REPORT #629

TAX SECTION

New York State Bar Association

Comments on 1989 Proposed Regulations Relating
To Golden Parachute Payments

by the Committee on Employee Benefits

September 20, 1989

Table of Contents

Tax Report #629

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New York State Bar Association

September 21, 1989

The Honorable Fred T. Goldberg
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Commissioner Goldberg:

Enclosed is a Report by our Committee on Employee Benefits on the 1989 Proposed Regulations Relating to Golden Parachutes Payments. The principal editors of this Report are Beverly F. Chase, Barbara Nims and Lawrence E. Wieman. The principal comments are summarized on pages 1-4 of the Report.

Sincerely,

Wm. L. Burke
Chair

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4610r

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Tax Report #629

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Comments on 1989 Proposed Regulations Relating To Golden Parachute Payments

by the Committee on Employee Benefits

September 20, 1989

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

This Report of the Committee on Employee Benefits[*] comments on proposed regulations under Section 280G of the Internal Revenue Code published by the Internal Revenue Service and the Department of the Treasury (the “Proposed Regulations”).[**] The Proposed Regulations relate to the “golden parachute” payment provisions of the Internal Revenue Code (the “Code”), which were enacted by the Tax Reform Act of 1984 and amended by the Tax Reform Act of 1986 and the Technical and Miscellaneous Revenue Act of 1988.

Summary of Comments

As an initial matter, the Committee feels obliged to express its view that the tax law is not the appropriate medium for addressing the concerns or perceived abuses associated with

[*] The Report was prepared by a Committee working group consisting of Richard L. Alpern, Beverly F. Chase, Adam D. Chinn, Kenneth C. Edgar, Jr., Robert C. Fleder, Brian T. Foley, George R. Ince, Claude E. Johnston, James P. Lawton, Michael Macris, Robert N. Maoris, Barbara Nims, Joseph S. Roslanovick, Pamela Scott, David Sicular, Scott P. Spector, Janet Taber, Christine J. Vickery and Lawrence E. Wieman. Ms. Chase, Ms. Nims and Mr. Wieman were the principal editors.

[**] 54 Fed. Reg. 19393 (May 5, 1989); 26 CFR 1.280G-1.

associated with golden parachute arrangements. Indeed, we believe that the golden parachute provisions of the Code may in fact have caused a proliferation of tax gross-up agreements, thus resulting in even more costly arrangements for companies and their shareholders. In view of the significant amounts that continue to be paid to executives in connection with changes in ownership and control, the Committee is skeptical that the golden parachute provisions of the Code, with their attendant complexities, have had or will in the future have the intended effect of significantly limiting such payments. The Committee believes it more likely that the golden parachute provisions of the Code will serve as an occasion for extensive tax planning or, for many midsized companies, as a complex trap for the unwary.

Nevertheless, despite the Committee's reservations regarding the golden parachute provisions, the Committee believes that the Proposed Regulations generally represent a balanced and comprehensive effort to interpret the provisions and carry out their underlying policies. We especially commend the high degree of specificity in the Proposed Regulations and the generous use of factual examples. Our Report suggests certain areas in which additional specific guidance is desirable and suggests modifications to certain of the central concepts which we believe would make the Proposed Regulations fairer and easier to administer.

The Report's major recommendations are as follows:

- Greater conformity with general income recognition principles of Section 83 of the Code is desirable to promote administrability, compliance and fairness. To the extent that the final regulations depart from established Section 83 concepts, they should provide unambiguous guidance. The Report suggests a revised method for applying the golden parachute provisions to employee stock options and addresses certain other valuation issues arising under the Proposed Regulations. The Report also urges that the final regulations be modified to provide that contingent payments are to be taken into account for purposes of calculating three-times-base- amount and allocating base amount only when such payments are made. (Q&As 12, 13, 24, 31, 32 and 33)

- The treatment in the Proposed Regulations of the exemption for payments constituting reasonable compensation for services rendered after a change in ownership or control should be modified to clarify that a payment of liquidated damages for, or a negotiated settlement with respect to, breach of an employment contract can qualify for the exemption. In addition, the blanket rule against “severance” payments qualifying as reasonable compensation should be modified. (Q&As 42 and 44)

- The broad exemption for payments made pursuant to contracts entered into after a change in ownership or control should be clarified to reduce the possibility of abuse. (Q&A 23)

- The definition of “change in ownership or control” should be modified in certain respects to clarify, among other things, the meaning of “acting as a group”, the circumstances necessary to rebut the presumption of a change in effective control, and the application of the definition to sales of subsidiaries. (Q&As 27, 28, 29 and 46)

In addition, the Report comments on the provisions of the Proposed Regulations relating to exempt payments with respect to certain corporations (Q&As 6 and 7); the definition of “officer” (Q&A 18); the definition of “highly compensated individuals” (Q&A 19); and the presumption that payments are contingent on the change (Q&A 26).

I. Recognition, Timing and Valuation of Parachute Payments

A. Compensatory Transfers of Property (Q&As 12 and 13)

Proposed Regulations Generally Follow Section 83 Principles. The Proposed Regulations provide that transfers of property are treated as payments in the nature of compensation if such transfers arise out of an employment relationship or are associated with the performance of services. Q&A 12 provides that, as a general rule, the principles of Section 83 will govern the valuation and timing of any such payment for purposes of the golden parachute provisions. The Committee supports this attempt to harmonize the golden parachute rules with existing income tax principles.

The Proposed Regulations depart from established Section 83 principles in two significant respects, however. First, Q&A 12(b) provides that a Section 83(b) election by a disqualified individual with respect to transferred property will not have any effect under the Proposed Regulations. Thus, although such an election would shift the individual's income recognition and taxation date, it would not change the date on which a parachute payment is considered to have been made and as of which excise tax might be payable.

Second, Q&A 13 provides that the vesting of a nonqualified stock option with an “ascertainable” fair market value (whether or not such fair market value is “readily ascertainable” within the meaning of regulations under Section 83) will be treated as a transfer of property for purposes of the Proposed Regulations. The subsequent exercise of any such option would not be treated as a payment in the nature of compensation for golden parachute purposes, as it would be for income tax purposes under Section 83. However, the Proposed Regulations provide that the deduction available to the corporation at the time of exercise will be reduced by any amount treated as an excess parachute payment at the time of vesting.

Greater Conformity with Section 83 Is Desirable.

The drafters of the Proposed Regulations have solicited public comment as to how the special rules of Section 280G should interact with income deferral rules such as those contained in Section 83. The Committee believes that Section 280G, which regulates certain payments in the nature of compensation, should operate *in pari materia* with income recognition and taxation principles, including those of Section 83, that govern compensation and compensatory transfers of property generally. In particular, we believe that failure to adhere more closely to the principles of Section 83 will result in the same kinds of intractable valuation issues that the enactment of Section 83 was intended to avoid. As more specifically discussed below, we believe that greater conformity to Section 83 will enhance administrability, while preserving the regulatory purpose of Section 280G.

Section 83(b) Elections Should Be Given Effect.

The Committee believes that Q&A 12(b), relating to Section 83(b) elections, should be modified. With respect to transfers of property that are made to disqualified individuals more than one year prior to a change in ownership or control, the Committee believes that a prior Section 83(b) election (whether or not the election was filed within the one-year period) should be given effect for purposes of Section 280G, but should not totally eliminate parachute treatment for the appreciation of the transferred property.

Thus, if the subsequent vesting of such property is contingent upon a change in ownership or control, the disqualified individual should be deemed to have received a payment, for purposes of Section 280G, equal to the fair market value of the property at the time it becomes substantially vested less the sum of (i) the amount, if any, paid by the disqualified person for the property and (ii) the amount, if any, included in income at the time of the transfer as a result of the Section 83(b) election. The disqualified individual would be deemed to have received this payment at the time the property became substantially vested. The Committee's approach would thus give partial effect to the prior election and would permit any corporate deduction previously taken to stand.*

The following example illustrates the Committee's suggested approach:

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* The treatment of any prior deduction is not addressed under the Proposed Regulations; however, the Committee notes that if a prior Section 83(b) election is ignored, no deduction arises at the time the Proposed Regulations would recognize the parachute payment. Thus under Q&A 12 as proposed, there would be no deduction to be disallowed under Section 280G.

> In 1989, corporation X issues 100 shares of common stock to Executive A. A pays $200 for the stock, which then has a fair market value of $500. The stock is subject to a substantial risk of forfeiture; however, upon a change of control the risk of forfeiture will lapse. A makes a Section 83(b) election. A includes $300 in gross income in 1989, and Corporation X takes a deduction for $300 in that year. In 1991, Corporation X undergoes a change in ownership and A's shares vest. The stock's value at the time of such vesting is $1,500. A is deemed to have received a payment of $1,000 in 1991 for purposes of Section 280G.

In the above example, if the stock would have vested without regard to the change in ownership if the Executive had continued to perform services for the Corporation, the portion of the $1,000 payment treated as contingent on the change would be determined under the principles of Q&A 24(c).

The Committee does not believe that the above-described treatment should apply with respect to property transfers effected within one year prior to the change in ownership or control unless the taxpayer successfully rebuts the presumption of contingency on the change. For transfers made within a year of the change, a Section 83(b) election made with respect to transferred property should be disregarded for purposes of the golden parachute provisions. However, if the taxpayer rebuts the presumption of contingency on the change with respect to a particular transfer, then a Section 83(b) election with respect to that property should be respected to the extent described above.

Stock Options. The Committee views the issues raised in applying Section 280G to employee stock options to be among the most troubling and difficult issues arising under the statute and the Proposed Regulations. We recognize that any resolution of these issues will be imperfect and will involve inherent defects, both conceptual and practical. After carefully considering the various competing objectives, however, we believe that closer conformity with the treatment of stock options under Section 83 will produce the fairest and most administrable system. Based on this premise, we propose and discuss in greater detail below an alternative method for the treatment of stock options under the golden parachute provisions of the Code.

Vesting of Stock Option Should Not Be Considered a Payment. The most disturbing aspect of the Proposed Regulations' provision that the vesting of a non-statutory option is a transfer of property, and therefore a payment for purposes of Section 280G, is that it requires the taxpayer to confront and resolve the conundrum surrounding the valuation of employee stock options.

The Committee emphatically believes that it is not enough to say, as does Q&A 13(a), that “the value of an option with an ascertainable fair market value ... is determined under all the facts and circumstances in the particular case.” The Proposed Regulations provide the taxpayer with no guidance as to how to determine in the first instance whether or not an option has an ascertainable fair market value. Then, assuming the taxpayer has somehow determined that an option has an ascertainable fair market value, the Proposed Regulations provide no meaningful guidance on how to ascertain what that fair market value is.

The proper valuation of employee stock options continues to confound valuation and accounting experts, and consensus on the issue has proven elusive. Valuation models developed for exchange-traded options have generally been rejected as inapposite to options with the characteristics generally seen in employee stock options. The regulations under Section 83 implicitly acknowledge this, and provide that the granting of an option without a “readily ascertainable fair market value” (that is, essentially, an option other than an exchange-traded option) is an open transaction, even if such option is immediately exercisable. The transaction closes when the option holder exercises the option, at which time the property transfer is deemed to occur. The property is valued solely by reference to its fair market value at the time of exercise (net of the exercise price), and no additional value is attributed to the opportunity to exercise the option. At the time of exercise, the amount transferred is easily monitored by the corporation and, through the reporting and withholding obligations, indirectly by the Internal Revenue Service.

The Committee believes that the policy choices on these issues underlying Section 83 and the regulations thereunder (and their judge-made predecessors) are no less compelling in the area of golden parachute payments. Thus, we believe that the vesting of an employee stock option should not be regarded as a transfer of property at that time, but that, upon exercise, a portion of the amount realized should be allocated to the notional value received upon vesting. Described below is a suggested model for this approach, which harmonizes the treatment of options with that implicitly dictated by the Proposed Regulations for other benefits that become vested, but are not paid, upon a change in control.

Treatment of the Lapse of the Obligation To Perform Services. The Proposed Regulations do not describe explicitly the appropriate treatment of a payment where the vesting of the right to receive such payment, but not the payment itself, is accelerated upon a change in control. The Committee believes that this omission should be rectified in the final regulations to confirm that such situations are to be treated in accordance with the principles outlined herein. The approach suggested by the Committee both for this situation and for the related situation in which an option vests upon a change in control, and the manner in which the Committee believes that for both situations the golden parachute provisions can best be harmonized with general income tax recognition principles, can be demonstrated through several illustrations:

Illustration 1:

> On June 15, 1985, Corporation X enters into a contract with Executive A under which Corporation X will pay Executive A $1 million on June 15, 1995 if he works for Corporation X through June 15, 1990. Such right will also become non-forfeitable upon a change in control of Corporation X. Such a change in control occurs on June 15, 1988 and A's right to receive the $1 million payment on June 15, 1995 thereupon vests. The payment itself is not accelerated.

Under general income recognition principles, no payment would be deemed made in the year of the change in control since the Corporation's unfunded promise to pay Executive $1 million in the future does not constitute a payment or a transfer of property. However, upon the change in control the Executive is absolved of the requirement that he continue his employment through June 15, 1990 in order to be entitled to that payment. Q&A 24(c), which addresses situations in which both the right to receive a transfer of property and the transfer itself are accelerated upon a change in control, suggests a method for placing a value on the lapse of an obligation to continue employment. Subject to the discussion of Q&A 24(c) below, the Committee believes that a similar approach should be applied where the vesting of the right to receive a payment accelerates upon a change in control but the actual payment does not.

The first part of the calculation described in Q&A 24(c) involves a comparison of the payment actually made by virtue of the change in control with the present value of the payment that would have been made absent the change. Where the payment is not accelerated, this portion of the Q&A 24(c) calculation would not apply. However, the second part of the Q&A 24(c) calculation, which involves placing a value on the lapse of the Executive's obligation to continue to perform services, is appropriate for situations where vesting, but not payment, is accelerated. For this purpose Q&A 24(c) suggests applying a 1% factor for each full calendar month between the time of vesting by virtue of the change in control and the time at which the right to receive the payment would otherwise have vested. Application of this method to the facts in Illustration 1 yields a valuation factor of 23%.

For purposes of calculating whether the total of the Executive's parachute* payments exceeds three times his base amount, and, if so, allocating the base amount among the Executive's various parachute payments, this 23% factor should be applied to the present value, at the time of the change in

* This Report will, consistent with common parlance, use the term "parachute payment" to refer to any payment in the nature of compensation that is contingent on a change in ownership or control, without regard necessarily to whether the recipient's three-times-base-amount threshold is equalled or exceeded.

control, of the §1 million payment to be made on June 15, 1995. The excise tax and loss of the deduction would not be imposed, however, until the $1 million payment is actually made. The amount of the payment then subject to such excise tax and non-deductibility would be $230,000 (23% multiplied by the $1 million payment) less the allocable portion of the Executive's base amount, determined as described above at the time of the change of control.*

Illustration 2:

> The facts are identical to those in Illustration 1 except that the payment to which Executive A would be entitled on June 15, 1995 is based on the application of a formula to the financial results of Corporation X during the 10 fiscal years preceding such date.

The analysis of Illustration 2 is identical to that of Illustration 1 except that at the time the change of control occurs the amount of the payment to be made on June 15, 1995

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* To be completely consistent, the portion of the base amount allocable to this payment should be increased by an appropriate interest factor. Otherwise, the percentage of a deferred payment that will be subject to the excise tax and the loss of deduction will be larger than the percentage of a payment with an equal present value, as of the time of the change in control, which is actually paid at such time. The Committee is unable to cite any authority in Section 280G or its legislative history for adopting such a rule; therefore, if such a rule is to be adopted, it may be appropriate to include it in a technical correction proposal. While arguably equitable, however, a rule providing for “growing” the base amount may add more complexity than is warranted, at least while indexing of basis is not commonly employed in the tax law.

cannot be calculated with certainty. Therefore, as discussed in connection with Q&A 33 below, the Committee believes that giving effect to such payment for purposes of determining whether the Executive's total parachute payments exceed three times his base amount and, if so, allocating that base amount among the various parachute payments, should be deferred until the amount of the payment is definitely ascertainable, that is, when the payment is made.

Application of Section 83 Principles to Options.

The treatment of options whose exercisability is accelerated upon a change in control parallels the treatment described in the Illustrations discussed above:

Illustration 3:

> On June 15, 1985, Corporation X grants Executive A a ten year option to purchase 1000 shares of Corporation X stock at an exercise price of $500 per share. The option does not have a readily ascertainable fair market value under Treas. Reg. $ 1.83-7(b). It will become exercisable on June 15, 1990 if A continues in the employ of Corporation X until that time but will be immediately exercisable upon a change in control of Corporation X. Such a change in control occurs on June 15, 1988, and the option thereupon becomes exercisable. Executive A exercises the option on June 15, 1992, at which time the fair market value of the shares received upon exercise is $1,500 per share.

Under Section 83 principles no transfer of property occurs either upon the grant of the option to the Executive or upon the vesting (becoming exercisable) of the option.

Rather, a transfer is deemed to occur only upon the exercise of the option and the value realized is calculated solely by reference to the fair market value of the shares received (net of the exercise price), with no additional value attributed to the opportunity to exercise the option. The Committee believes that in Illustration 3, as in Illustration 1, the timing of recognition for income tax purposes can be respected for purposes of the golden parachute provisions without undermining either the policy objectives or the literal language of Section 2806.

If Section 83 treatment of the vesting of the option is respected, no transfer will be deemed to occur at the time the option vests either upon a change in control or on June 15, 1990. Rather, the transfer of property which constitutes the “payment” occurs on June 15, 1992 when the option is exercised. Thus, as in the case of Illustration 1, the first portion of the calculation suggested in Q&A 24(c) would not apply since there would be no “payment” prior to the time at which the payment would, or in this case could, have been made absent the change. Only the value attributable to the lapse of the obligation to continue to perform services would be deemed to be a parachute payment. Because the period by which the vesting of the option was accelerated due to the change in control includes 23 full calendar months, Q&A 24(c) suggests that the portion of any amount realized by the Executive which should be considered a parachute payment is 23%.

As in Illustrations 1 and 2, for purposes of applying the three-times-base-amount test and allocating the base amount among the Executive's various parachute payments, the 23% factor would be applied to the present value, as of the change in control, of the amount ultimately realized. For the purpose of determining the amount subject to excise tax and deduction loss, however, 23% of the undiscounted amount realized would be used. Thus, in Illustration 3, the amount of the payment subject to excise tax and non-deductibility would be $230,000 (23% x ($1,500-$500) x 1000 shares) less the allocable portion of the Executive's base amount.

As in Illustration 2, at the time of the change in control the amount, if any, that the Executive will realize upon the exercise of the option cannot be ascertained. Therefore, for the reasons discussed below in connection with Q&A 33, the Committee recommends that the accelerated vesting of the option not be given effect for purposes of the three- times-base-amount calculation or the allocation of base amount among parachute payments unless and until the option is exercised. If the Executive were never to exercise the option, no amount would be realized and no parachute payment would be deemed to have been made, just as would be the case in Illustration 2 if the application of the performance formula resulted in the amount payable by the Corporation being zero or if the Corporation were simply to default on its obligation to make the promised payment.

Illustration 4:

> The facts are identical to those in Illustration 3 except that Executive A exercises the option on June 15, 1989, a year before the option would otherwise have vested absent a change in control.

The Committee believes that the treatment of Illustration 4 should be slightly different from that of Illustration 3. As in Illustration 3, the Executive in Illustration 4 receives a payment equal to the fair market value of the shares received (net of the exercise price) upon exercise of the option multiplied by the 23% factor reflecting the lapse of the obligation to perform services. In Illustration 4, however, the Executive receives the payment one year earlier than the payment could have been made in the absence of the change in control. Thus, the Committee believes that the element of value addressed in the first portion of the calculation set forth in Q&A 24(c) has been recognized and should be included in the value of the parachute payment. In this regard, see our discussion of Q&A 24(c) below wherein the Committee has suggested modifications to the method of calculating such value.

Treatment of Incentive Stock Options. The Committee believes that, at least with respect to the excise tax payable by the disqualified individual, the same analysis should be applied to both statutory and non-statutory options. Although in the case of statutory options there is no corresponding deduction to disallow under Section 280G, we do not believe that the absence of reciprocal treatment justifies distinguishing between the two types of employee stock options for purposes of the golden parachute provisions.

Statutory options are undeniably used for compensatory purposes and, notwithstanding the special income tax treatment generally accorded to them, receive ordinary income treatment in certain circumstances, for example, in the calculation of alternative minimum tax and in the case of disqualifying dispositions. Moreover, applying a consistent analysis to statutory stock options under Section 280G will avoid the need to monitor whether or not a disqualifying disposition has occurred.

B. The Accelerated Payment of Deferred Vested Amounts (Q&A 24(b))

Q&A 24(b) Permits Apportionment of Payment. Where a payment is "substantially certain" to have been made regardless of a change in ownership or control but is treated as "contingent" on the change solely because the timing of the payment is accelerated by the change, Q&A 24(b) limits the parachute portion of the payment to the excess of the amount of such accelerated payment over the present value of the payment that would have been made absent a change. Under Q&A 24(b) as proposed, such present value is to be computed using 120% of the applicable federal rate ("AFR").

However, Q&A 24(b) also contains a special rule to the effect that if (i) the amount of the future payment is not readily ascertainable, and (ii) the acceleration does not significantly increase the present value of the payment, then the present value of the payment that would have been made absent acceleration will be deemed to be equal to the full amount of the accelerated payment. The application of this rule would thus result in a parachute payment of zero.

The Proposed Regulations do not otherwise discuss whether or how future actual or deemed dividends, interest or other earnings affect the application of the above-described special rule. Example (3) in Q&A 24 does indicate, however, that the accelerated payment under a deferred compensation arrangement (described therein as a non-qualified individual account plan) will result in a zero parachute amount if (1) the arrangement's earnings rate is not restricted in a manner that would prevent the earning of a market rate of return and (2) the normal payment date is uncertain. Apart from the mention of earnings rates in Example (3), Q&A 24(b) provides no guidance as to how to determine, when the amount of a payment absent a change in ownership or control is not readily ascertainable, whether or not the acceleration significantly increases the present value of such payment.

In a typical deferred compensation arrangement, the deferred compensation is credited by the employer to an unfunded individual account. The individual account may be notionally invested in a variety of ways, including “phantom” stock of the employer. The notional returns or dividend equivalents are added to the account balance. Many of these notional investments are designed to provide returns equivalent to market investments, but few would be equivalent to a guaranteed return of 120% of AFR.*

Example (3) in Q&A 24 implicitly stands for the proposition that the accelerated payment of a vested account balance under such an “individual account” or “defined contribution” type arrangement should not result in a parachute payment, as long as the arrangement has the potential of providing a market rate of return. Stated another way, when an entitlement is expressed as a stated amount payable at an undetermined time in the future at a fluctuating rate of interest which is not designed to be below market, clause (ii) of the special rule is satisfied, that is, acceleration of the payment does not increase its present value. This result obtains because the rate used to project future value should offset the rate used to determine the present value of such future value.

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* Frequently, such arrangements do not provide for interest rates or rates of return that can be described, strictly speaking, as market rates. Usually, however, such rates can be justified economically by taking into account tax effects or other market forces acting on either the individual or the corporation.

The Committee agrees with this principle; however, we believe that it should be no less applicable when the arrangement's earnings rate is fixed at a market rate and the payment date is known. Moreover, while we recognize and endorse the certainty and practical administrative convenience provided by fixing a discount rate in the regulations, unless the rate specified is fixed in relation to the usual commercial realities in the absence of a parachute event, economic distortion will result.

In the situation where it is possible to ascertain the arrangement's earnings rate and payment date, the method prescribed in Q&A 24(b) will almost always result in a parachute payment because the earnings rate, even if a market rate, will almost always be lower than 120% of the AFR. As a result, two arrangements having substantially similar expected economic results may receive dramatically different treatment under Q&A 24(b), depending on whether long-term expectations are stated in terms of a variable or a fixed rate of return or depending upon the manner in which the payment date is expressed.[*]

[*] For example, one arrangement may provide for payment “at retirement”, while another arrangement may provide for payment “at age 65”.

Discount Rate Should be Lowered. The Committee believes that the situations described above demonstrate that 120% of the AFR, while mandated for certain other purposes in Section 280G, is inappropriately high for use in the Q&A 24(b) calculation.

Section 280G(d)(4) directs that “present value”, as used in the statute, be calculated using 120% of the AFR. However, the term “present value” is used in Section 280G only for purposes of the three-times-base-amount test (subsection (b)(2)(A)(ii)) and the allocation of base amount (subsection (b)(3)(B)(i)).* Q&A 24(b) relates to neither of these provisions; rather, it prescribes a method to be used for determining what portion of a payment should be considered contingent on a change of control.

The Committee believes that, in the absence of statutory guidance on the discount rate to be used for such purpose, the final regulations should stipulate a rate that reflects the expected rate of return on a balanced portfolio of investments over a time period equivalent to the period between the time of payment and the time payment would otherwise have been made. In fixing the rate, the regulations should take into account the tax characteristics of the arrangement in the absence of a parachute

* It should be noted that in both cited subparagraphs of Section 280G, the use of a high discount rate is advantageous to the taxpayer.

event and the tax attributes and risk profiles of such a balanced portfolio of investment. Based on these premises, we believe that the discount rate should be lower than 120% of AFR, as such a rate implicitly would require the taxpayer to seek high yield, high risk investments in order to obtain, on the date payment would otherwise have been made, the projected payment implied by such a high discount rate. We suggest that 100% of the AFR would be a more realistic rate, although we believe that an even lower rate, such as 80% of the AFR, could be justified.

Lowering the discount rate will provide for more consistent treatment of deferred compensation arrangements and will eliminate all or a portion of the artificial parachute payment that results solely from a disparity between the earnings rate of the arrangement, which may well be a market rate, and the discount rate stipulated for administrative predictability by Q&A 24(b). Under the Committee's proposal, when the rate of return (whether fixed or floating) on a vested deferred compensation account is, at the time of payment, equal to or greater than the stipulated rate, there would be no parachute payment, specified rate should be a safe harbor.

In addition, when a floating rate of return on such an account is below the stipulated percentage of the AFR at the time of payment and not otherwise justified on a facts and circumstances basis, the floating rate at that time should be presumed to be a fixed rate of return for purposes of calculating the future value of the payment at the originally scheduled payment date. Thus, where the rate of return at the date of payment (whether fixed or floating) is below the specified percentage of the AFR, the parachute payment would be equal to the present value of the earnings on such account balance at a rate equal to the difference between the stipulated rate and the arrangement's earnings rate, from date of payment until the originally scheduled payment date.

We further believe that the the taxpayer should have an opportunity to demonstrate that, on the basis of the facts and circumstances applicable to his situation, a lower rate is appropriate; that is to say, that the acceleration of his payment has not resulted in an increase in its expected present value.

To summarize, the Committee believes that the question of whether or not the acceleration of a payment significantly increases its present value should be resolved by examining the rate of return of the arrangement at the time of payment relative to a stipulated percentage of the then prevailing AFR. The taxpayer should also have the opportunity to show that a lower rate is appropriate if the minimum rate is not met. We have suggested that the stipulated “safe harbor” discount rate be fixed at no higher than 100% of AFR, and that it be applied uniformly as both a test and a measure of the parachute portion of an accelerated payment.

Q&A 24(b) as proposed provides no direct guidance on how to determine what portion of an accelerated payment is contingent on the change if the amount of the originally scheduled payment is not readily calculable but the acceleration does significantly increase the payment's present value. However, Q&A 24(b) specifically refers to Q&A 33 as a source of guidance for determining present value. Under the principles of Q&A 33, the taxpayer would be required to reasonably estimate the date on which the payment would have been made and determine the portion of the payment that is contingent on the change under the normal Q&A 24(b) method based on such date.

Although the Committee has raised certain objections to the general approach of Q&A 33, which are discussed at greater length below, we believe that its use is appropriate and should be retained in the Q&A 24(b) context, where there is no dispute that a payment has been made. Accordingly, when the acceleration of a payment significantly increases its present value (because the arrangement pursuant to which such payment was made provides for a below market interest rate), but the amount of the originally scheduled payment is not readily calculable because the original payment date is unknown, the parachute payment should be deter-mined by applying the Q&A 24(b) approach based on a reasonable estimate of the date on which such payment would have been made absent the change.

Special Rule for Defined Contribution Arrangements -- Payment of Vested Account Balance Should Not Be a Parachute Payment. If the Q&A 24(b) discount rate is not lowered as we recommend, the Committee believes that the final regulations should contain a special rule for defined contribution type arrangements, whether or not such arrangements contain ascertainable earnings rates and payment dates. Such arrangements are usually designed to achieve bona fide corporate compensation objectives and do not implicate the policies disfavoring golden parachute arrangements. No portion of earned vested amounts should be subjected to excise tax or non-deductibility simply because an artificial difference between the account balance and the present value of its projected future value can be produced by using different rates for projecting out and discounting back. Thus, if the discount rate required by Q&A 24(b) is not moderated, the Committee believes that the final regulations should provide that, absent unusual circumstances, the present value of fully vested amounts or property under any “defined contribution” type arrangement, the payment of which is accelerated in connection with a change in ownership or control, should be deemed to equal the amount paid, without further adjustment by any discount factor.

The Committee recognizes that arrangements that are essentially of a defined benefit nature could be designed in a distorted fashion to take advantage of this special rule for defined contribution arrangements. To guard against this abuse, the final regulations could provide that the “unusual circumstances” referred to above would exist, and therefore the special rule would not apply, if two elements are present. The first element would exist if the arrangement contemplates, implicitly or explicitly, an interest rate that is less than reasonable in relation to market forces acting on either the individual or the corporation. A bright line test of 80% of the AFR at the time the arrangement was entered into might be established for this purpose. The second element would be present if the arrangement were structured to provide a benefit upon or in connection with a change in ownership or control that could not have been replicated under the arrangement upon a termination of employment other than in connection with a change in control.

To illustrate, assume that Corporation X enters into a deferred compensation arrangement with Executive A in which the Corporation promises to pay the Executive $1 million, payable in 20 years at 4% simple interest. Payment is accelerated in the event of a change in control, but only in such event. The long-term AFR at the time the arrangement is established is 7%.

This is essentially a defined benefit arrangement, but it has been made to resemble a defined contribution arrangement by providing for a large “account balance” with a nominal interest rate. Because the interest rate is less than 80% of the AFR at the time the arrangement is established and because the benefit received by the Executive upon a change in control cannot be replicated in the event of the Executive's retirement or other termination of employment, under the Committee's suggested analysis the arrangement would not be eligible for the special rule applicable to defined contribution arrangements.

C. The Accelerated Payment of Amounts Otherwise Dependent Upon the Performance of Services (Q&A 24(c))

Q&A 24(c) Permits Apportionment of Payment. Where a payment is substantially certain to have been made regardless of a change in ownership or control if the disqualified individual continues to perform services, but is treated as contingent upon the change because the timing of the payment is accelerated by the change, Q&A 24(c) of the Proposed Regulations limits the amount of the payment that will be treated as contingent upon the change. The amount treated as contingent will be the lesser of (i) the amount of the accelerated payment and (ii)(A) the excess of the amount of such accelerated payment over the present value, computed using 120% of the AFR and without regard to the risk of forfeiture, of the payment expected to be made absent the change, plus (B) an amount to reflect the probability of forfeiture prior to the scheduled vesting date equal to at least 1% of the amount of the accelerated payment for each month from the date of the change (or, if earlier, the vesting acceleration date) to the date the payment would otherwise have been made. Subject to the specific comments set forth herein, the Committee supports the approach embodied in Q&A 24(c).

Equating Present Payment With Future Value and Using Discount Rate of 120% of AFR Distorts Economic Reality. The Proposed Regulations take the position that (1) the future value of a payment, if not readily calculable, should be treated as being equal to the present payment and (2) the present value of a payment is then to be determined by application of a discount rate equal to 120% of the AFR.

The Committee recognizes that equating a payment's future value with the current payment amount, if such future value is not otherwise calculable, is a rule of convenience which is easily applied. However, the distortions potentially produced by the rule are troubling. Such a rule essentially assumes that the property in question has a rate of return or growth of zero. This assumption ignores the earnings and appreciation potential inherent in most property interests, and is particularly inapposite to many common compensation devices. For example, individual account arrangements may be entitled to floating (and therefore not precisely calculable) rates of return. The fact that the future payment is not precisely calculable should not result in an assumed zero rate of return. Similarly, restricted stock awards frequently provide for current receipt of dividends by the executive, even though the stock itself is substantially unvested. In such a case, the present market price of the stock would represent the market's best estimation of its effective total rate of return to a future date, without any further discounting of the present price. The inequity inherent in a zero growth assumption is exacerbated by the use of a discount rate of 120% of AFR for determining present value, a telling argument, we believe, for not using an aggressive or penal rate in any “bright line” rules.

The Committee also notes that the first portion of the Q&A 24(c) method implicitly assumes that the disqualified individual's position is unequivocally improved by the accelerated payment. In certain types of incentive arrangements, however, the early payment of the award eliminates the “time premium” element of the award, as in the case of a ten year stock option which is cashed out early in its term. This potential detriment is another consideration that militates against any method required by Q&A 24(c) that inherently inflates the parachute portion of a payment.

Suggested Modifications. The Committee believes that the convenience and ease of application of the Q&A 24(c) method could be preserved, while achieving a more economically realistic result, if the discount rate were lowered to no higher than 100% of the AFR, as discussed above in connection with Q&A 24(b). For purposes of calculating the portion of a payment that constitutes a parachute payment, the lower rate is economically more realistic and is not inconsistent with the language of Section 280G. Consistent with the Committee's suggested approach under Q&A 24(b), there should be no element of value under the first portion of the Q&A 24(c) method of valuation when the payment in question is of a vested individual account balance on which interest is credited at a fixed or floating rate which at the time of payment is at or above the stipulated percentage of the AFR, notwithstanding that in the case of a floating rate the exact amount of the expected payment is not readily calculable.

Similarly, when the interest rate on an individual account balance is a floating rate which at the date of payment is below the stipulated rate, the future value of the expected payment should be projected using the then current floating rate, with the result that the first element of value under Q&A 24(c) would be the projected return at the spread between the stipulated rate and the lower contractual rate at the time of payment.[*] Moreover, where the payment in question is the accelerated vesting of restricted stock on which dividends are being paid currently (or where such dividends are deemed reinvested in additional restricted stock or are credited to an individual account earning a rate of interest at or above the

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[*] Consistent with our comments under Q&A 24(b), we believe that, if the originally scheduled payment date is unknown, a reasonable estimate should be made of the date on which the payment would have been made in the absence of the change in control.

specified percentage of the AFR), the market price of such stock should be deemed to equal the present value of its future value.

If such changes in the manner of determining present value are not made, the Committee recommends that, at a minimum, the rule imposed under Q&A 24(c) that future value automatically equals the amount of the payment when the future value is otherwise not readily calculable be revised to operate as a bright line “safe harbor”, and that taxpayers be permitted to use other reasonable methods to establish future value if they can demonstrate that the method used is more reasonable than that applied under such safe harbor rule.

Adjustment Factor To Reflect Elimination of Obligation To Perform Services. The Committee also believes that the proposed 1% per month adjustment for lapse of the obligation to perform services should be revised in certain key respects to provide greater certainty and to determine more accurately the parachute amount involved. First, to avoid double counting and to be consistent with the logic and rationale of the proposed formula, the adjustment factor should be applied not to the accelerated payment, as currently proposed, but rather to the present value of the future payment (up to, but not in excess of, the amount of the full present payment).

1% Should Be Safe Harbor. Second, to provide for greater certainty and easier administration without adversely affecting the Internal Revenue Service's ability to reach abuse situations, the 1% adjustment factor should be revised to operate as a safe harbor rather than as a minimum. Specifically, the Committee recommends that the 1% factor be constituted as a safe harbor for all payments otherwise covered by Q&A 24(c) that are paid pursuant to awards or agreements made or entered into more than one year prior to the change in ownership or control or pursuant to arrangements as to which the one-year presumption of contingency on the change can be successfully rebutted.

Scope of Q&A 24(b) and (c). Moreover, the Committee believes that the final regulations should clarify whether or not Q&A 24(c) is applicable to awards that are themselves within the one-year presumption. In this regard, the Committee notes that the provisions of Q&A 24(b) are applicable only to payments that are subject to Section 280G “solely because the change accelerates the time at which the payment is made” (emphasis added). Q&A 24(c), however, is not similarly limited. The Committee believes that there is no basis for this difference, and that the ability to treat only a portion of a payment as a parachute payment under Q&A 24(b) and (c) should be limited to those payments that would not be considered contingent on the change but for the acceleration of the payment.

The treatment provided under Q&A 24(c) should be available, however, for arrangements that are amended within the one-year presumption period merely to add a change of control acceleration feature. In such instances there is no dispute that the payments are contingent on a change in control. Moreover, these situations provide no opportunity for abuse in terms of the size of the payments, nor is there any policy reason favoring “old and cold” acceleration provisions over new ones. Thus, if and to the extent that the one-year presumption of Q&A 25 would otherwise apply to such arrangements by reason of their recent amendment, the presumption should not adversely affect their eligibility for valuation under Q&A 24(b) and (c).

Departure from 1% Safe Harbor. The proposed 1% per month adjustment factor of Q&A 24(c) has the attractiveness of being a simple rate to apply and audit; however, the Proposed Regulations shed no light on how or why the 1% figure was computed, selected or derived. The Committee believes that, in some situations, the rate may overvalue the release from the obligation to perform future services. In such event, the taxpayer should be permitted to apply a factor lower than 1% per month if the taxpayer can demonstrate that a lower factor would be more appropriate, based, for example, on the specific events of forfeiture possible under the arrangement, the anticipated forfeiture risk in light of the average historic turnover rate for the disqualified individual group or the amount of vesting service accrued prior to the change with respect to the particular award. In order to monitor such situations, the Internal Revenue Service could require that the use of a rate of less than 1% be disclosed on one or both of the company's and the individual's tax returns.

Finally, if the 1% factor is retained as a minimum, rather than a safe harbor, the final regulations should provide guidance as to the significant facts underlying the derivation of the factor. In particular, guidance should be provided as to the items which the Internal Revenue Service will consider, and the relative importance to be accorded such items, in determining that the 1% adjustment factor is inadequate.

D. Calculation of “Three-Times-Base-Amount Test” (Q&As 31, 32 and 33)

Proposed Treatment of Contingent Parachute Payments. Where the present value of a payment cannot be determined with certainty because the timing or amount of such payment, or the right to receive such payment, is conditioned on the occurrence of an uncertain future event or condition, the Proposed Regulations require that (1) the present value of such payment nonetheless be estimated for purposes of the three-times-base-amount and base amount allocation calculations and (2) when such payment is actually made or becomes certain not to be made, any prior calculations and allocations be recomputed. The Proposed Regulations specify that an uncertain future event or condition that may reduce the present value of a payment will only be taken into account if the possibility of the occurrence of such event or condition can be ascertained on the basis of generally accepted actuarial principles or otherwise estimated with reasonable accuracy.

The Committee questions the practicality and appropriateness of requiring that calculations required by the Code be based on estimates of uncertain future payments and events. Example (1) under Q&A 33 demonstrates the un-workability of this approach: in the example, the corporation is described as having “reasonably estimate[d] that there is a 50-percent probability” that the executive's employment will be terminated within a year. In virtually no real life situation will a taxpayer have any rational basis for assigning numerical probabilities to uncertain future events in the lives of individuals. Moreover, the corporation's obligation in the example to estimate the likelihood that it will fire an employee, prior to making its business decision in that regard, is an unwarranted intrusion by tax regulations into a continuing employment relationship. It would be preferable to base the calculations required by the statute and the regulations on the amounts of actual payments when and as such payments are received or otherwise become certain to be paid, discounted to the time at which the change occurred.

As discussed above, the Committee believes that the approach taken in Q&A 33 should be more consistent with the “open transaction” and constructive receipt principles generally applied to compensation arrangements for income tax purposes. The Proposed Regulations' approach would produce greater administrative burdens for employers and affected individuals (and for the Internal Revenue Service) in characterizing and valuing uncertain payments, monitoring such payments and filing amended excise and corporate income tax returns and refund claims. In particular, the approach creates the burdensome requirement to file amended returns in most, if not all, cases not barred by the statute of limitations. The Committee doubts that the burdens and costs associated with this approach are likely to be offset by any resulting benefits, such as substantially better compliance or higher net tax revenues.

Accordingly, the Committee urges that the Proposed Regulations be revised to specify that payments which, at the time of the change in ownership or control, are not certain to be made are to be taken into account in making the three- times-base-amount and base amount allocation calculations only if and when such items are paid or become certain to be paid. We acknowledge that the statute may be read to require the allocation of base amount and collection of excise tax, if any, beginning in the first year in which parachute payments are made; however, we do not believe that this is a mandatory reading of the statute. Moreover, we believe that the broad grant of regulatory authority in Section 280G(e) would support a more sensible “open transaction” approach in the final regulations.

The Committee also recommends that the final regulations provide guidance as to how tax return amendments are to be filed, and specifically recommends that, for easier administration, changes in prior excise tax and income tax returns resulting from current year transactions be required to be reported only on the appropriate return(s) for the current year.[*]

This approach avoids having to deal with returns for years as to which the statute of limitations may have run. The application of the statute of limitations in these circumstances may have harsh and unfair consequences, from the standpoint of the government as well as that of the taxpayer. These consequences may seem especially offensive and inequitable if the Proposed Regulations' requirement to assign arbitrary “probabilities” to future events is retained.

Ability To “Lock In” AFR. The Proposed Regulations state that, for purposes of applying the three-times-base- amount test and allocating the base amount among parachute payments to determine the amount of “excess parachute payments”, present values are to be determined as of the earlier of the date of the change in ownership or control or the date the payment is made, based on 120% of the AFR on such date. Where payments are made

[*] In the event that the reconciling calculation would result in a determination that an earlier employer deduction should be disallowed, any such deduction could be recaptured in the current year under general tax benefit rule principles. A technical correction may be needed to impose such reversal for a closed year* The Committee has not addressed, as we were unable to form a consensus regarding, the issue of whether or not interest should be collected on excise tax attributable to a parachute payment made in a prior year, the calculation of which is affected by subsequent parachute payments.

pursuant to a contract, the disqualified individual and the corporation may elect to have the present value determined based on 120% of the AFR in effect on the date such contract was entered into, if the contract sets forth such election.

If the valuation approach appearing in Q&A 24(b) and (c) of the Proposed Regulations is not modified in accordance with the Committee's recommendations expressed above or where, notwithstanding such modifications, present value techniques are nonetheless relevant under the regulations, the provision in Q&A 32 permitting taxpayers to lock in a particular AFR at the time that a contract is executed is quite helpful. However, the Committee would broaden the ability to determine the AFR by contract in several key respects. First, if an AFR can be locked in on a prospective basis for new agreements, consideration should also be given to permitting an AFR to be locked in retroactively on a one-time basis for agreements already in place at the time that the regulations become final. In this regard, the regulations should clarify that such an amendment would not adversely affect the status of an agreement entered into more than one year prior to the change in ownership or control.

Also, as an administrative matter, the final regulations should permit companies to lock in an AFR for multiple awards pursuant to plans and for multiple plans or other compensation arrangements, rather than requiring that the AFR be specified in each individual award or contract. Such a provision should also provide that, once established on a plan-wide basis, the AFR cannot be varied in subsequent individual awards or through the division of the plan into separate plans.

II. Reasonable Compensation

A. Damages for Breach of Contract (Q&A 42)

The Proposed Regulations generally provide that clear and convincing evidence that payments are reasonable compensation for services to be rendered after a change in ownership or control will not exist if the individual to whom such payments are made does not, in fact, perform such services. However, Q&A 42(b) states that if services are not performed, but the employment of the individual is involuntarily terminated before the end of the contract term and damages are paid for breach of that contract, a showing of five factors is generally considered clear and convincing evidence that the payment is reasonable compensation for post-change services. The five factors are:

(i) the contract was not entered into, amended, or renewed in contemplation of the change in ownership or control,

(ii) the compensation would have qualified as reasonable under Code Section 162,

(iii) the payment does not exceed the present value of payments which would have been received under the contract if the payee had continued to perform services until the end of the contract term,

(iv) an offer to provide personal services was made and rejected, and (v) the damages are reduced by mitigation.

Contemplation of Change in Control at Time of Entry into Contract Should Not Be a Factor. The Committee believes that the first factor should be deleted. Virtually any corporate executive who enters into an employment contract would certainly be aware of and, in entering such an agreement, would be likely to reflect upon the potential effect of a change in the ownership or control of his employer. Accordingly, an evaluation of a particular factual circumstance in terms of the first factor would necessarily require inquiring into and drawing distinctions among various gradations in the states of mind of the particular parties involved. Such a task would necessarily be extremely difficult and inherently uncertain.

<u>“Involuntary” Termination</u>. The Committee also believes that the reference in Q&A 42(b) to “involuntary” terminations should be clarified to encompass certain constructive terminations. Many employment contracts contemplate that an employee may terminate the contract in the event of certain conduct by the employer. For example, under certain employment agreements, if an employer materially reduces an employee's responsibilities or requires the employee to relocate, the employee is entitled both to cease performing services and to receive a payment. In such circumstances the employee should be permitted to prove that any payments received are reasonable compensation for post-change services.

As proposed, Q&A 42(b), which speaks in terms of “involuntary” terminations, does not explicitly encompass situations such as those discussed above, although it can fairly be read to apply to such situations. This ambiguity can be eliminated by amending the language of Q&A 42(b) as follows: “If the employment of a disqualified individual is involuntarily terminated, <u>or if by reason of actions of the employer the</u>

disqualified individual is permitted to terminate the contract, before the end of a contract term and the individual receives a payment by virtue of such termination, a showing of the following factors . . . .” (proposed amendment emphasized).

Offer To Provide Personal Services. Q&A 42(b)(4), which looks to whether an employee whose employment has been terminated has made an offer to provide services, should be revised to render it consistent with commercial practice. An employee who has been involuntarily terminated or whose responsibilities have been reduced would be extremely unlikely thereafter to make a formal offer to the organization that terminated him or reduced his responsibilities to perform the services for which he has been relieved of responsibility. Rather, the appropriate question is whether the employee would have been willing to continue employment under the terms of the contract absent the conduct of the employer. This factor should be satisfied if the requisite willingness exists, that is, the employee is available for work and has not expressed an intention to refuse to honor his commitment to continue to be available.

Such a modification of Q&A 42(b)(4) would be consistent with the policy underlying the statement in the Senate Finance Committee Report on the Tax Reform Act of 1986 that, in order for a payment to qualify as reasonable compensation for services to be rendered, an “offer to work” must be made by the payee and rejected. Senate Finance Committee Report on the Tax Reform Act of 1986, p. 919. The nature of the work for which an “offer” is to have been made is not specified in that report, and it is most reasonable to conclude that the work referred to is that which the employee was performing prior to the change in control or that for which he or she was hired. In addition, it is more reasonable to interpret the concern expressed in the Senate

Report as one addressed to the employee's willingness to continue performing such services rather than to the existence or nonexistence of a formal offer to perform such services in the face of a termination or reduction of responsibilities.

Liquidated Damages. Q&A 42(b) should make clear that the damages for breach of an employment contract that can qualify as reasonable compensation for services to be performed after a change in control can include liquidated damages specified in such a contract or payments made upon a negotiated settlement of a claim for breach, and not only damages awarded upon an adjudication. In addition, as discussed below in connection with Q&A 44, the Committee believes that the denomination of a payment as “severance” ought not to preclude proof that such payment qualifies as reasonable compensation under the analysis suggested in Q&A 42(b).

Mitigation. As drafted, Q&A 42(b)(5) of the Proposed Regulations could be interpreted to require that a disqualified individual actually receive earned income which reduces his or her payment on account of the breach of contract in order to satisfy the requirement contained in that subparagraph. Such a reading would be extremely unfair and lead to arbitrary results. Generally, discharged employees seek comparable employment, but they are sometimes unsuccessful in their search and often not successful immediately. Therefore, the Proposed Regulations should be modified to ensure that the requirement with respect to mitigation is that payments, including amounts paid as liquidated damages, be “subject to reduction by mitigation”, rather than that such payments be “reduced by mitigation”.

In addition, the requirement that damages be subject to reduction by mitigation should be considered satisfied if a controversy over mitigation of damages is settled. For example, an employment contract may provide that upon termination the employee becomes entitled to a lump sum which approximates the discounted present value of his compensation under the remaining term of the contract. If, subsequent to the execution of the contract, the employee agrees to a reduction in the lump sum payment in consideration of a release from the obligation to mitigate damages, the requirement that damages be subject to mitigation should be deemed satisfied.

B. Severance Payments (Q&A 44)

Q&A 44 sets forth a blanket rule that severance payments, and damages for failure to make severance payments, cannot qualify as reasonable compensation for services actually rendered before, or to be rendered on or after, a change in ownership or control. The Committee believes that such a categorical approach is inappropriate. Rather, where a payment is made to a disqualified person upon the termination of his or her employment, a careful review of the facts and circumstances provides a better basis for determining whether such payment constitutes a parachute payment or qualifies as reasonable compensation.

The approach of Q&A 44, which irrefutably presumes to be parachute payments those payments that can be labeled severance payments, can lead to wholly arbitrary results. For example, if an employment contract provides that upon termination prior to the end of the term of the contract an employee is entitled to receive a payment, such payment would apparently be characterized under Q&A 44 as severance, whereas it might as easily qualify as liquidated damages for breach of the contract. Under the Proposed Regulations, the latter characterization would permit the taxpayer to prove, under Q&A 42, that the payment represents reasonable compensation for services to be rendered after the change in ownership or control while the former characterization would preclude such proof. Similarly, an employer may have provided generous protection under a severance policy in lieu of other compensation. In such event, it should be possible to demonstrate that severance paid in connection with a termination following a change in control constitutes reasonable compensation for services rendered prior to the change.

In view of the foregoing, the Committee believes that the blanket rule of Q&A 44 is not justified and should be abandoned. The final regulations should permit payments upon termination, whether or not denominated severance, to be shown to be reasonable compensation for services rendered before, or to be rendered on or after, the change upon proof by clear and convincing evidence of factors similar or analogous to the guidelines set forth in Q&A 42(b).

The Committee believes that the modification of Q&A 44 suggested above is consistent with the Senate Finance Committee Report on the Tax Reform Act of 1986. That report states that damages for failure to make severance payments would not constitute reasonable compensation for services to be rendered after the change because the willingness to work and mitigation factors set forth in Q&A 42(b) would not be present. This statement does not dictate a blanket rule with respect to severance payments. The committee believes that a balanced factor-based analysis of payments upon termination such as that set forth in Q&A 42(b) is more consistent with the legislative policies behind the golden parachute provisions of the Code than is the regulation-by-label embodied in the proposed version of Q&A 44.

Broad-Based Severance Plans. In addition to the general approach to payments upon termination outlined above, the Committee believes that where such payments are made pursuant to a broad-based, nondiscriminatory plan or program, such payments should be deemed not to be parachute payments, regardless of whether such plan or program, or the payments under it, are or could be characterized as severance payments. To qualify for such an exemption, the payments would have to be made pursuant to a plan or program that applies to a substantial portion of the employer's non-highly- compensated employees and the amounts of the payments would have to be based on an objective formula such as a fixed amount, a percentage of salary or wages, the employees' years of service or some combination of such factors. Of course, for payments to be exempt, the plan or program would need to provide for payments upon termination generally and not solely upon termination following a change in ownership or control.

Where an employer has decided to make severance payments available to its employees generally under a nondiscriminatory plan or program and where such severance payments are triggered by termination regardless of the existence of a change in ownership or control, the Committee believes that few of the policy concerns behind the golden parachute provisions of the Code are implicated. Therefore, the Committee believes that the Proposed Regulations should be modified to provide that such payments are deemed not to be parachute payments.

C. Covenants Not To Compete and Consulting Agreements (Q&A 42)

The Proposed Regulations are unclear as to whether payments for a covenant not to compete or a consulting obligation may be treated as reasonable compensation for services actually rendered after a change in ownership or control. The Committee believes that such payments should qualify as reasonable compensation to the extent that (i) the payments reasonably reflect the value of the obligation to refrain from competing or to hold oneself available for consultation and (ii) the payee actually discharges such obligations. The availability of such treatment should be limited, however, to payments with respect to covenants that would constitute substantial risks of forfeiture under the principles of Treas. Reg. § 1.83-3(c)(2).

The Proposed Regulations already recognize in Q&A 11 that a payment on account of a covenant not to compete is a payment in the nature of compensation that is capable of valuation; the same should be true, a fortiori, for an agreement to hold oneself available for consulting services. There is no reason that such payments, where they result from arms-length bargaining, should be excluded categorically from reasonable compensation. Accordingly, the Committee recommends that Q&A 42(a) be amended to state: "However, except as provided in paragraph (b) of this A-42, such clear and convincing evidence will not exist if the individual does not, in fact, perform the services. For this purpose, actual performance of services may include compliance with a covenant not to compete or an agreement to hold oneself available to perform consulting services. See Q&A – [44A]." (proposed amendment emphasized).

The Committee also suggests the addition of a new question and answer following Q&A 44 to provide explicitly that under certain circumstances payments for a covenant not to compete or a consulting obligation may be treated as reasonable compensation for services actually rendered. The language of such question and answer could be as follows:

> Q - [44A]: May payments for a covenant not to compete or a consulting obligation be treated as reasonable compensation?
>
> A - [44A]: Yes. Any payments shown by clear and convincing evidence to be properly allocable to a covenant not to compete or a consulting obligation are considered reasonable compensation if the obligation not to compete or to hold oneself available for consultation would constitute a "substantial risk of forfeiture" under principles analogous to those set forth in Treas. Reg. § 1.83-3(c)(2), such obligation is actually performed and such payments qualify as reasonable compensation under section 162.

III. Agreements Entered Into After a Change in Ownership or Control (Q&A 23)

Proposed Regulations Broadly Exempt Contracts Entered Into After the Change. Q&A 23 of the Proposed Regulations addresses the treatment of payments made pursuant to agreements entered into after a change in ownership or control. The Proposed Regulations provide that payment under such agreements will not be treated as contingent on the change unless the post-change agreement was executed pursuant to a legally enforceable agreement that was entered into before the change. The Committee favors a rule that permits acquirors of corporations to make, after a change of control, whatever arrangements they determine to be in their interests with employees of an acquired corporation, without suffering non-deductibility of any part of those payments.

We assume, however, that evidence of a legally enforceable obligation to enter into a post-change agreement can be adduced from a number of sources, including a term sheet, letter of intent, agreement in principle and even an oral agreement among the parties. We would expect that the Internal Revenue Service will scrutinize carefully such post-change agreements to ensure that no legally enforceable obligation to enter into the arrangement existed prior to the change.

Moreover, when a disqualified individual is offered or enters into an agreement after the change in ownership or control in consideration of or in connection with a waiver or cancellation of contractual rights existing prior to the change, whether and to what extent the new agreement is eligible for the exemption under Q&A 23 should be clarified.

The following example illustrates this issue.

> Executive A is employed by Company X pursuant to an employment agreement which provides that, in the event of a change in control of Company X, A's annual base salary, which is currently $100,000, will become $300,000. A change in control of Company X occurs. A's contract contains other provisions that Company X, after the change in control, wishes to modify. Company X enters into a new five year contract with A, in consideration of A's waiving her rights under the old contract. The post-change contract provides for an annual base salary of $400,000.

In the above example, it would appear that all payments under the new contract are eligible for the exemption under Q&A 23 as proposed, even if the Executive's employment terminated shortly after the change and the Executive received the remaining salary owed under the contract as a severance payment.

IV. Definition of Change in Ownership or Control (Q&As 27. 28, 29 and 46)

The definitions of “change in the ownership of a corporation”, “change in the effective control of a corporation” and “change in the ownership of a substantial portion of the assets of a corporation” contained in Q&As 27, 28 and 29 are generally quite clear and specific. The Committee supports strongly the efforts to achieve clarity which are manifest in these Q&As. Nevertheless, the Committee believes that the definitions merit further clarification in several respects.*

Meaning of “Acting as a Group”. Each of the definitions contains the notion that a specified portion of the stock or assets of a corporation has been acquired by a single person or several persons “acting as a group”. Although the Q&As contain some guidance as to the meaning of “acting as a group”, they include no generally applicable definition of that concept. Such a definition could aid measurably in delineating the limits of Section 280G's applicability. Much of the benefit of such a definition will only be available, however, if “acting as a group” is defined in such a manner that a determination of whether particular individuals or entities fall within the definition can be made on the basis of information to which the

* The Committee also notes that determining the relevant percentages of stock ownership or stock acquisition under the provisions of Section 318, as provided in Q&As 27 and 28, can lead to anomalous results where stock options issued by persons other than the issuer of the underlying stock (e.g., exchange-traded stock options) are involved. Such anomalies are not, however, unique to the golden parachute provisions; accordingly, the Committee believes that the present report is not the appropriate forum for addressing this concern.

corporation can have access. Otherwise, the corporation whose tax deduction is at issue under Section 280G, will, in certain instances, be unable to determine whether a change in the ownership of the corporation or a change in the effective control of the corporation has occurred.

Securities Law Definition Should Be Adopted. The question of when more than one individual or entity should be considered to be acting in concert and their holdings of the same class of stock aggregated is one that is familiar under the federal securities laws. Under Section 13(d)(3) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), “[w]hen two or more persons act as a partnership, limited partnership, syndicate, or group for the purpose of acquiring, holding, or disposing of securities of an issuer, such syndicate or group shall be deemed a 'person' for purposes of [Section 13]”. Substantial jurisprudence has developed under Section 13(d)(3) as to when more than one individual or entity constitutes such a “person”. If Q&As 27, 28 and 29 were to define “acting as a group” on the basis of whether the individuals or entities in question would be deemed a single “person” under Section 13(d) of the Exchange Act, the availability of this developed jurisprudence would lend needed certainty to this area. A second benefit of using the Section 13(d) concept flows from the fact that under Section 13(d)(1) of the Exchange Act, any “person” is required to report to the SEC and the issuer any acquisition of equity securities of that issuer registered under the Exchange Act that renders such person's aggregate holdings of the class of equity securities of which such acquired securities form a part greater than 5% of such class of equity securities. A report is also required for any further acquisition of 1% or more of such securities. If “acting as a group” were defined in terms of single “person- hood” under Section 13(d) of the Exchange Act, then an issuer that is a public company (and it is principally for such issuers that lack of information would be likely to be a significant problem) would, by virtue of the filings with the issuer required under Section 13(d)(1), necessarily have in hand the information necessary to determine whether, and when, a change in ownership or effective control of the corporation had occurred.

Overcoming the Presumption of Change in Effective Control. Another area that merits clarification relates to the question under Q&A 28 of what evidence is sufficient to overcome its presumption that a change in effective control of a corporation has occurred upon the acquisition by a person or group of 20% of the voting power of the corporation within 12 months. Although Q&A 28 states that the presumption it creates is rebuttable, the present language of the Q&A gives little indication of what will constitute sufficient evidence to establish such a rebuttal. The Committee suggests that the final regulations provide examples of actual circumstances in which the presumption would be overcome. For example, where one shareholder has a larger stake than that held by a shareholder who acquires more than a 20% stake in a single year, it should be fair to presume that the second shareholder has not gained effective control. Also, if the holder of a newly acquired 20% stake actually tried to assert control but was unsuccessful, this should rebut the presumption.

Application to Entities Other Than Individuals and Corporations. The exceptions set forth in Q&A 29(b)(1),(b)(2), (b)(3) and (b)(4) appear only to contemplate transfers to individuals and corporate entities. However, there is nothing inherently opposed to the policy behind the exceptions contained in those subsections (i.e., that beneficial ownership not pass into substantially different hands) in transfers to partnerships, joint ventures, limited partnerships, trusts and other entities. Thus, the Committee believes that such subsections should be modified to ensure that such transfers, if they do not involve transfers of ultimate beneficial ownership, are excepted in subsection (b).

Application to Sales of Subsidiaries. The Committee interprets Q&As 27, 28 and 29, together with Q&A 46, to result in the conclusion that the sale of a subsidiary does not trigger the application of the golden parachute provisions of the Code or the Proposed Regulations unless the fair market value of such subsidiary constitutes a “substantial portion” of the affiliated group's assets. Accordingly, for example, payments made to the executives of a subsidiary, where the fair market value of such subsidiary constituted less than one-third of the total value of the affiliated group's assets, in connection with a sale, spinoff or initial public offering of such subsidiary, would not be parachute payments. This result obtains because although the ownership of the subsidiary may have changed, there has not been a “change in ownership” of the “corporation”, as defined in Q&A 46, nor a change in ownership of a substantial portion of the “corporation's” assets.

The Committee believes that this result affords necessary flexibility to selling corporations and suggests that an appropriate example confirming this result be added to the final regulations. The Committee notes that if the final regulations are clarified in a manner that negates this interpretation, many public companies would be unable to obtain relief under Q&As 6 and 7, as currently proposed. We believe that the final regulations should provide a mechanism for exempting sales of subsidiaries that do not constitute a substantial portion of the affiliated group's assets. If a direct exemption is not provided through the definition of change in ownership or control, then the selling corporation should be permitted to approve any payments in question under Section 280G(b)(5) and Q&As 6 and 7 even if securities of the selling corporation or of another member of the affiliated group are readily tradable on an established securities market.

V. Miscellaneous

A. Exempt Payments With Respect to Certain Corporations (Q&As 6 and 7)

Shareholder Approval Should Not Be Required To Determine the Right to Payment. In discussing the shareholder approval requirements that must be met in order for certain payments to be exempt payments under the Proposed Regulations, Q&A 7 provides that the shareholder vote described therein must determine the right of the disqualified individual to receive or, in the case of a payment made before the vote, retain the payment.

We note that this requirement does not appear in the statute or in the legislative history. Moreover, the imposition of this requirement may render shareholder approval impracticable or impossible to obtain in the case of payments made before the change or made pursuant to a contract in existence at the time of the change.

The following example demonstrates these concerns:

> Corporation X, a corporation described in Q&A 6(a)(2)(i), enters into a five year employment agreement with Executive A. The agreement provides for certain payments to be made to Executive A upon the occurrence of certain changes in ownership of

> Corporation X. The agreement is conditioned on shareholder approval and is unanimously approved by the shareholders of Corporation X at that time. Two years after the agreement is executed, Investor M acquires 40% of the voting stock of Corporation X, in a transaction that does not trigger any payments to A. Two years thereafter, Corporation X is merged with and into Corporation Y, a public corporation, and payments to Executive A are made under the employment agreement. Whether or not M approves the payments, the requirement of Q&A 7 that 75% of the shareholders immediately prior to the change in ownership approve the payments to A, and that such approval determine A's right to retain the payments, cannot be satisfied, as A's contractual right to the payments cannot be abrogated.

The Committee believes that the statute and the legislative history should not be interpreted to require that shareholder approval determine the right of the individual to receive or retain the payment. Since both the statute and the legislative history unambiguously require a vote of those who are shareholders immediately prior to the change, the Committee believes that it is clear, albeit implicit, that the statute and legislative history require only ratification of potential parachute payments by such shareholders. To interpret the provision otherwise would mean that only arrangements entered into contemporaneously with the change in ownership or control could obtain the benefits of the shareholder approval provisions of Section 280G(b)(5)(A)(ii). The Committee finds nothing in the statute or the legislative history, nor any justification in the policies underlying the statute, to indicate that these provisions should be interpreted so restrictively.

If the Department of the Treasury nonetheless attempts to impose such a requirement by regulation, the final regulations should provide that the approval of the requisite proportion of shareholders at the time the contract is entered into will satisfy the requirements of Q&A 7, if the contract is conditioned on such approval.

Q&A 7 Should Be Applied Prospectively Only.

Finally, in view of the fact that neither the statute nor the legislative history discusses a requirement that shareholder approval determine the right to the payment, as opposed to determining simply the character of the payment under the golden parachute provisions, we believe that, whether or not modified to reflect our comments, Q&A 7 should be applied prospectively only. For purposes of determining whether any such shareholder approval obtained prior to the effectiveness of the final regulations was sufficient under Section 280G(b)(5)(B), a good faith effort to comply with the statute should be deemed to comply with the regulations. Moreover, for purposes of any contract entered into prior to the final regulations, the ratification of payments thereunder by the requisite proportion of shareholders immediately prior to the change in control or at the time of effectiveness of the regulations, should be deemed sufficient for purposes of Q&A 7, even if such approval cannot determine the right to payment.

B. Definition of Officer (Q&A 18)

Q&A 18(a) provides that whether an individual is an officer with respect to a corporation is to be determined upon the basis of all relevant facts and circumstances. Subsection (b) further provides that an individual who is an officer with respect to any member of an affiliated group that is treated as one corporation pursuant to Q&A 46 is treated as an officer of such one corporation. Subsection (c) provides that 10% of the employees of the corporation, or of any member of an affiliated group treated as one corporation, but not less than 3 and not more than 50 people, shall be treated as officers of the corporation (emphasis added).

Numerical Tests Should Not Be Applied to Each Group Member. The Committee believes that it is inappropriate to apply the tests set forth in Q&A 18(c) to each member of an affiliated group. We recognize that Q&A 18(b) appears in the statute and is necessary to prevent abuse; however, the limits set forth in subsection (c) should be applied to the affiliated group as a whole. As currently written, since subsections (b) and (c) appear to be intended to override the “facts and circumstances” analysis called for by subsection (a), these provisions could result in a grossly over- inclusive group of “officers” that would include individuals who may have only modest authority within the corporation, as defined by Q&A 46.

In addition, these provisions would have the effect of disfavoring corporations with more complex corporate structures as compared with companies which merely have separate divisions. We are aware, for example, of certain industries in which companies typically have hundreds, or even thousands, of subsidiaries. It is presumably not intended to treat such companies differently from companies of equivalent size that have, for business reasons, organized differently, nor can we see any policy justification for doing so. If modified as we suggest, however, subsections (b) and (c) should operate to identify satisfactorily the individuals within the affiliated group who should be considered officers.

C. Definition of Highly Compensated Individuals -- Exception for Individuals Performing Brokerage, Legal or Investment Banking Services (Q&A 19)

Exemption for Certain Brokerage, Legal or Investment Banking Services. Q&A 19(b) provides that an individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual's trade or business and the individual performs similar services for a significant number of clients unrelated to the corporation.

The Committee finds the definition of “highly-compensated individuals” contained in Q&A 19 of the Proposed Regulations generally to be clear and fair. In particular, the exception for certain service providers from characterization as highly-compensated individuals is extremely helpful; however, one aspect of the definition warrants expansion. The Proposed Regulations should not penalize persons providing services, such as brokerage, legal or investment banking services, through start-up operations by subjecting them to the provisions of Section 280G. In such cases the service provider may not qualify for the exception as currently drafted, notwithstanding that such services are performed in the ordinary course of the individual's trade or business, because the service provider has not developed a significant number of clients unrelated to the corporation undergoing a change in ownership or control. There appears to be no basis under the statute or its underlying policies to subject such start-up ventures to a tax (or the corporation receiving such services to a loss of the deduction) merely because the service provider is a newly-formed business. Thus, the exception from the definition of “highly-compensated individual” should be revised so as not to exclude start-up service providers.

The necessary correction could be accomplished by eliminating the requirement that the individual perform similar services for a significant number of clients unrelated to the corporation undergoing the change in ownership or effective control. The concern of the drafters of the Proposed Regulations that this exception could be abused could be addressed by revising the requirement that the services be performed in the ordinary course of the individual's trade or business. The Committee believes that the exemption should be available to anyone who was legitimately in business prior to the change or continued to be in such business thereafter. Moreover, we believe that the legitimacy of the business can be ascertained, for these purposes, by determining whether the expenses incurred in such business were deductible under the principles of Section 162. Accordingly, we suggest that Q&A 19(b) be revised to read as follows:

> “An individual who is not an employee of the corporation is not treated as a highly-compensated individual with respect to the corporation on account of compensation received for performing services (such as brokerage, legal, or investment banking services) in connection with a change in ownership or control of the corporation, if the services are performed in the ordinary course of the individual's trade or business, and the expenses of such business would be deductible under Section 162.”

D. Presumption that Payment Is Contingent Upon a Change (Q&A 26)

Q&A 26. Q&A 26(b) identifies certain types of contracts that generally will avoid the statutory presumption attaching to contracts entered into within a year prior to the change in ownership or control. Subsection (3) grants relief to certain “standard” contracts entered into between a corporation and a newly-hired employee. The provision requires, however, that the individual not have performed services for such corporation prior to the individual's taxable year, which in virtually all cases will be the calendar year, in which the change in ownership or control occurs. The following example demonstrates how this provision can somewhat arbitrarily discriminate between individuals whose situations are materially similar:

> Corporation X hires Individual A on June 1, 1989 pursuant to a contract described in Q&A 26(b)(3). On August 1, 1989, Corporation X undergoes a change in ownership. Corporation Y hires Individual B on December 1, 1989 pursuant to a contract described in Q&A 26(b)(3) and undergoes a change in ownership on February 1, 1990. Both individuals had been employed for 2 months when their employers experienced a change in ownership; however, payments under B's contract are presumed to be contingent on the change, while A's payments are not.

We suggest that subsection (3) be modified to refer to a contract between a corporation and an individual who did not perform services for the corporation prior to the period beginning 1 year prior to the change in ownership or control. This will remove the current bias in Q&A 26 favoring changes in ownership or control that occur later in the calendar year.