

Revenue Rulings

Rev. Rul. 2005-39, 2005-2 CB 1, 06/16/2005, IRC Sec(s). 280G

Golden parachute payments—excess parachute payment—change in control.

Full Text:

Issues

1) In determining whether a corporation has experienced a change in ownership or control under § 280G(b)(2)(A)(i) of the Internal Revenue Code, are unvested shares of restricted stock for which an election under § 83(b) has been made treated as outstanding stock?

2) In determining the amount of stock held by a shareholder for purposes of testing whether the shareholder is a disqualified individual under § 1.280G-1, Q/A-17 of the Income Tax Regulations, are unvested shares of restricted stock for which an election under § 83(b) has been made treated as outstanding stock?

Facts

Corporation X and Corporation Y are unrelated publicly-held companies. Both Corporation X and Corporation Y maintain restricted stock plans and option plans for their respective employees. Immediately prior to the merger described below, without considering any outstanding options or restricted stock, the shareholders of Corporation X own stock with a total fair market value of \$105x and the shareholders of Corporation Y own stock with a total fair market value of \$105x.

Employees of Corporation X hold restricted Corporation X stock that is not substantially vested but with respect to which elections under § 83(b) have been made. They also hold vested options to purchase vested stock of Corporation X. The fair market value of this Corporation X restricted stock and the Corporation X stock subject to these options is \$3x.

Employees of Corporation Y hold restricted Corporation Y stock that is not substantially vested but with respect to which elections under § 83(b) have been made. They also hold vested options to purchase vested stock of Corporation Y. The fair market value of this Corporation Y restricted stock and the Corporation Y stock subject to these options is \$2x.

Certain employees of Corporation X and Corporation Y also hold restricted stock that is not substantially vested with respect to which no election under § 83(b) has been made and vested options to purchase substantially nonvested stock.

On February 20, 2005, Corporation X merges into Corporation Y, with Corporation Y as the surviving corporation. In the merger, the shareholders of Corporation X receive Corporation Y stock in exchange for their Corporation X stock. The holders of nonvested restricted Corporation X stock receive nonvested restricted Corporation Y stock in exchange for their nonvested restricted Corporation X stock. The holders of options to acquire Corporation X stock receive options to acquire Corporation Y stock in exchange for their options to acquire Corporation X stock. After the merger, Corporation Y stock (vested or nonvested, as applicable) will be issued on the exercise of all outstanding options.

Law

Section 83(a) provides that the excess of the fair market value of property transferred in connection with the performance of services over the amount (if any) paid for the property is included in the gross income of the person performing the services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier.

Section 83(b) permits any person performing services in connection with which property is transferred to elect to include in gross income for the taxable year in which the property is transferred the excess of its fair market value at the time of transfer (determined without regard to lapse restrictions) over the amount (if any) paid for the property.

Section 1.83-1(a) provides that property transferred to an employee in connection with the performance of services by such employee is not taxable until the employee acquires a beneficial ownership interest in such property and it has become substantially vested (as defined in § 1.83-3(b)) in such employee. Until such property becomes substantially vested, the transferor is regarded as the owner of such property, and any income from such property received by the employee is included in the gross income of such employee as additional compensation for the taxable year in which such income is received.

Section 1.83-3(b) provides that property is substantially nonvested if it is subject to a substantial risk of forfeiture and is nontransferable.

Section 1.83-2(a) provides that the employee providing the services may elect to include in gross income under § 83(b), as compensation for services, the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restrictions) over the amount (if any) paid for such property. If this election is made, the substantial vesting rules of § 83(a) and the regulations thereunder do not apply with respect to such property. Thus, property with respect to which this election is made is includible in gross income as of the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested.

In Rev. Rul. 83-22, 1983-1 C.B. 17, an employee who received restricted stock made an election under § 83(b) and later earned dividends on the restricted stock. The ruling provides that the regulations under § 83(b) treat stock transferred to an employee in connection with the performance of services as substantially vested when the employee makes an election under § 83(b), and the employee is considered the owner of the stock. Accordingly, the ruling holds that a dividend paid to the employee who has made a § 83(b) election is not additional compensation to the employee, but retains its character as a dividend in the hands of the employee.

Section 280G denies a deduction for any excess parachute payment. Section 4999 imposes a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, within the meaning of § 280G(b).

An excess parachute payment is defined in § 280G(b)(1) as an amount equal to the excess of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment.

Section 280G(b)(2)(A) defines a 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 in the ownership of a corporation, the effective control of a corporation, or the ownership of a substantial portion of the assets of a corporation (a change in ownership or control), and (ii) the aggregate present value of the payments in the nature of compensation which are contingent on such change equals or exceeds an amount equal to 3 times the base amount.

=Section 1.280G-1, Q/As-27 and 29, provides guidance concerning whether a corporation is considered to have undergone a change in ownership or control in a merger.

Section 1.280G-1, Q/A-27(a), provides that a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in Q/A-27(b)), acquires ownership of stock of the corporation that, together with stock held by such person or group, possesses more than 50 percent of the total fair market value or total voting power of the stock of such corporation. Section 1.280G-1, Q/A-27(b), provides that persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering. However, persons will be considered to be acting as a group if they are owners of a corporation that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation.

Section 1.280G-1, Q/A-27(c), provides that § 318(a) applies to determine stock ownership. Section 1.280G-1, Q/A-27(c), also provides that stock underlying a vested option is considered owned by an individual who holds the vested option (and the stock underlying an unvested option is not considered owned by an individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined in § 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option.

Section 1.280G-1, Q/A-29, provides that a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as defined in Q/A-29(c)), acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than one-third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets.

Section 1.280G-1, Q/A-29(b)(1), provides that there is no change in ownership or control under Q/A-29(a) when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in Q/A-29(b).

Section 1.280G-1, Q/A-29(c), contains the same language as § 1.280G-1, Q/A-27(b), concerning when persons will be considered to be acting as a group. Section 1.280G-1, Q/A-29(d), refers to Q/A-27(c) for purposes of determining stock ownership.

For purposes of determining when a payment in the nature of compensation under § 280G(b)(2)(A) has been made, § 1.280G-1, Q/A-12(b), provides that an election made by a disqualified individual under § 83(b) with respect to the transferred property does not apply. A payment in the nature of compensation for purposes of that determination is generally considered made (or to be made) when the property is transferred to, and becomes substantially vested in, such individual. The § 280G regulations, however, are silent for purposes of determining whether restricted stock subject to an election under § 83(b) is outstanding when determining whether there has been a change in ownership or control.

The position in § 1.280G-1, Q/A-12(b) was adopted, in part, because the legislative history provides that all transfers of property are to be valued for purposes of the golden parachute rules. See H.R. Conf. Rep. No. 98-861, 98 Cong. 2d Sess. at 851 (1984), 1984-3 C.B. (Vol. 2) 851; Joint Committee on Taxation Staff, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 98 Cong. 2d Sess. (1984) at 203. The vesting of payments contingent on a change in control frequently provides substantial benefits to an individual without regard to whether an election under § 83(b) has been made. This concern, however, is not present when determining whether a change in ownership or control has occurred.

Analysis

The regulations under § 280G have generally adopted objective rules to determine whether a change in ownership or control has occurred. Pursuant to § 1.280G-1, Q/A-27(c), vested stock underlying a vested option is considered owned by the individual who holds the vested option. Thus, the vested shares subject to vested options held by the former Corporation X employees and the Corporation Y employees are considered outstanding for purposes of determining whether a change in ownership or control occurred. However, the substantially nonvested shares underlying vested options held by the former Corporation X employees and the Corporation Y employees are not considered outstanding for purposes of determining whether a change in ownership or control occurred.

In determining whether a change in ownership or control has occurred, § 1.280G-1, Q/A-27(c) generally implements an expansive rule for determining the shares treated as owned by an individual, treating, for example, shares subject to a vested option as owned by the holder of the option. Accordingly, an employee should be considered the owner of unvested shares of restricted stock for which an election under § 83(b) has been made for purposes of § 1.280G-1, Q/A-27 because the regulations under § 83(b) treat stock transferred to an employee in connection with the performance of services as substantially vested when the employee makes an election under § 83(b), and the employee is considered the owner of the stock for that purpose. However, restricted stock with respect to which an election under § 83(b) has not been made is not considered outstanding for purposes of determining whether a change in ownership or control occurred.

Consequently, the shareholders of Corporation X and Corporation Y, along with the employees holding vested options to receive vested stock and holding restricted stock that has been subject to an election under § 83(b), will be treated as acting as a group with respect to their acquisition of stock or assets. Applying the above-described rules, the Corporation X shareholders acquired ownership of

Corporation Y stock (\$108x) that has more than 50 percent of the total fair market value of the Corporation Y stock (\$215x) outstanding immediately after the merger. Thus, there is a change in control of Corporation Y under § 1.280G-1, Q/A-27.

Turning to Corporation X, all of the assets of Corporation X were transferred to Corporation Y in exchange for Corporation Y stock. Because more than 50 percent of the fair market value of the outstanding stock of Corporation Y is owned by the former shareholders of Corporation X (immediately after the exchange), the transfer of assets to Corporation Y is not treated as a change in ownership of a substantial portion of the assets of Corporation X under § 1.280G-1, Q/A-29(b)(1).

Additionally, for purposes of determining the amount of stock owned by an individual under § 1.280G-1, Q/A-17, the same rule as described above applies. Thus, an individual who holds restricted stock with respect to which an election under § 83(b) has been made is considered to hold the outstanding stock under § 1.280G-1, Q/A-17.

Holdings

1) In determining whether a corporation has experienced a change in ownership or control under § 280G(b)(2)(A)(i) of the Internal Revenue Code, unvested shares of restricted stock for which an election under § 83(b) has been made are treated as outstanding stock.

2) In determining the amount of stock held by a shareholder for purposes of testing whether the shareholder is a disqualified individual under § 1.280G-1, Q/A-17 of the Income Tax Regulations, unvested shares of restricted stock for which an election under § 83(b) has been made are treated as outstanding stock.

Drafting Information

The principal authors of this revenue ruling are Erinn Madden and Jean Casey of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this revenue ruling, contact Ms. Casey or Ms. Madden at (202) 622-6030 (not a toll free call).