Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: February 2, 2009

to: Barry Shott
Industry Director, Financial Services (LM:F)

from: William C. Schmidt
Senior Counsel, Executive Compensation (Tax Exempt & Government Entities)

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subject: PLR-108299-08 (Withdrawal of ruling requests)

LEGEND

Taxpayer =
Plan =
Division 1 =
Division 2 =

In accordance with section 7.07(2) of Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 28, we are notifying you that certain rulings requested by Taxpayer in a February 21, 2008 ruling request that was submitted to our office for rulings under sections 83 and 280G of the Internal Revenue Code were withdrawn in anticipation of an adverse ruling. It is our understanding that your office has audit jurisdiction over Taxpayer.

FACTS

The relevant facts in the ruling request are as follows. Taxpayer is a privately-held corporation that currently maintains the Plan, which provides for the granting of certain rights with respect to its stock (Stock Rights) to designated executives of Taxpayer. The Stock Rights are comprised of options to purchase shares of Taxpayer's Class A common stock at the book value per share of such stock, as determined by Taxpayer's board of directors, and the right to purchase shares of Taxpayer's Class B

common stock at its par value per share. Under the Plan, a certain percentage of Stock Rights must be exercised each year or be cancelled. Stock Rights are also cancelled upon termination of employment, unless termination occurs due to retirement, disability or death. Taxpayer has certain rights and obligations to repurchase at book value the Class A common stock (the book value restriction). Taxpayer also has certain rights and obligations to repurchase the Class B common stock at par value. The Plan does not provide that an executive who participates in the Plan would be entitled to receive the fair market value of Class A common stock held by the executive under any circumstances. Taxpayer represents that its policy has been to consistently enforce the book value restriction.

Taxpayer intends to enter into a transaction (the Transaction) whereby its Division 1 will be acquired by an unrelated third-party (Buyer). In connection with the Transaction, Taxpayer will contribute the assets and liabilities of its Division 2 to a newly-created corporation (Newco). Taxpayer will distribute shares of Newco to its stockholders in a taxable transaction. Newco will redeem the shares of its stock that were distributed to stockholders of Taxpayer who are associated with its Division 1. No rulings are being requested with respect to these steps of the Transaction.

Thereafter, Taxpayer, which will then consist solely of its Division 1, will merge (the Merger) with a wholly-owned subsidiary of Buyer. Taxpayer will be the surviving corporation in the Merger and will become a subsidiary of Buyer. The Transaction will result in a change in the ownership of a substantial portion of Taxpayer's assets for purposes of section 280G of the Code. In connection with the Transaction, the book value restriction provided for in the Plan will be cancelled. Accordingly, stockholders of Taxpayer will be entitled to fair market value for their shares of Class A common stock upon the closing of the Transaction.

Effective upon the Merger, certain unvested Stock Rights will become fully vested and such Stock Rights and certain shares of Class A common stock will be cashed-out based on the Transaction consideration (which will be paid in cash). Certain other shares of Class A common stock and unvested Stock Rights will be "rolled over" into shares or stock rights that are not subject to the book value restriction and that may be subject to different vesting provisions. Such shares will be subject to repurchase provisions based on fair market value, a specified discount from fair market value or the Transaction consideration, and not upon the book value of the shares. Taxpayer represents that any vesting conditions placed on Share Rights and repurchase provisions that apply to shares of common stock that are rolled over are being imposed as a condition of the Transaction in order to retain executives, or discourage them from competing, and are not a condition to the removal of the book value restriction.

Taxpayer represents that the cancellation of the book value restriction affects all shares of Class A common stock and Stock Rights. Additionally, the cancellation of the book value restriction is occurring pursuant to a negotiated, arms'-length transaction. Further, the executives of Taxpayer who participate in the Plan will not take a salary

adjustment in connection with such cancellation. Finally, Taxpayer will not treat the cancellation of the book value restriction as a compensatory event and will provide such statement in writing to such executives.

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 (as defined in section 280G(b)(3)) allocated to such payment.

Under section 280G(b)(2)(A) of the Code, a "parachute payment" includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual (as defined in section 280G(c)) if (i) such payment is contingent on a change 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 that 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.

Section 1.280G-1, Q/A 11(a) of the Treasury Regulations provides that, for purposes of section 280G, all payments—in whatever form—are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, life insurance, pension benefits and other deferred compensation (including any amount characterized as interest thereon).

Section 1.280G-1, Q/A 11(d) provides that transfers of property are treated as payments in the nature of compensation for purposes of § 1.280G-1, Q/A 11.

Under § 1.280G-1, Q/A 12(a), a transfer of property is considered a payment made (or to be made) in the taxable year in which the property transferred is includible in the gross income of the disqualified individual (as defined in § 1.280G-1, Q/A 15) under section 83 and the regulations thereunder. In general, such a payment is considered made (or to be made) when the property is transferred (as defined in § 1.83-3(a)) to the disqualified individual and such individual becomes substantially vested (as defined in § 1.83-3(b) and (j)) in such property.

Regarding stock options, § 1.280G-1, Q/A 13(a) provides that an option (including an option to which section 421 of the Code applies) is treated as property that is transferred when the option becomes substantially vested within the meaning of § 1.83-3(b) and (j). Thus, for purposes of sections 280G and 4999, the vesting of an

option is treated as a payment in the nature of compensation. The value of an option at the time the option vests is determined in accordance with all of the facts and circumstances in a particular case. Rev. Proc. 2003-68, 2003-2 C.B. 398, provides guidance on the valuation of stock options solely for purposes of sections 280G and 4999. Section 3.01 of Rev. Proc. 2003-68 provides that for purposes of sections 280G and 4999, the value of a stock option will not be considered properly determined if the option is valued solely by reference to the spread between the exercise price of the option and the value of the stock at the time of the change in ownership or control.

Under § 1.280G-1, Q/A 13(b), any money or other property transferred to the disqualified individual upon the exercise, or as consideration on the sale or other disposition, of an option described in § 1.280G-1, Q/A 13(a) after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under § 1.280G-1, Q/A 11. Nevertheless, the amount of the otherwise allowable deduction with respect to such transfer is reduced by the amount of the payment treated as an excess parachute payment.

Section 1.280G-1, Q/A 22(a) provides that a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is conditioned upon another event. Generally, a payment is treated as one that would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. A payment that becomes substantially vested as a result of a change in ownership or control will not be treated as a payment that was substantially certain to have been made whether or not the change occurred.

Under § 1.280G-1, Q/A 22(c), a payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of deferred compensation that was fully vested without regard to the change, the payment may be treated as contingent on the change.

Section 1.280G-1, Q/A 24(a)(1) provides that if a payment is treated as contingent on a change in ownership or control, the full amount of the payment generally is treated as contingent on such change. However, in certain circumstances, described in § 1.280G-1, Q/A 24(b) and (c), only a portion of the payment is treated as contingent on the change.

Section 1.280G-1, Q/A 24(c)(1) applies in the case of a payment that becomes vested as a result of a change in ownership or control if, without regard to the change, it is contingent only on the continued performance of services for the corporation for a specified period of time and is attributable, at least in part, to services performed before the date the payment is made or becomes certain to be made. In such a case, under §

1.280G-1, Q/A 24(c)(2), the portion of the payment that is treated as contingent on the change in ownership or control generally is the amount by which the payment exceeds the present value of the payment that was expected to be made absent the acceleration (determined without regard to the risk of forfeiture for failure to continue to perform services), as described in § 1.280G-1, Q/A 24(b), plus an amount, as determined in § 1.280G-1, Q/A 24(c)(4), to reflect the lapse of the obligation to continue to perform services.

Under § 1.280G-1, Q/A 24(c)(4), the amount reflecting the lapse of the obligation to continue to perform services is 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the individual's right to receive the payment would have been vested.

In response to Taxpayer's request, we provided the following rulings:

1. The removal of the book value restriction with respect to the Class A common stock is a noncompensatory cancellation of a nonlapse restriction under section 83 of the Code.

2. No portion of the Transaction consideration payable with respect to the vested Class A common stock will constitute a parachute payment under section 280G of the Code.

3. The amount of the parachute payment attributable to accelerating the vesting of unvested Stock Rights in connection with the Transaction will be determined by applying § 1.280G-1, Q/A 24(c) of the Regulations to the value of such Stock Rights at the time of vesting (taking into account the Transaction consideration, not limited by the book value restriction).

WITHDRAWN RULINGS

In addition to rulings requested regarding the Class A common stock and Stock Rights described above, Taxpayer also asserted it was obligated to make payments measurable with respect to Taxpayer's stock (which they referred to as Shadow Stock and Shadow Rights) to certain foreign employees and that certain of such rights would become vested as a result of the merger. Taxpayer requested rulings that the Shadow Stock would be treated the same as the Class A common stock, and that the Shadow Rights would be treated the same as the Stock Rights. Taxpayer represented that Shadow Stock and Shadow Rights are awarded separate and apart from the Plan, pursuant to Taxpayer's policy to maintain equivalent compensation packages for its executives. Taxpayer further represented that Shadow Rights and Shadow Stock accounts are administered as if actual Stock Rights and stock had been issued. The Taxpayer also represented that as Shadow Rights become vested they are deemed exercised and the executive is credited with a number of shares of Shadow Stock that is

equivalent to the number of shares the executive would have received if the Shadow Rights had been Stock Rights. Taxpayer stated that it maintains a spreadsheet that tracks the exercise price and book value of each award of Shadow Rights and Shadow Stock. We requested that Taxpayer provide documentation evidencing the awards of Shadow Stock and Shadow Rights to executives of Taxpayer.

In response, Taxpayer provided us two forms of offer letters for executives located in two foreign jurisdictions. Each letter provides that, due to tax and legal considerations, executives of Taxpayer who are citizens of the country specified in the letter could not participate in the Plan. Each letter states that it is Taxpayer's intention to take into account such executive's inability to own stock in Taxpayer at the time the executive retires or his or her employment relationship with taxpayer terminates for any reason. Taxpayer's intention, as stated in the letters, is to determine the economic benefit the executive would have realized if the executive had participated in the Plan and to pay the executive an "ex gratia payment" to be made in addition to any severance or retirement payment made to the officer.[1] In so doing, Taxpayer would take into account, as best it could, the number of shares the executive probably would have owned and simulate the taxes that would have been paid (and the tax and other costs Taxpayer would have incurred).

Based on the foregoing, we concluded that Taxpayer had failed to establish that it had a legal obligation to make payments to executives pursuant to Shadow Rights and Shadow Stock. In fact, based on the letters, it appears that if Taxpayer had created such a legal obligation, it may have violated the laws of the two countries involved. It further appears that the offer letters were drafted to carefully avoid creating any such obligation and that the letters declare Taxpayer's intention to make what amounts to a gift to the executive upon termination of the officer's employment.

Because the Taxpayer failed to document its claim that it had a legal obligation to make payments pursuant to the Shadow Rights and Shadow Stock, we believed that any payments that Taxpayer makes to its executives with respect to Shadow Rights and Shadow Stock in the context of the Merger will be payments that are contingent on a change in the ownership or control of Taxpayer and § 1.280G-1, Q&A 24(b) and (c) would not apply to them. We informed Taxpayer that we would rule adversely on their ruling requests related to the Shadow Stock and Stock Rights, and they withdrew those ruling requests.

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

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[1] Ex gratia means as a favor, not compelled by legal right. In Latin, it means "out of goodwill". BLACK'S LAW DICTIONARY 594 (7th ed. 1999).