section 280G (Senate Committee Report (’86 TRA, PL 99-514 10/22/86) 1986-3 (Vol. 3) C.B. 918) states that the provision applies to controlled groups of corporations, which in some cases can include non-US affiliates:

   The bill provides that, except as otherwise provided in regulations, all members of an affiliated group of corporations (sec. 1504) shall
be treated as a single corporation for purposes of the golden parachute provisions. Any person who is an officer or highly compensated individual with respect to any member of the affiliated group is treated as an officer or highly compensated individual of such single corporation. Notwithstanding the general definition of an affiliated group of corporations, for purposes of this provision, an affiliated group of corporations also includes the following: . . . (3) Foreign corporations (unless the disqualified individual is employed by a foreign corporation that is acquired by another foreign corporation, neither of which is subject to tax in the U.S.); . . .

Thus the provision denying a deduction for certain amounts paid would apply to amounts paid by a controlled foreign corporation, such as a non-U.S. subsidiary of a U.S. parent, to an employee of the controlled foreign corporation. This corporation might not be a U.S. taxpayer, and the denial of the deduction would not have an impact on its U.S. tax liability.

However, the calculation of the controlled foreign corporation’s earnings and profits account (under section 312) does have an impact on its parent organization, in connection with the determination of dividends, foreign tax credits, and liquidations.

BANKRUPTCY

1. Recommendation.

Several private letter rulings address the application of section 280G to financially distressed corporations undergoing corporate reorganizations. In some instances, the corporations are in a reorganization proceeding in the United States Bankruptcy Courts. In other situations, however, the corporations are engaged in reorganizations outside of a bankruptcy filing. We recommend that rulings set forth in the private letter rulings discussed below be incorporated into the final regulations.

2. Change In Control.

A number of private letter rulings address whether the involuntary acquisition of equity by holders of debt is a “change in the ownership or effective control of a corporation” under section 280G(b)(2)(A).

2.1. PLR 9811057.

PLR 9811057 (Dec. 17, 1997) addressed whether the approval, confirmation, and implementation of a corporation’s plan of reorganization, adopted pursuant to Chapter 11 of the United States Bankruptcy Code, is a change (i) in the ownership or effective control of the corporation or (ii) in the ownership of a substantial portion of the corporation’s assets. The facts of the ruling state that the taxpayer and its subsidiaries filed voluntary petitions for reorganization under Chapter 11. A Creditors’ Committee was appointed to represent the interests of the taxpayer’s unsecured creditors and an Equity Committee was appointed to represent the interests of the taxpayer’s shareholders. Under the Chapter 11 plan of
reorganization, all the existing shares of taxpayer’s common stock were to be cancelled and new shares were to be authorized. When the plan was to become effective, the largest shareholder would own approximately 13% of the corporation’s outstanding shares.

Pursuant to the Q&A-27 of the 1989 Proposed Regulations, “... a change in the ownership or control of a corporation occurs on the date that any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, possesses more than 50 percent of the total fair market value or total voting power of the stock of such corporation.” In addition, Q&A-28 of the 1989 Proposed Regulations states that “... a change in the effective control of a corporation is presumed to occur on the date that ... any one person, or more than one person acting as a group, acquires ... ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation ...”. Since the taxpayer’s creditors collectively acquired 100% of the corporation’s voting power, Q&A-27 of the 1989 Proposed Regulations would provide that a change of control had occurred. Similarly, Q&A-28 of the 1989 Proposed Regulations would establish a presumption that a change of control occurred. The Service ruled, however, that neither the approval, confirmation, nor implementation of the plan of reorganization was a change in the ownership or effective control. Furthermore, the Service ruled that section 280G did not apply to any compensatory payments made in connection with the plan of reorganization. In its analysis, the Service stated that

> [t]he passive receipt of stock by a creditor under a bankruptcy plan of reorganization is essentially involuntary in that the creditors of the bankruptcy estates typically would prefer that the debt be paid in cash rather than the stock of the debtor. The fact that the creditors are represented by a Creditors Committee and that the plan of reorganization of the debtor provides for the creditors to receive stock instead of cash is a function of the financial resources of the estate and is not indicative of any intention on the creditors part, either singly or acting as a group, to acquire control of the debtor.

This ruling sets forth the principle that the passive receipt of stock by multiple creditors in a bankruptcy plan of reorganization should be disregarded for purposes of section 280G. We believe that the ruling’s holding is appropriate, and find support for the holding in the statute’s legislative history. Congress enacted section 280G, at least in part, to discourage transactions that reduced amounts that might otherwise be paid to target corporation shareholders.\(^\text{12}\) In a Chapter 11 bankruptcy proceeding, when the interests of preexisting equity holders are to be completely cancelled, the preexisting equity holders will not be paid any consideration for their shares. There are no assets that could be preserved for the corporation’s preexisting shareholders. Accordingly, since no amount will otherwise be paid to these shareholders, the statute’s purpose is not advanced by a contrary conclusion. We do not believe, however, that the same result is justified when a creditor intentionally pursues and acquires equity during the course of a bankruptcy proceeding. In these cases, the creditor would be acting with the

intention of acquiring control of the taxpayer and the conclusions reached in the ruling should not apply.

2.2. PLR 9442919.

PLR 9442919 (Jul. 14, 1994) addressed the corporate reorganization outside of a bankruptcy proceeding of a financially strapped taxpayer. The facts of the ruling state that the taxpayer was a widely held corporation undergoing a business downturn that caused it to change its capital structure. Pursuant to the reorganization, holders of convertible debentures issued by the taxpayer’s parent corporation received 79% of the equity and voting power of the taxpayer’s stock. The ruling also states that an unofficial committee represented the debenture holders. After citing the relevant provisions of Q&A-27 and Q&A-28 of the 1989 Proposed Regulations, the Service reasoned that although the debenture holders were represented by a committee, the receipt of stock by the debenture holders was essentially involuntary since the debenture holders would have preferred to have retained the convertible debenture rather than receiving stock. The Service stated that the debenture holders did not intend to gain control of the taxpayer regardless of their acquisition of 79% of the taxpayer’s voting power. The Service ruled that the exchange of debentures for 79% of the taxpayer’s voting power was not a change of control.

3. Shareholder Vote.

At least one private letter ruling addresses the method for obtaining shareholder approval under section 280G(b)(5)(B) while a taxpayer is in a reorganization proceeding under Chapter 11 of the United States Bankruptcy Code.

3.1. PLR 200212013

The relevant facts of PLR 200212013 (Dec. 17, 2001) were that the taxpayer was a corporation undergoing financial hardship. Subsequent to filing for relief under Chapter 11, the corporation was de-listed from an established stock exchange pursuant to the corporation’s voluntarily application to the Securities and Exchange Commission. During the course of the Chapter 11 proceeding, the corporation sought Bankruptcy Court approval for the implementation of a compensation plan for key employees. A committee of creditors advised the Bankruptcy Court that it consented to the proposed compensation plan, which then approved the plan. Thereafter, the corporation was acquired by its parent holding company and the key employees were entitled to payments under the compensation plan. Although taxpayer acknowledged that the acquisition by its parent holding company was a change of control under section 280G(b)(2)(A), the Service concluded that the amounts paid to the key employees were not parachute payments.

The Service reached its conclusion pursuant to the private company exemption set forth in section 280G(b)(5)(A). Under section 280G(b)(5)(A), a parachute payment does not include any payment to a disqualified individual if immediately before a change of control (i) no stock in the acquired corporation was readily tradeable on an established securities market, and (ii) certain shareholder approval requirements were met with respect to the payment. Without any analysis, the Service concluded that “[t]he shareholder approval requirements of section 280G(b)(5)(B) of the Code were satisfied upon the bankruptcy court’s order approving the
[compensation] Plan because the creditors’ committee and the bankruptcy judge represented the shareholders’ interests and the shareholders were not otherwise eligible to approve the payments under the [compensation] Plan.”

This ruling permits an alternative method for satisfying the shareholder approval requirements when there is practical method for explicitly satisfying such requirements when a Chapter 11 bankruptcy proceeding is pending. Furthermore, Q&A-7 of the 1989 Proposed Regulations and the Proposed Regulations impose additional requirements such as the vote must be a meaningful and separate vote of shareholders. Interpreting section 280G in a manner that fosters a successful bankruptcy reorganization is consistent with other provisions of the Internal Revenue Code.\textsuperscript{13}

\textsuperscript{13} \textit{See, e.g.}, § 108(a)(1)(A) (exclusion from income of cancellation of indebtedness); § 368(a)(1)(G) (inclusion within the definition of reorganization of certain bankruptcy-related transactions); and § 382(l)(5) and (l)(6) (special rules for determining limitation on net operating losses and other tax attributes).