

Internal Revenue Service

Department of the Treasury

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Person to Contact:

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Date:
June 7, 2000.

Employee =
Corporation A =
Corporation B =
Stock Option Plan =
Date 1 =
Date 2 =
Date 3 =
Date 4 =
Year Y =

This is in response to your letter of February 3, 2000, submitted by your authorized representative, requesting rulings under section 280G of the Internal Revenue Code. Specifically, a ruling was requested, under the facts outlined below, whether Employee is a "disqualified individual" within the meaning of section 280G(c) of the Code due to the value of stock ownership in Corporation A. The facts as submitted are as follows.

Employee was employed by Corporation A in Year Y. Employee was not an officer of Corporation, nor a member of the group consisting of the highest paid 1 percent of the employees of the corporation.

During Year Y, Corporation A adopted the Stock Option Plan. The Stock Option Plan provided for both incentive stock options designed to meet the requirements of section 422 of the Code and nonstatutory options. Options issued under the Stock Option Plan were governed by the Stock Option Plan and the Stock Option Agreement, as amended. Under the Stock Option Agreement, if options are outstanding at the time of a change in control (as defined in the Stock Option Agreement), but are not fully

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exercisable, the options will generally accelerate so that the options will become exercisable immediately before the change in control. The options will not become exercisable on an accelerated basis if the options are assumed by the successor corporation. In that case, the options would be converted to options of the successor corporation and would continue to become exercisable in accordance with the terms of the Stock Option Agreement. However, the Stock Option Agreement provides that if there is an involuntary termination (as defined in the Stock Option Agreement) of the employee's services within 18 months of a change in control, the options that are outstanding at the time of the involuntary termination, but are not fully exercisable would accelerate and become fully vested.

On Date 2, Employee received incentive stock options and nonstatutory options under the Stock Option Plan (Options). The Options issued to Employee generally became exercisable on a four-year vesting schedule.

On Date 3, Corporation A underwent a change in control when it was acquired by Corporation B. Employee became an employee of Corporation B. Corporation B assumed Corporation A's Stock Option Plan and Employee's Corporation A Options were converted to Corporation B Options of equivalent value. The vesting schedule remained the same.

Following the change in control, Employee terminated employment with Corporation B on Date 4. The termination constituted an involuntary termination under the Stock Option Agreement and Employee's Options were accelerated and became exercisable on Date 4.

The "disqualified individual determination period" is from Date 1 to Date 3. During the disqualified individual determination period, Employee's ownership interest in Corporation A, other than the Options described above, consisted of the right to purchase shares under the Corporation A employee stock purchase plan.

No Corporation A stock was owned by Employee's spouse, children, grandparents or parents at any time during the disqualified individual determination period. In addition, Employee was not a partner in any partnership that owned Corporation A stock; a beneficiary in any trust (or a grantor in any trust) that owned Corporation A stock; or a direct or indirect owner of 50 percent of the value of any corporation that owned Corporation A stock.

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

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Section 280G(b)(2)(A) of the Code defines the term "parachute payment" as any payment in the nature of compensation to (or for the benefit of) a disqualified individual if (i) such payment is contingent on a change (I) in the ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation; and (ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such change equals or exceeds an amount equal to three times the base amount.

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

Section 280G(c) defines a "disqualified individual" as an individual who is (1) an employee, independent contractor, or other person specified in the regulations who performs personal service for any corporation, and (2) is an officer, shareholder, or other highly compensated individual.

Section 1.280G-1 of the Proposed Income Tax Regulations, Q&A 15, published in the Federal Register on May 5, 1989 (54 Fed. Reg. 19,390), provides that an individual is a disqualified individual with respect to a corporation if, at any time during the "disqualified individual determination period," the individual is an employee or independent contractor of the corporation and is, with respect to the corporation, a shareholder, an officer, or a highly-compensated individual.

Q&A 17 provides that shareholders are disqualified individuals if they own stock of a corporation having a fair market value that exceeds the lesser of \$1 million dollars, or 1 percent of the total fair market value of the outstanding shares of all classes of the corporation's stock. For purposes of determining the amount of stock owned by an individual, the constructive ownership rules of section 318(a) shall apply. Section 318(a)(4) states that if a person has an option to acquire stock, such stock shall be considered as owned by such person.

Section 1.280G-1, Q&A 20 provides that the "disqualified individual determination period" is the portion of the year of the corporation ending on the date of the change in ownership or control of the corporation (the "change in ownership period") and the twelve month period immediately preceding such change in ownership period. For purposes of Q&A 20, a corporation may elect to use its taxable year or the calendar year.

It has been represented that Employee was not an officer or a highly-compensated individual during the disqualified individual determination period. Thus, in order to be a disqualified individual, Employee must have owned Corporation A stock having a fair market value that exceeded the lesser of \$1 million or 1 percent of the total fair market value of the outstanding shares of all classes of the corporation's stock. It has been represented that in this case the \$1 million was the lesser amount and that

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other than the stock options under the Year Y grants, the fair market value of Employee's Corporation A stock was less than \$1 million. If Employee constructively owns the stock under the Year Y option grants, Employee will be a disqualified individual.

In determining which of the outstanding stock options are considered to be stock during the disqualified individual determination period for purposes of Q&A 17, options which are exercisable, or are exercisable upon the occurrence of an insubstantial condition precedent are considered outstanding stock. See Rev. Rul. 89-64, 1989-1 C.B. 91. Conversely, options which are not currently exercisable and are only exercisable upon the occurrence of a substantial condition precedent are not outstanding stock for this purpose. Here, the facts indicate that only the options under the Year Y grants that were exercisable at the time of the change in control cause Employee to constructively own the stock for purposes of Q&A 17. Options that were not exercisable at the time of the change in control did not cause such constructive ownership.

Accordingly, based strictly on the information submitted and Employee's representations set forth above, we rule as follows:

- 1) Employee is not a "disqualified individual" with respect to Corporation A within the meaning of section 280G(c) of the Code.
- 2) The provisions of section 280G of the Code do not apply to any payments, including the vesting of options under the Stock Option Plan, that are received by Employee in connection with Corporation A's Date 3 change in control.
- 3) The provisions of section 4999 of the Code do not apply to any payments, including the vesting of options under the Stock Option Plan, that are received by Employee in connection with Corporation A's Date 3 change in control.

Except as specifically ruled on above, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. The taxpayer should attach a copy of this ruling to any income tax return to which it is relevant.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent that the regulations are

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inconsistent with any conclusion in the ruling. However, when the criteria in section 12.05 of Rev. Proc. 2000-1, 2000-1 I.R.B. 4, 47 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances. In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely yours,
ROBERT B. MISNER
Assistant Chief,
Executive Compensation Branch
Office of the Division Counsel/Associate
Chief Counsel (Tax Exempt and
Government Entities)

Enclosure:
Copy for 6110 purposes