Report #1021

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS UNDER SECTION 280G OF THE INTERNAL REVENUE CODE

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Introduction

On February 19, 2002 the Treasury Department published proposed regulations (referred to in this report as the "**New Proposed Regulations**") under Sections 280G and 4999 of the Internal Revenue Code of 1986, as amended (the "**Code**"). Both sections relate to so-called "excess parachute" payments. In general, excess parachute payments are payments to a corporation's employees (or directors or significant shareholders) that exceed a specified threshold and are made in connection with a change in control of the corporation. Section 280G denies the payor an income tax deduction with respect to excess parachute payments, while Section 4999 subjects recipients of such payments to a 20% excise tax. The New Proposed Regulations replace an earlier set of proposed regulations under the same sections issued by the Treasury Department in 1989 (the "**1989 Proposed Regulations**"). Simultaneously with the release of the New Proposed Regulations, the Internal Revenue Service released Rev. Proc. 2002-13, 2002-8 I.R.B. 549, which addresses the appropriate valuation of compensatory stock options in the context of Section 280G. Rev. Proc. 2002-13 was subsequently modified by Rev. Proc. 2002-45, 2002-27 I.R.B. 27.

This report[1] contains the comments of the New York State Bar Association Tax Section (the "Tax Section") with respect to the New Proposed Regulations and Revenue Procedure 2002-13. The New Proposed Regulations provide welcome clarification as to a number of previously uncertain issues. However, the Tax Section believes several aspects of the New Proposed

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[1] The principal author of this report is Andrew Stumpff. Renata Ferrari, Albert Feuer, Gretchen Harders-Chen, Amy Krisburg, Karen Krueger, Laraine Rothenberg and Larry Silver also drafted portions of the report. Helpful comments were received from Beverly Chase, Samuel Dimon, Stephen Fackler, Rob Fleder, Brian Foley, Jonathan Levy, Jonathan Lewis, Angela Macropoulos, Douglas McClintock, Emily McMahon, Barbara Nims, Steve Pennacchio, Brian Robbins, David Schizer, Michael Schler, Max Schwartz, Lewis Steinberg, and Larry Witdorchic.

Regulations, as well as Revenue Procedure 2002-13 and 2002-45, merit reconsideration as discussed herein.

This report is divided into three parts. The first concerns the valuation of stock options, the issue as to which, in our view, the New Proposed Regulations and Revenue Procedure 2002-13 and 2002-45 are of most significance. In this section we assess the primary valuation approach adopted by the New Proposed Regulations and Revenue Procedures 2002-13 and 2002-45, which is based on the "Black-Scholes" option valuation model; identify certain drawbacks to that approach; and suggest several alternatives.

In the second section of the report we comment upon various other aspects of the New Proposed Regulations. Our most significant comments in this part concern the statutory exception for shareholder-approved payments provided by small or closely held corporations. We observe that, while the definition of the relevant shareholder population for approval purposes has been liberalized in the New Proposed Regulations, the definition is still too restrictive to be of practical benefit in many situations. We suggest that the Treasury Department has sufficient interpretive latitude to expand the definition further.

In the third and final section of the report, we take the opportunity presented by the government's consideration of this subject to make certain recommendations with respect to the statute itself, reflecting our experience in applying the provisions during the more than 15 years that have now elapsed since their enactment.

I. Valuation of Stock Options

Changes in corporate control frequently result in the accelerated vesting[2] of compensatory stock options held by the acquired corporation's employees. The value attributable to acceleration must then taken into account in computing "excess parachute payments" for purposes of Sections 280G and 4999. In general, the value of accelerated vesting of any payment is measured, under both the 1989 Proposed Regulations and the New Proposed Regulations, by attributing one per cent of the payment's value, per month of acceleration, to the lapse of the requirement that the individual continue to perform services as a condition to receiving the payment. In the case of options, the difficult question arises as to

[2] In some contexts, the "vesting" of an option or other item of compensation means that the item has become nonforfeitable. In the case of options, it can have the different meaning that the option has become exercisable. For simplicity, and because it describes actual practice in the majority of cases, in this report "vesting" is treated as synonymous with an option's simultaneously becoming exercisable and nonforfeitable.

how the value of the option should be measured: that is, by what amount the one-percent-per-month factor should be multiplied.

For income tax purposes, the principle has long been settled that the holder of a compensatory option does not recognize income until the option is actually exercised.[3] (We refer to this principle in this report as the "open transaction" approach.) In the 1989 Proposed Regulations, the Treasury Department took the markedly different approach for parachute tax purposes of treating value as having been received by the optionholder as soon as an option vests.[4] The 1989 Proposed Regulations did not specify how the value was to be determined, other than to say it should be "determined under all the facts and circumstances in the particular case."

In the absence of more detailed guidance, in the intervening years some practitioners have taken the view that option value may be measured, for parachute purposes, by reference to the "spread" between the stock's value and the option exercise price on the date of vesting. Others have used different valuation methods, including measurement techniques such as the "Black-Scholes" and "binomial" methods, which were originally developed for use in the financial markets to measure the expected present value of an option and which take into account such factors as the volatility of the underlying stock, interest rates, and the option's term. (For simplicity, in this report we refer generally to any valuation method based on either the Black-Scholes or binomial model as a "Black-Scholes-based approach.")

Option valuation was directly addressed in the New Proposed Regulations and in Revenue Procedure 2002-13. Although Section 3.01 of the Revenue Procedure suggests that options may be valued using any method that is consistent with generally accepted accounting principles and the New Proposed Regulations, Section 3.02 appeared effectively to mandate, for virtually all "compensatory options," the use of either of two Black-Scholes-based approaches described in, respectively, Revenue Procedure 98-34, 1998-1 C.B. 983 (originally prescribed for use in estate and gift tax valuations), and in Revenue Procedure 2002-13 itself.

[3] With respect to nonstatutory stock options, *see* Section 83(e) and Treasury Regulation Sections 1.83-7(a) and 1.83-7(b)(2). An exception applies if the option is one that is traded on an established exchange, an exception that in practice virtually never applies to compensatory options since such options are rarely traded on established markets and generally differ from options on the same underlying stock that are so traded.

[4] *See* Q/A-13(a). The Treasury Department reserved the treatment of statutory stock options for future regulations.

A number of commentators (including the Tax Section) wrote to Treasury to object that requiring the use of one of these two methods was too restrictive; and that in any event a valuation method should be permitted that took into account such factors as the possibility of an early termination of the option's exercise period (which would decrease option value). In response, on June 13 the government released Rev. Proc. 2002-45. This revenue treats the valuation methods outlined in Rev. Proc. 2002-13 as safe harbors, rather than the exclusive methods for valuing option acceleration. The new revenue procedure reiterates that any valuation method must take into account the factors listed in the New Proposed Regulations,[5] however, and makes a point of stating that valuing an option purely by reference to the "spread" between stock value and exercise price will not be acceptable.

General Comments. In our report on the 1989 Proposed Regulations[6], the Tax Section urged the Treasury Department to reconsider the immediate valuation requirement with respect to options, and instead to conform parachute tax principles more closely to the open transaction principle that applies for income tax purposes. That is, we objected to the notion of fixing the value of an option — using *any* method — on the date of vesting rather than the date of exercise.

We continue to believe that neither the use of the option "spread" or a Black-Scholes-based approach is a satisfactory method for determining tax liability as of the date of accelerated vesting. Valuing an option with reference solely to the spread as of the vesting date creates the obvious likelihood of undervaluation. Under this approach, for example, an option whose exercise price is equal to the stock's fair market value (an "at-the-money option") would be assigned a value of zero, even though any such option with a significant remaining term (the typical term of a compensatory option is ten years) would clearly have substantial worth due to the possibility of future stock appreciation.

Black-Scholes-based approaches suffer from at least equally significant drawbacks, however, as a means of measuring tax liability for optionees. The most difficult problems stem from the fact that in the large majority of cases, the period during which an option may be exercised depends on the optionee's tenure with the employer. For example, it is not uncommon for an optionee to be given a 60- or 90-day period after termination of employment in which to exercise. The value of any particular option – even if vested -- thus continues to depend to a

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[5] These factors include the option spread of the probability of the underlying stock's increasing or decreasing, and the period during which the option can be exercised.

[6] New York State Bar Association Tax Section Report #629, Comments on 1989 Proposed Regulations Relating to Golden Parachute Payment (Sept. 20, 1989).

great degree on a factor that is not susceptible of meaningful prediction: an individual employee's future job tenure.

The usual method for valuing property rights, for tax and other purposes, is to ascertain the amount that a buyer would pay to a willing seller for such rights in an arm's-length transaction. Valuation of compensatory options is problematic because this information is not available. In part this is because most (though by no means all) compensatory options are by their terms nontransferable except to family members. Even where compensatory options may be transferred, however, it is the Tax Section's observation that arm's-length pricing information generally cannot be developed, precisely because a typical option's value depends on such factors as the optionee's job tenure, rendering the option incapable of rational valuation by a prospective buyer.

There is, in any event, reason to doubt that a Black-Scholes-based method is a "best estimator" of value in the case of compensatory options, even as applied to a statistically large sample. Neither a business nor an academic consensus currently appears to exist that Black-Scholes is an appropriate method in this context.[7] Black-Scholes was developed as a tool for valuing exchange-traded options, from which compensatory options differ in the following important respects: First, the term of compensatory options is typically much longer than that of exchange-traded options, a difference that dramatically magnifies the impact of the assumptions, including volatility, employed in the valuation. Second, exchange-traded options are transferable, while compensatory options typically are not, as noted above. In addition, the term of an exchange-traded option is fixed, while that of a compensatory option is, as noted above, usually subject to curtailment upon the termination of the optionee's employment. These differences are sufficiently fundamental to call into question the validity of applying to compensatory options the underlying mathematical and probability analysis on which the Black-Scholes method is based.

Finally, to the extent a Black-Scholes method is the appropriate approach to option valuation, we note that the New Proposed Regulations appear to be internally inconsistent as to measurement of the change in option value, if one compares the treatment of options that are "cashed out" (*i.e.*, cancelled in exchange for a payment of the spread value at the time of the change in control) with that of options whose vesting is accelerated but which remain outstanding. Where options are cashed out, the holder has suffered a *reduction* in the value of

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[7] *See, e.g.* B. Hall & K. Murphy, Stock Options for Undiversified Executives, 33 J. Acctg. & Econ. 3 (2002) (pointing out that because executives' investments are heavily weighted toward company stock, and because options are normally nontransferable, the value of options to executives is less than their "cost" as measured by Black-Scholes).

his or her options as measured by Black-Scholes. Thus, in this case it arguably would be appropriate to reduce the value taken into account for parachute purposes by an amount equal to the difference between the Black-Scholes value of the option (which is foregone) and the amount of the cash-out payment (which is received), a calculation that could even produce a negative result. In the latter case, the acceleration and cash-out of options could be said to have resulted in a net *diminution* of the optionee's overall wealth. However, we read the New Proposed Regulations as requiring that the full value of any cash-out be included in valuing parachute payments.

Alternative Approaches. Only imperfect solutions to the problem of valuing option acceleration are available. While we are of the view that immediate Black-Scholes valuation is not an appropriate approach, the Tax Section has not reached a consensus on the best alternative. Accordingly we set forth below for Treasury's consideration what appear to us to be the most plausible possibilities, and assess the arguments for and against adoption of each of those approaches.

The following are the approaches we suggest for consideration, each of which is more fully discussed below:

1. Open transaction.
2. Temporarily open transaction.
3. Immediate measurement for purposes of three times base amount test; open transaction approach for purposes of tax assessment.
4. Elective approach.

1. Open transaction. Under an "open transaction" approach, options would not be valued for parachute purposes until they are exercised, at which time they should be assigned a value equal to the difference between the value of the stock received and the exercise price. An argument can be made that this approach best serves the interest of the government and taxpayers in appropriately measuring change in control payments, just as it does in measuring income under Section 83. We observe, for example, that if a Black-Scholes-based approach is in fact an accurate estimate of option present value, then applying an open transaction approach should result in receipt by the government, over the long term, of the same tax revenue as would the Black-Scholes-based approach. The open transaction approach would simply distribute the liabilities arguably more equitably among the taxpayer population, by taxing amounts only to the extent actually realized.

If an open transaction approach is adopted, we believe further consideration will have to be given to the logistics of parachute tax compliance, since relevant values may not be known for years after the change in control.

This timing problem is further complicated in the parachute tax context by the nature of the "three-times-base-amount" test on which liability is predicated. An option exercise in a later tax year may lead to a retroactive conclusion that the parachute threshold had been triggered, implying that other amounts, previously paid and not reported as parachute payments, should have been treated as subject to the excise tax regime.

On the other hand, in other contexts where Congress or the Treasury Department has adopted an analogous "deemed realization" approach, the taxpayer's ultimate actual wealth realization is not simply ignored, but instead used as a basis for retroactive adjustment. For example, a securities dealer marks its securities inventory to market each year by assuming that it had sold all the inventory at then-current market prices, and it recognizes gain or loss currently on those deemed sales, even though its actual gain or loss on the ultimate sale in a later year may be much different. Similarly, the rules governing accrual of OID income by the holder of a contingent debt obligation (e.g., a debt obligation that pays at maturity the principal amount plus some factor based on the value of a commodity on the maturity date) require the holder to recognize income currently each year based on projections regarding the ultimate payout on the obligation. In both cases, the regimes provide an adjustment mechanism designed to ensure that the taxpayer does not ultimately include any more income than he actually realizes. For the mark-to-market rules, this is taken care of by basis adjustments to the securities, so that when one sums up all the "deemed" and actual gains and losses, one obtains the same net amount as one would have by deferring recognition to the time of the actual sale – the difference is essentially one of timing. Likewise, the contingent debt rules provide for adjustments as contingencies are resolved and payments are actually made on the debt instrument, so that the taxpayer ultimately includes the net amount actually received.

We believe that the Treasury Department should, whether or not the open transaction approach to option valuation is adopted, provide more elaborate guidance as to retroactive adjustments. Even under the New Proposed Regulations as presently drafted, a number of situations may arise in which events after the year of change in control could retroactively affect parachute calculations. In Part II. D. below, we offer some thoughts as to how these logistical difficulties can best be addressed.

2. Temporarily open transaction. In practice, a disproportionately high proportion of the uncertainties existing at the time of a change in control tend to be resolved within one or two years. For example, large-scale personnel adjustments or other restructurings will often have been accomplished relatively soon after a transaction is consummated. As a result, a case can be made for keeping option transactions open for some fixed period after

a change in control (*e.g.*, until the end of the tax year in which or after which the transaction is completed), and then applying an estimate of value such as Black-Scholes or spread value.

Under this approach, all of the shortcomings discussed above with respect to use of Black-Scholes spread as estimate of value would continue to be present, but their magnitude would be diminished. The approach could be defended as a compromise between theoretical purity and the practical demands of tax administration.

3. Immediate Measurement for Purposes of Three-Times-Base-Amount Test; Open Transaction Approach for Purposes of Tax Assessment. The most significant difficulty with an open transaction approach is probably the retroactive administrative problem posed by the three-times-base-amount "cliff" test. To the extent the transaction remains open it may become necessary, years after a change in control, to recharacterize other amounts previously received as parachute payments. In other words, holding the transaction open can cause required retroactive application of excise tax to amounts unrelated to the transaction held open.

On way to eliminate this problem and reflect the impact of accelerated vesting – without taxing recipients on option income they may never receive – would be to apply the three-times-base amount test including an estimate of the value of accelerated options, but refrain from attaching parachute penalties with respect to those options until they are exercised. Thus, for example, if an employee received cash payments contingent on a change in control that total 2.5 times his or her base amount, plus accelerated vesting of options the Black-Scholes value of which, multiplied by 1% for each month of acceleration exceeded .5 of the base amount, the three-times-base test would be deemed triggered in the year of the change in control, and excise tax would be owed with respect to the cash payments. The employee would not, however, owe immediate excise tax with respect to the options. Instead the options would attract excise tax only upon exercise; and if the spread actually realized upon exercise, multiplied by 1% per month of acceleration, proved to be less than .5, the employee would be entitled to claim a refund for the excise tax previously paid with respect to the cash payments.

This approach would also represent a compromise in theoretical purity, but would have the following advantages: employees would not be assessed, immediately and irrevocably, excise tax on option value based on a speculative – and highly controversial estimate; employees would nonetheless have to take into account such an estimate in determining whether excise tax is owed on amounts that are actually received; and finally, despite the foregoing advantages, which depend to some degree on keeping transactions open after the relevant year,

retroactive recharacterization of amounts as subject or not subject to excise tax might be expected to be minimized (especially to the extent that Black-Scholes estimator accurately predicted option value).

4. **Elective Approach.** Depending upon subsequent events, taxing an executive immediately upon a change in control (either on the basis of a Black-Scholes valuation or some other approach) may result in more or less tax, as compared with an open transaction approach. If stock prices appreciate more, prior to option exercise, than would be predicted under the Black-Scholes model, the Black-Scholes estimation will have resulted in under-taxation. If stock prices appreciate less robustly or decline, the reverse will be true.

This leads to the possibility of leaving to the employee the decision whether to be taxed immediately or to permit the transaction to remain open. Much as with an election under Section 83(b), such an elective decision would reflect, in a given case, the employee's assessment of the likelihood of future appreciation (as well as the expected time of exercise). No systematic bias toward greater or less tax should result (assuming Black-Scholes is a generally accurate estimator of option value).

We note that the Treasury Department has adopted a similar approach, under the New Proposed Regulations, with respect to certain deferred payments. (See Section II.H below.) Options can be viewed as one form of deferred compensation.

5. **Technical Recommendations.** In any event, assuming the Treasury Department retains the general approach to stock options set forth in the New Proposed Regulations and Revenue Procedure 2002-13, we have the following more technical observations: First, further consideration should be given to the appropriate measure of stock volatility to apply in performing valuations under Revenue Procedure 2002-13 and Revenue Procedure 98-34. Revenue Procedure 2002-13 provides that in the case of a stock publicly traded on an established securities market, the expected volatility to be used for valuation purposes is that disclosed in the corporation's financial statements. One possible objection to this approach is that the measurement period for financial statement disclosure may significantly differ from the expected term of the options in question.

For nonpublicly traded companies, on the other hand, volatility is to be treated as the same as that for a "comparable" publicly traded corporation. This provision introduces a substantial element of subjectivity – and in the case of many (particularly small, or new) corporations, no truly comparable publicly traded corporation may exist. (We note that it appears to be unclear under Revenue Procedure 2002-13, as drafted, whether volatility should be determined by reference to the "target" or "acquiror" corporation's stock.) Finally, by

recognizing only three categories of volatility ("low," "medium" and "high"), Revenue Procedure 2002-13 could be viewed as failing sufficiently to distinguish among companies with widely varying return, dividend and risk characteristics.

II. Other Comments on the Proposed Regulations

A. Small Corporation Exception

Section 280G specifically exempts several types of payments from the definition of the term "parachute payment." This exemption includes payments by certain corporations if, immediately before the change in ownership or control of the corporation, no stock of the corporation is readily tradable on an established securities market and shareholder approval of the payment is obtained.

Under the Code and the 1989 Proposed Regulations, the shareholder approval requirements are met with respect to any payment if the payment was approved by a separate vote of the persons who owned, immediately before the change in ownership or control, more than 75 percent of the voting power of all outstanding stock of the corporation, and there is adequate disclosure to shareholders of all material facts concerning all material payments (which but for this exclusion) would be parachute payments. The New Proposed Regulations clarify that there must be adequate disclosure to every shareholder entitled to vote (and not just to shareholders who hold 75% or more of the voting power). In addition, the New Proposed Regulations provide an administrative safe harbor that the determination of who is entitled to vote may be based on the shareholders of record at the time of any vote in connection with a transaction or event giving rise to a change in ownership or control within the three-month period ending on the date of change in ownership or control, provided there is adequate to disclosure to every shareholder entitled to vote.

Timing of Vote. Under the 1989 Proposed Regulations, the practical issue arose that change in control payments are typically approved months or years in advance of any anticipated change in ownership or control and not on the eve of a change in control. Agreements are often entered into at the time of hiring an executive or at the time employment contracts are renewed. In the absence of Section 280G, the employment agreements (and the payments thereunder) would not be submitted for shareholder approval. If the agreements are – contemporaneously with the execution – approved by shareholders in an attempt to comply with Section 280G, the ownership of the shares may change prior to the change in control. Thus, for purposes of Section 280G, the payment may not be approved by 75% of the shareholders *immediately prior to a change in control.* It is, we believe, impractical and inconsistent with business practices for an executive to be at risk for compensation that triggers on a change in ownership or control which may have been granted years (and certainly more than three months) before the change in control.

The New Proposed Regulations ameliorate but do not eliminate this problem. Under the new rule, if there is a change in ownership of the stock of the corporation within a three month period leading up to the change in ownership or control, the determination of who is entitled to vote based on the shareholders of record within such period would be sufficient.

The Senate has stated in the context of approving the small corporation exemption that the purpose of the golden parachute provisions are to protect equity shareholders whose interests may be impaired by parachute payments.[8] Given that equity shareholders of private corporations are not as vulnerable to corporate manipulation by corporate officers as the dispersed shareholders of publicly traded corporations, stringent approvals in relation to the timing of a shareholder vote where the rights of shareholders are not adversely affected by the parachute payments imposes unnecessary and impractical restraints on private corporations that do not serve to advance the purposes of Section 280G.

Alternative Approaches. One approach would be to liberalize further the rule of administrative convenience introduced under the New Proposed Regulations. To be of significant practical assistance, the period for determining the shareholders of record should be expanded to a greater length of time, *e.g.* one year. Another alternative would be to expand the period an even greater length of time, but condition the expansion on the shareholders of record not having changed by a percentage of 25% or more.

A second approach would be to require a second affirmation or vote by the new shareholders. In this way, the executive would know at least that one favorable vote occurred at the time he or she enters into the employment arrangement. Moreover, the regulation could make it clear that those who voted in advance could agree to vote favorably on the second vote.

Yet a third possible approach would focus on those transferees who acquire shares after the initial approval of parachute payments. The Treasury Department might deem the shareholder populations at the time of approval and time of the transaction to be identical if each transferee, as part of his or her acquisition of stock, expressly consented to the parachute payment rights previously approved.[9]

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[8] P.L. 100-647 (Technical and Miscellaneous Revenue Act of 1988) (11/10/88).

[9] In fact, it is our view that such consent could in any event reasonably be *presumed* that leads us to believe the Treasury Department would be justified in substantially relaxing the basic requirement that the shareholder approval population be the same as the change-in-control shareholder population.

Arguably the language of the statute impedes the Treasury Department from pursuing one of the liberalizing approaches discussed above. The relevant language requires that a payment be approved by "a vote of the persons who owned, immediately before the [change in control], more than 75 percent of the voting power of all outstanding stock of the corporation." We acknowledge that this provision lends itself, on its face, to a focus on the identity of the "persons" who are 75% shareholders immediately before a change in control event. We submit, however, that the probable congressional intent, and certainly a reading that would fall within the Treasury Department's interpretational authority, would be to construe the phrase as designating "owners of shares that, immediately before the change in control, represented more than 75 percent of the voting power." Such an interpretation would countenance any of the suggested modifications discussed above and thereby confer practical significance upon the statutory exception, as contrasted with the interpretation advanced under either set of Proposed Regulations.

A further issue concerns the degree to which special "280G disclosure" must be provided to all shareholders prior to a vote. Section 280G requires "adequate disclosure to shareholders," but does not specify the standards under which adequate disclosure should be provided. The legislative history indicates that adequate disclosure should include full and truthful disclosure of the material facts necessary to make the disclosure not materially misleading.[10] In this context, the requirements of notice and disclosure under state corporate law should be sufficient to determine the extent to which a matter of corporate law has been properly submitted to shareholders entitled to vote,[11] provided the information disclosed is truthful and not materially misleading. Although we understand the counterargument that Congress may have specifically intended extraordinary shareholder action outside of state corporate law protections in the context of the shareholder approval requirement, we nonetheless believe the Treasury Department should provide that if the vote taken complies with the requirements of state law with respect to notice and disclosure, the disclosure should be "adequate" for purposes of Section 280G. Such an approach would, in our view, be consistent with the intent of Congress.

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[10] P.L. 99-514 (Tax Reform Act of 1986) (10/22/86)

[11] In the context of shareholder approval by entity shareholders, the Senate has indicated that the normal voting rights of the entity shareholder should be determinative. P.L. 100-647 (Technical and Miscellaneous Revenue Act of 1988) (11/10/88).

B. Definition of Change in Control – Overlapping Share Ownership

Q/A-27(a) of the 1989 Proposed Regulations provided that a change in the ownership (and hence a change in control) of a corporation will not be deemed to have occurred merely by virtue of the acquisition of additional stock by an individual or "group" who owned at least 50% of the corporation prior to the transaction. Q/A-27(b) went on to provide that persons will be considered to be acting as a "group" if they are owners of an entity that enters into a merger or similar transaction with the corporation.

Taken together, these provisions left open the possibility that, where sufficient cross-ownership of stock existed, a merger of two corporations could occur in which neither experienced a change in control. For example, assume that Corporation A merges with Corporation B and that immediately after the merger, former shareholders of Corporation A hold 52% of the surviving entity's stock, and former shareholders of Corporation B hold 48% of the surviving entity's stock. If the former holder of 5% of Corporation B's stock also held stock in Corporation A, the conclusion could be reached that the merger does not represent a change in control of either A or B, since more than 50% of the surviving entity's stock can be said to be held by the former shareholders of each of A (52%) and B (48% + (.05 x 52%) = 50.6%).

In the New Proposed Regulations, the Treasury Department has made the clarifying change that a shareholder is considered to be acting as a group with other shareholders in an entity only to the extent of his or her ownership in the entity prior to the transaction. In effect, the overlapping shareholder must be treated as two different persons.

The overlapping shareholder analysis has typically been used in the context of "mergers and equals" involving two widely held public companies of roughly equal size, such as the transaction described above. In these situations, it is often unclear, as a practical matter, whether in fact control of either company has changed. As noted above, some practitioners have used the existence of overlapping shareholdings to argue that neither company experiences an acquisition of more than 50% of its stock and hence neither company has a change in ownership as defined in Q&A 27. However, even if one accepts the premise of this argument (namely, that a merger may occur without either company undergoing a change of control), it is not necessarily the case that there is no 280G change of control at all, as Q&A 28 will create a presumption that both companies have experienced a change of control by virtue of the acquisition of 20% or more of their stock. This presumption must be rebutted by each company, by establishing that power to control the company has not been shifted to another person or group. In a true "merger of equals" in which membership of

the board of directors of the combined entity is agreed upon and no new shareholder bloc that can control the combined entity emerges, it is conceivable that the presumption could be rebutted for both companies. Conversely, it is conceivable that neither company might be capable of rebutting the presumption, resulting in a change of control of both companies.

It is not clear to the Tax Section whether the Treasury Department believes that it is impossible to have a merger of two public companies in which both, or neither, company has a change of control within the meaning of Section 280G. However, we submit that a per-se rule that every merger must result in at least one change of control – which appears to be the consequence under Q&A 27 of the New Proposed Regulations – would be misguided.

We believe that this approach does not focus on the most important aspects determining shifts of control in public company mergers. The differences of shareholdings between the two separate groups of pre-merger shareholders in the typical merger-of-equals scenario in which the overlapping shareholder position has been used are not usually of any practical import – indeed, it is often not clear at the time a transaction is agreed upon and approved by the two shareholder groups which of the two groups will have a majority of the combined entity. Rather, the measures of control that matter after the merger are those that are to be examined under Q&A 28 – which company's management control, who are the members of the post-merger board of directors, and whether or not any single shareholder controls a large block of stock (see, e.g., PLRs 200041020, 200034013, 200029035, 199915021, 199943032, 199920009, 199905012, 199949009). We therefore recommend that the Treasury consider reversing the rule of the New Proposed Regulations that requires treating an overlapping shareholder as two separate shareholders for purposes of Q&A 27, and instead rely upon the presumption created under Q&A 28 to ensure that true measures of control are examined to determine whether a change of control has occurred.

If this recommendation is not adopted, we request that Treasury clarify that the result set forth in the New Proposed Regulations does not necessarily apply where the shareholders of one of the merging corporations are *actually* (as contrasted with deemed to be) "acting as a group." For example, for illustrative purposes, assume that in the above example two individuals, I and J, who invest together pursuant to a shareholders' agreement, owned all of the stock of A and 51% of the stock of B, pre-merger. The New Proposed Regulations would appear to treat the merger of A and B as having resulted in a change in control of B, since the B shareholders in their deemed separate capacity own only 48% of the surviving entity. Here, this result is surely incorrect, since I and J, who are

actually acting as a group, controlled both B pre-merger and the surviving entity post-merger.[12]

Finally, it would be helpful if the Treasury would announce its position on whether there is a per-se rule that every merger of two public companies must be deemed to result in one and only one change of control, or whether it is possible to have two changes or no change.

C. Definition of Change in Ownership of Substantial Portion of Corporation's Assets

One of the elements of a "change in control" of a corporation under Section 280G is a change in the ownership of a substantial portion of the assets of a corporation. Q/A-29 of the 1989 Proposed Regulations provided that this element of the definition would be deemed to have occurred where a person or group acquires assets from a corporation that have a total fair market value equal to or more than one-third of the total fair market value of all the assets of the corporation.

This test requires, in the case of a sale of assets, that a fraction be computed equal to the ratio of the assets being sold to the total assets of the corporation. If the fraction exceeds one-third, a change in control will have occurred. The 1989 Proposed Regulations did not provide any additional guidance, however, concerning the proper determination of the numerator and denominator of this ratio. One question thus left unanswered, which arises with some frequency, is the effect of corporate debt. For example, a corporation may own $150X of tangible property, such as buildings or cash, and owe $30X in debt. If the corporation sells $45X of its tangible property for cash, has it undergone a change in control? If the 1989 Proposed Regulations are read as requiring a sale of at least one-third of the assets to which the corporation literally holds title, the answer is no (since 45/150 is less than one-third). On the other hand, if the test is read as requiring merely a sale of one-third of the corporation's *net* assets (that is, taking into account a reduction for the corporation's debt), the answer is yes (since 45/(150-30) is greater than one-third).

The New Proposed Regulations appear to answer this question, by amending Q/A-29 to cause the definition to be triggered upon a sale of one-third of the "gross" fair market value of the assets of the corporation. Accordingly, in the above example the Treasury Department would appear to require that the

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[12] With respect to both Corporations A and B, therefore, the transaction could be said to have represented the acquisition of additional stock by groups that each owned more than 50% of the stock of A and B, respectively, and more than 50% of the stock of the surviving entity.

$30X in debt be ignored (thus resulting in the conclusion that no change in control had occurred). We observe that if this is the Department's intention, it should probably be stated more clearly. Although the bare addition of the modifier "gross" before "fair market value of the assets" seems to impel the result just given, it would be less subject to interpretation if the regulation were instead to say "fair market value of the assets (without taking into account debt)".[13]

D. Effect of Uncertain Future Events

Q/A-33 provides that where a payment may be contingent on the occurrence of an uncertain future event or condition, such as the involuntary termination of such individual's employment with the corporation, it must be reasonably estimated whether the payment will be made. If it is reasonably estimated that there is a 50-percent or greater probability that the payment will be made, the full amount of the payment is considered for purposes of the 3-times-base-amount test and the allocation of the base amount. Conversely, if it is reasonably estimated that there is a less than 50-percent probability that the payment will be made, the payment is not considered for either purpose. This provision is similar to the rule contained in Q/A-33 of the 1989 Proposed Regulations, which provided simply that a "reasonable estimate" be made of the time and amount of the future payment, to serve as the basis for computing present value of the payment.

In our report on the 1989 Proposed Regulations, we questioned the practicality and appropriateness of requiring that calculations required by the Code be based on estimates of uncertain future payments and events. While constraining the probability estimate to a binary choice between a 50-percent-or-more or less-than-50-percent likelihood should theoretically reduce this problem, as a practical matter the requirement remains unacceptably difficult and subjective. In reality, it is often effectively impossible to assign <u>any</u> meaningful probability to the occurrence of a future event such as an employee's involuntary termination. In those situations where an employer does have a good idea whether its employee will be terminated, it may not wish to share that information with the employee, as the New Proposed Regulations would seem to require in order for the employee to compute his or her excise tax liability.

<u>Alternative Approaches</u>. The practical difficulties raised by Q/A-33 of the Proposed Regulations are not unrelated to problems discussed earlier in this report concerning the valuation of options whose vesting has been accelerated. In the context of that discussion we recommended that the government adopt an "open

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[13] It is not clear to the Tax Section that "gross fair market value" is a readily ascertainable and generally accepted quantity within the financial or accounting industries.

transaction" approach to options, which would entail waiting until the option is exercised to determine the parachute tax consequences.

In general, we would propose that the Treasury Department replace Q/A-33 of the New Proposed Regulations with a rule providing that, where the fact or amount of a payment to be made in the future is contingent on an uncertain future event or condition, the calculation of excess parachute payments will be suspended until the occurrence of such event or condition (or until it becomes certain that the event or condition will not occur). We believe that an administrative framework could reasonably easily be developed to accommodate such a suspension. To the extent necessary, such an approach may entail administrative suspension of the statute of limitations for a particular year. We do not believe that any of these potential logistical obstacles should be regarded as insuperable and, in any event, such complications as may arise are preferable to a scheme that would require assigning final tax liabilities based on predictions of intrinsically unpredictable phenomena.

E. Pre-Change-in-Control Contract Novation

Generally, payments are not treated as contingent on a change in control (and thus are not susceptible of characterization as parachute payments) if they are made pursuant to an agreement entered into after the change in control (a "post-change agreement"). Q/A-23(a) of the New Proposed Regulations specifies that if an individual has a right to receive a parachute payment under an agreement entered into prior to a change in ownership or control (a "pre-change agreement") and gives up that right as bargained-for consideration for benefits under a post-change agreement, the agreement is treated as a post-change agreement only to the extent the value of the payments under the agreement exceed the value of the payments under the pre-change agreement. Accordingly, to the extent payments under the post-change agreement have the same value as the parachute payments under the pre-change agreement, such payments retain their character as parachute payments.

We regard this clarification as logical and, in fact, consistent with our interpretation of the 1989 Proposed Regulations. However, some practitioners have expressed concern that the new language of Q/A-23(a) might be read as precluding the possibility that some of the payments due under a pre-change agreement might be characterized as reasonable compensation, where a post-change agreement has been substituted for the pre-change agreement. We do not so read the new language, and ask that the Treasury Department confirm our interpretation of the New Proposed Regulations.

F. Effect of Section 83(b) Election

We reiterate a point made in our comments on the 1989 Proposed Regulations, to the effect that the Treasury Department should reconsider the effect of an election under Code Section 83(b) on the timing of valuation for purposes of Section 280G. In particular, 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. 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.

The Tax Section believes that this provision 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 Tax Section believes that a prior Section 83(b) election 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 Tax Section's approach would thus give partial effect to the prior election and would permit any corporate deduction previously taken to stand.

We recognize the contrary argument could be made that the excise tax regime for Section 280G is properly viewed as entirely independent of the income tax regime effectuated in part by Section 83. Under this view, the fact that an individual has already recognized income with respect to property does not negate the real benefit realized when the property later becomes nonforfeitable as a result of a change or control. Nonetheless we think it inequitable, when an employee has elected effectively to treat property as already vested (and to suffer the corresponding income tax treatment), subsequently to apply excise tax as though a "second transfer" has occurred. We also believe it advisable from an administrative and theoretical standpoint, where possible, to apply the parachute regime in a manner consistent with principles applicable to calculation of income tax.

G. Determination of Base Amount Following Change in Employment Status

The "base amount" and "base period" are fundamental concepts under the parachute tax regime. In general, an executive is treated as receiving excess parachute payments if he or she receives total payments contingent on a corporate change in control that exceed three times his or her "base amount." Both the New Proposed Regulations and the 1989 Proposed Regulations generally define the base amount as "average annual compensation for services performed for the corporation" for taxable years in the "base period". The "base period" is generally defined as the most recent five taxable years ending before the date of the change in ownership or control during which the disqualified individual was an employee or independent contractor of the corporation.

The definition of base amount does not contain any qualifying language with respect to the capacity in which services were performed. The definition of base period, however, expressly contemplates an individual performing services as either an employee or independent contractor. The inclusion of any compensation paid to an individual, whether derived from such individual's services as an employee or independent contractor without differentiation, can result in an artificially low base amount. In circumstances where a disqualified individual performs services for a corporation as an independent contractor, such as an outside director or other similar role, prior to becoming employed by the corporation, for example, the definitions of "base amount" and "base period" can lead to unfair and unjustified results.

Illustration. In each of 1998, 1999, 2000 and 2001, Mr. A is an independent contractor who performs services for Corporation X. In each of 1998 and 1999, Mr. A is compensated $15,000 for his services, in 2000, he is compensated $25,000 and in 2001, he is compensated $50,000 for such services. In February 2002, Corporation X and Mr. A enter into an employment agreement under which he assumes a position of senior vice president and is entitled to receive a base salary of $600,000 a year for the next three years. Under his employment agreement, if there is a "change in control", Mr. A will become entitled to certain compensation and other benefits.

In June of 2002, Corporation X undergoes a change in control. Under the Proposed Regulations, Mr. A's base amount would only be $141,000.[14] As a result of including compensation Mr. A received while an independent director, Mr. A's base amount bears little relationship to his current position and current base salary.

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[14] ($15,000 + $15,000 + $25,000 + $50,000 + $600,000)/5 = $141,000.

Alternative Approach. Where an individual has changed capacity during the base period from independent contractor to employee (or *vice versa*), the Tax Section suggests that only the period coinciding with such individual's service in the same capacity as that in effect at the time of the change in control be included in the "base period."

H. Election to Treat Deferred Payments as Made in the Year of Change in Control

Q/A-11(c) sets forth the general rule that if (1) the present value of cash compensation payments to be made in multiple years is reasonably ascertainable in the year of the change in ownership or control (the "**Change Year**"); and (2) the earliest of the payments is certain to be made in the Change Year, then the recipient may treat the set of payments as having all been made in the Change Year. Such an election will permit the recipient to satisfy his or her tax obligation (and, often, his or her employer to satisfy its gross-up obligation) at the time the taxes are paid for the Change Year, and will fix the present value of the excise tax paid. We welcome the addition of this elective principle, which will help reduce administrative complexity in complying with the Section 280G regime. We offer the following suggestions and requests for clarification:

Clarify Lump Sum Valuation. We would suggest that the Treasury Department clarify whether treating the compensation payments as made in the Change Year means that such payments, but not the allocable portions of base amount, are to be discounted as described in Q/A-38 (applicable to allocation of base amount to multiple years). We note that if so, lump-sum treatment would cause the aggregate amount of the applicable excise tax to decrease (and should therefore presumably be elected by any informed taxpayer), because the full unreduced base amount would be subtracted from the reduced, present value of the future parachute payments.

Applicability to Fringe Benefits Other than Life Insurance. Under the New Proposed Regulations the lump-sum election is applicable to all fringe payments other than "health benefits or coverage." Even cash payments are eligible for the election only if they are reasonably ascertainable pursuant to Section 3121(v) and Treasury Regulation Section 1.3121(v)-1(e)(4), which allows assumptions to be made only about interest rates and mortality assumptions.

This limitation is, arguably, unnecessarily restrictive. For example, life insurance is the only type of fringe benefit that appears to satisfy the assumption condition. (Even in the case of life insurance, if premiums were not fixed in the Change Year future payments could be affected by factors other than mortality and interest rates.) We would recommend that a lump sum election should be allowed for any benefit at least in the case where arms-length group insurance quotations for equivalent coverage are available and reasonable projections of the

applicable group insurance premiums may be generated and are used.[15] On the other hand, we agree with the Treasury Department that, for example, no lump sum election should be permitted for health benefit payments pursuant to a medical reimbursement plan in which reasonable projections of the amounts to be reimbursed are not available, such as, for instance, a plan with very large annual and/or lifetime reimbursement limits.

If the Treasury Department were to adopt the foregoing approach, it would need to address those cases in which the value of the fringe benefits ultimately proved different from the projections of value of those benefits used for purposes of Section 280G. Several approaches to this issue could be considered. First, in accord with the "reasonably ascertainable" standard of Section 3121(v) and Treasury Regulation Section 1.3121(v)-1(e)(4), the government might disregard any discrepancies if the projected costs were reasonable when made. Such a rule could be limited to cases where the fringe benefits are a *de minimis* portion of the parachute payments. Alternatively, the government might simply disregard any discrepancies that are *de minimis.* (For example, any differences that are less than the smallest of 1% of the present value of the parachute payments treated as paid in the Change Year, 10% of the present value of the fringe benefits treated as paid or the benefits received in the Change Year, or $100,000, could be disregarded.) Finally, discrepancies that need to be addressed could be treated in the same manner as other contingent payments, *i.e.*, by amending the parachute calculation as described in Q/A-33(b). In any case, the Treasury Department could require that the employer disclose the actual payments or value of the benefits in order to permit monitoring of the reasonableness of the projections.

I. Application of Rules to Exempt Organizations

The New Proposed Regulations extend explicit golden parachute exemptions to tax-exempt organizations, under certain circumstances. We believe consideration should be given to further clarifying and broadening those exemptions.

The golden parachute provisions appear to have been enacted to discourage departing executives from taking advantage of their employer's shareholders by receiving on a change of control large corporate payments, which do not constitute reasonable compensation, *i.e.*, golden parachute payments. This goal is of dubious relevance to exempt organizations, which often have no shareholders.[16] Instead, not-for profits often have members and/or beneficiaries.

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[15] Cf. Q/A-31(b)(2).

[16] In fact, in New York shareholders of such corporations are prohibited under the New York Not-for Profit Corporate Law, NY N-PCL § 501.

On the other hand, there may be a danger that the members and/or beneficiaries of tax-exempts might be injured, in a manner analogous to shareholders, by golden parachute payments. Thus the Service appears to have intended to restrict the new exemption to entities which may not permit such payments by their nature, such as entities organized by Congress or religious organizations, or recognized as charitable by statute, such as 501(c)(3) organizations.

The New Proposed Regulations in Q/A-5 and 6 thus exempt payments made by entities which before and after the change of control or ownership are (1) 501(c)(1) organizations, which are organized under an Act of Congress; (2) 501(c)(21) organizations, which are organized to provide benefits to black lung victims; (3) 501(d) organizations, which are religious organizations; (4) 529 organizations, which are qualified tuition programs; or (5) organizations which are subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual.

We would suggest that the Service clarify whether a statutory prohibition of falling in the last category must be derived from federal tax law and/or state law. If only the former, the exempt organizations are those exempt under Sections 501(c)(3) (charities), 501(c)(4) (civic leagues), 501(c)(6) (business leagues), 501(c)(13) (cemetery companies), 501(c)(19) (veterans organizations), or 501(c)(26) (state sponsored health insurers for the uninsurable).[17] This last category applies to entities that at times make large payments to executives in concert with those institutions' mergers and spinoffs, namely, major health care not-for-profit organizations, which are 501(c)(3) charities. It is not clear if all state anti-inurement provisions would have the same effect.

III. Observations Concerning the Statute

The following comments concern matters arising under the statute itself. While they are not amenable to being directly addressed by the Treasury Department, we raise them here because publication of the New Proposed Regulations seems an appropriate moment to record our recommendations, to the extent the statute is later subject to legislative reconsideration in whole or in part.

As practitioners, our first observation concerns the statute's lack of efficacy in producing the modifications in corporate behavior that Congress

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[17] We suggest that the last category of the exemption also should include organizations exempt under Section 501(c)(9) (voluntary employee benefit associations) and 501(c)(11) (teachers' retirement funds). The statutory conditions applicable to both types of organizations generally prohibit private "inurement," but contain an exception for receipt of benefits provided under the relevant plan, which does not implicate Section 280G concerns.

presumably desired. In our report on the 1989 Proposed Regulations, we noted that:

> In view of the significant amounts that continue to be paid to executives in connection with changes in ownership and control, the Tax Section 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 Tax Section 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.[18]

The unfolding of events has justified this skepticism. We observe no material effect of the golden parachute tax regime in restraining corporate change in control payments.[19] To the contrary, it is not uncommon for corporations to pay "gross-up" amounts to their employees, holding the employees harmless from the effect of any excise tax under Section 4999. Thus the parachute provisions have the perverse result in many cases of substantially *increasing* the cost to shareholders of change in control arrangements, without any detriment to the payments' recipients.[20] Given the demonstrated willingness of corporate directors and managers to pass such tax costs on to shareholders, and the significance of tax planning and related transaction costs, it would be preferable and more effective for Congress, if it wishes to regulate compensation practices, to do so directly via corporate governance mechanisms rather than indirectly through the use of tax penalties.

Finally, short of outright repeal we believe technical revisions of the statute are merited in a number of instances, as follows:

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[18] NYSBA Report #629, *supra.* note 5.

[19] Corporations justify change in control arrangements, like other compensation arrangements, by reference to the practices of their peers. Accordingly, the primary question relevant to a board of directors considering adoption of such an arrangement is whether "everybody else is doing it."

[20] The increase in cost to the corporation associated with a gross-up is exponential in nature, since the additional gross-up payment is itself a parachute payment subject to gross-up, on which an additional gross-up amount must be paid; and since the entire set of payments, including gross-ups, is nondeductible.

Treatment of officers of affiliated group members. The last sentence of Section 280G(c)(5) provides that any person who is an officer of any member of the deemed "single corporation" described above shall be treated as an officer of the single corporation. This has the (surely unintended) result of causing even officers of small and insignificant subsidiaries to be treated as "officers" of the entire deemed corporation, and therefore subject to excise tax. We believe this sentence should be deleted from the statute and replaced with a concept of "officer," similar to that applicable under U.S. securities laws, that treats any person with sufficient policy-making authority as an officer of a parent corporation, regardless of the specific subsidiary or division by which he or she is employed.

Definition of base amount. The "base amount," with respect to which change in control payments are measured under the statute, is defined as "includible compensation" for the base period. We suggest it would be more appropriate to include in the base amount elective contributions, for example, to Section 401(k) plans, and similar deferred amounts.