Internal Revenue
bulletin

Bulletin No. 2002–9
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HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2002–8, page 564.
Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through March 2002. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through March 2002.

REG–209114–90, page 576.
Proposed regulations under section 280G of the Code provide guidance about the denial of the deduction to a corporation for any excess golden parachute payment to certain individuals.

Notice 2002–17, page 567.
This notice provides guidance, in a question and answer format, on the tax relief provided under Executive Order No. 13239 (2001–53 I.R.B. 632) for U.S. military and support personnel involved in the military operations in Afghanistan.

Rev. Proc. 2002–16, page 572.
Optional election to make monthly 706(a) computations. This procedure allows certain partnerships that invest in assets exempt from taxation under section 103 of the Code to make an election that enables money market fund partners to take into account monthly the inclusions required under sections 702 and 707(c).

EMPLOYEE PLANS

Notice 2002–16, page 567.
Weighted average interest rate update. The weighted average interest rate for February 2002 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

Announcement 2002–24, page 606.
Catch-up contributions for individuals age 50 or over. This document contains a change in the hearing date for REG–142499–01 (2001–45 I.R.B. 476) from February 21, 2002, to April 30, 2002. It also extends the time to submit written comments and outlines of oral comments from January 31, 2002, to April 15, 2002.

EXCISE TAX

T.D. 8983, page 565.
Final regulations under section 6071 of the Code relate to the time for eligible air carriers to file a return for the third calendar quarter of 2001.

REG–209114–90, page 576.
Proposed regulations under section 280G of the Code provide guidance about the denial of the deduction to a corporation for any excess golden parachute payment to certain individuals.

ADMINISTRATIVE

REG–125626–01, page 604.
Unit livestock price method. Proposed regulations under section 471 of the Code provide rules relating to the annual reevaluation of unit livestock prices and the depreciation of livestock raised for drafting, breeding, or dairy purposes. A public hearing is scheduled for June 12, 2002.

Finding Lists begin on page ii.
Index for January and February begins on page iv.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

Part. I Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through March 2002. This ruling announces the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through March 2002.

Rev. Rul. 2002–8

In Rev. Rul. 90–60 (1990–2 C.B. 3), the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of "bond factor" amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11 (1999–1 C.B. 275) established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period January through March 2002.

Table 1
Rev. Rul. 2002–8
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998
Jan '02	17.76	32.73	45.44	56.24	65.46	65.92	66.46	66.99	67.63	68.35	69.24
Feb '02	17.76	32.73	45.44	56.24	65.46	65.75	66.28	66.80	67.44	68.16	69.05
Mar '02	17.76	32.73	45.44	56.24	65.46	65.57	66.10	66.62	67.26	67.98	68.86

Table 1 (cont'd)
Rev. Rul. 2002–8
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year			
Month of Disposition	1999	2000	2001	2002
Jan '02	70.13	70.98	72.28	72.55
Feb '02	69.92	70.77	72.05	72.55
Mar '02	69.73	70.58	71.84	72.55

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3 (1998–1 C.B. 248); Rev. Rul. 2001–2 (2001–2 I.R.B. 255); and Rev. Rul. 2001–53 (2001–46 I.R.B. 489).

DRAFTING INFORMATION

The principal author of this revenue ruling is Gregory N. Doran of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. Doran at (202) 622–3040 (not a toll-free call).

Section 706—Taxable Years of Partner and Partnership

26 CFR 1.103: Interest on state and local bonds.
26 CFR 1.702: Income and credits of partner.
26 CFR 1.706: Taxable year of partner and partnerships.
26 CFR 1.706–1(c): Closing of Partnership Year.
26 CFR 1.707: Transactions between partner and a partnership.
26 CFR 1.851: Definition of regulated investment company.
26 CFR 1.852: Taxation of regulated investment companies and their shareholders.

May a money market fund partner in a partnership that invests in bonds that are exempt from taxation under § 103 make monthly allocations of partnership items under § 706(a)? See Rev. Proc. 2002–16, page 572.

Section 6071.—Time for Filing Returns and Other Documents

26 CFR 40.6071(a)–3: Time for an eligible air carrier to file a return for the third calendar quarter of 2001.

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 40

T.D. 8983

Time for Eligible Air Carriers to File the Third Calendar Quarter 2001 Form 720

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the time for eligible air carriers reporting air transportation excise taxes to file Form 720, "*Quarterly Federal Excise Tax Return*," for the third calendar quarter of 2001. These regulations affect certain air carriers.

DATES: *Effective Date*: These regulations are effective February 6, 2002.

Applicability Date: For date of applicability of these regulations, see § 40.6071(a)–3(c).

FOR FURTHER INFORMATION CONTACT: Susan Athy (202) 622–3130 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Subchapter C of chapter 33 of the Internal Revenue Code (Code) imposes tax on the amount paid for: taxable transportation by air of any person (section 4261(a)); each domestic segment of taxable transportation (section 4261(b)); use of international air travel facilities (section 4261(c)); and taxable transportation of property by air (section 4271(a)) (air transportation excise taxes). Section 6071 generally provides that return filing dates are prescribed by regulation. Under § 40.6071(a)–2, a return of air transportation taxes was due by the last day of the second month following the quarter for which it was made. On August 8, 2001, the regulations were amended to remove this provision but the provision remained in effect for the third calendar quarter of 2001. Thus, the return of air transportation taxes for that quarter was due on November 30, 2001.

Under section 6151, generally, tax must be paid at the time the return is

required to be filed. In general, under section 6601, interest must be paid on any amount of tax not paid by the last day for payment. Accordingly, if the return due date prescribed in § 40.6071(a)–2 remains in effect for the third calendar quarter of 2001, interest would be imposed on third-quarter air transportation excise taxes not paid by November 30, 2001.

Section 301(a) of the Air Transportation Safety and System Stabilization Act (the Act), Public Law 107–42 (115 Stat. 236) provides relief to eligible air carriers with respect to the semimonthly deposits required for air transportation excise taxes. The relief contained in the Act applies to deposits only and does not extend the return filing and associated payment date. By extending the filing date for eligible air carriers, these final regulations will provide return filing, payment, and interest relief consistent with the deposit relief provided for air transportation excise taxes by section 301(a) of the Act. Notice 2001–77 (2001–50 I.R.B. 576) provided that regulations would change the third calendar quarter 2001 filing date.

Explanation of Provisions

These final regulations change the date by which eligible air carriers reporting tax that includes the air transportation excise taxes imposed by subchapter C of chapter 33 must file excise tax returns for the third quarter of 2001. The due date for these returns is postponed from November 30, 2001, to January 15, 2002. For these taxpayers, payment of their third-quarter excise tax liability may also be delayed until January 15, 2002.

Special Analyses

This Treasury decision is necessary to provide immediate relief to the eligible air carriers affected by the events of September 11, 2001. This Treasury decision provides additional time for eligible air carriers to file the third calendar quarter 2001 Form 720 and to pay certain taxes due with the return. Therefore, it has been determined that notice and public comment are unnecessary and contrary to the public interest and a delayed effective date under section 553(d) of the Administrative Procedure Act (5 U.S.C. chapter 5) is not required. Also, it has been determined that section 553(b) of the Administrative Procedure Act does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. It also has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. Pursuant to section 7805(f) of the Code, these final regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Susan Athy, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 40 is amended as follows:

PART 40—EXCISE TAX PROCEDURAL REGULATIONS

Paragraph 1. The authority citation for part 40 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 40.6071(a)–3 also issued under 26 U.S.C. 6071(a).* * *

Par. 2. Section 40.6071(a)–3 is added to read as follows:

§ 40.6071(a)–3 Time for an eligible air carrier to file a return for the third calendar quarter of 2001.

(a) *In general*. If, in the case of an eligible air carrier, the quarterly return required under § 40.6011(a)–1(a) for the third calendar quarter of 2001 includes tax imposed by subchapter C of chapter 33 —

(1) The requirements of § 40.6071(a)–2 as in effect on August 7, 2001, do not apply to the return; and

(2) The return must be filed by January 15, 2002.

(b) *Definition of eligible air carrier*. *Eligible air carrier* has the same meaning as provided in section 301(a)(2) of the Air Transportation Safety and System Stabilization Act; that is, any domestic corporation engaged in the trade or business of transporting (for hire) persons by air if such transportation is available to the general public.

(c) *Effective date*. This section is applicable with respect to returns that relate to the third calendar quarter of 2001.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

Approved January 23, 2002.

Mark Weinberger,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on February 5, 2002, 8:45 a.m., and published in the issue of the Federal Register for February 6, 2002, 67 F.R. 5471)

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2002–16

Notice 88–73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103–465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for January 2002 is 5.45 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
February	2002	5.70	5.13 to 5.98	5.13 to 6.27

Drafting Information

The principal author of this notice is Todd Newman of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please call Mr. Newman at (202) 283–9888 (not a toll-free number).

Tax Relief for Those Involved in Operation Enduring Freedom

Notice 2002–17

PURPOSE

This notice provides guidance in a question and answer format on the tax relief provided under Executive Order No. 13239 (2001–53 I.R.B. 632), 66 Fed. Reg. 241 (December 14, 2001), for U.S. military and support personnel involved in the military operations in Afghanistan.

BACKGROUND

The Executive Order, effective September 19, 2001, designates Afghanistan (including the airspace above) as a combat zone for purposes of section 112 of the Internal Revenue Code.

The provisions of the Code affected by the declaration of a combat zone include the following:

(1) Section 2(a)(3) (relating to the special rule where a deceased spouse was in missing status);

(2) Section 112 (relating to the exclusion from gross income of certain combat pay received by members of the U.S. Armed Forces);

(3) Section 692 (relating to income taxes of members of the U.S. Armed Forces on death);

(4) Section 2201 (relating to members of the U.S. Armed Forces dying in a combat zone or by reason of combat-zone-incurred wounds, etc.);

(5) Section 3401(a)(1) (defining wages relating to combat pay for members of the U.S. Armed Forces);

(6) Section 4253(d) (relating to taxation of phone service originating from members of the U.S. Armed Forces in a combat zone);

(7) Section 6013(f)(1) (relating to a joint return where an individual is in missing status); and

(8) Section 7508 (relating to the time for performing certain acts (including filing, paying, assessing, collecting, claiming a refund, and litigating) postponed by reason of service in a combat zone).

Under the Executive Order, the deadline extension provisions under § 7508 apply to members of the U.S. Armed Forces (and those serving in support of the U.S. Armed Forces) in the combat zone.

QUESTIONS AND ANSWERS

The following questions and answers generally apply to members of the U.S. Armed Forces on active duty and are patterned after the questions and answers in Notice 99–30 (1999–1 C.B. 1135) (Tax Relief for Those Affected by Operation Allied Force) and Notice 96–34 (1996–1 C.B. 379) (Tax Relief for Those Affected by Operation Joint Endeavor). Taxpayers covered by the relief provisions discussed in this Notice should write "Enduring Freedom" in red at the top of their returns. Covered taxpayers who receive a notice from the IRS regarding a collection or examination matter should return the notice to the IRS with the words "Enduring Freedom" at the top of the notice and on the envelope so the IRS can suspend the action. For additional information on the tax treatment of members of the U.S. Armed Forces, including reservists, decedents, or persons missing in action, consult Publication 3, *Armed Forces Tax Guide*.

PART 1 — MILITARY PAY EXCLUSION

Q-1: What geographic area is included in the combat zone covered by this notice?

A-1: The geographic area included in the combat zone is Afghanistan (including the airspace above).

Q-2: I am a member of the U.S. Armed Forces performing services in Afghanistan. Is any part of my 2001 military pay for serving in this area excluded from gross income?

A-2: Yes. Afghanistan comprises the combat zone. If you serve in the combat zone as an enlisted person or as a warrant officer (including commissioned warrant officers) for any part of a month, all your

military pay received for military service that month is excluded from gross income. For commissioned officers, the monthly exclusion is capped at the highest enlisted pay, plus any hostile fire or imminent danger pay received. Therefore, for 2001, the most an officer can earn tax-free each month is $5,043 ($4,893, the highest monthly enlisted pay, plus $150 hostile fire or imminent danger pay). Although the Defense Authorization Bill had not been signed when this publication was written, we expect the officer exclusion to increase to $5,532.90 in 2002 ($5,382.90, the highest monthly enlisted pay, plus $150 hostile fire or imminent danger pay). Amounts excluded from gross income are not subject to federal income tax.

Q-3: My husband and I are both enlisted personnel serving in the U.S. Armed Forces in the combat zone. Are we both entitled to the income tax exclusion for military pay?

A-3: Yes. Each of you qualifies for the income tax exclusion for your military pay.

Q-4: I am a member of the U.S. Armed Forces stationed on a ship in the Indian Ocean. I fly missions over Afghanistan as part of the military operations in the combat zone. Is any part of my military pay excluded from gross income?

A-4: Yes. The combat zone includes the airspace over Afghanistan, so you are serving in the combat zone. See Q & A 2 for a discussion of the amount of your military pay that is excluded.

Q-5: If I am injured and hospitalized while serving in the U.S. Armed Forces in the combat zone, is any of my military pay excluded from gross income?

A-5: Yes. Military pay received by enlisted personnel who are hospitalized as a result of injuries sustained while serving in the combat zone is excluded from gross income for the period of hospitalization, subject to the 2-year limitation provided below. Commissioned officers have a similar exclusion, but it is limited to the maximum enlisted amount per month. See Q & A 2. These exclusions from gross income for hospitalized enlisted personnel and commissioned officers end 2 years after the date of termination of the combat zone.

Q-6: My wife is currently serving in the U.S. Armed Forces in the combat zone and will be eligible for discharge when she returns home. If she is discharged upon her return, will the payment for the annual leave that she accrued during her service in the combat zone be excluded from gross income?

A-6: Yes. Annual leave payments to enlisted members of the U.S. Armed Forces upon discharge from the service are excluded from gross income to the extent the leave was accrued during any month in any part of which the member served in the combat zone. If your wife is a commissioned officer, a portion of the annual leave payment she receives for leave accrued during any month in any part of which she served in the combat zone may be excluded. The leave payment cannot be excluded to the extent it exceeds the maximum enlisted amount (see Q & A 2) for the month of service to which it relates less the amount of military pay already excluded for that month.

Q-7: I am an enlisted person serving in a combat zone. If I reenlist early while I am in the combat zone and receive my reenlistment bonus several months later when I am stationed outside the combat zone, is any part of my reenlistment bonus excluded from gross income?

A-7: Yes. The reenlistment bonus is excluded from gross income although received in a month that you were outside the combat zone, because you completed the necessary action for entitlement to the reenlistment bonus in a month during which you served in the combat zone.

Q-8: My brother, who is a civilian in the merchant marine, is on a ship that transports military supplies between the United States and the combat zone. Is he entitled to the combat zone military pay exclusion?

A-8: No. Those serving in the merchant marine are not members of the U.S. Armed Forces. The combat zone military pay exclusion applies only to members of the U.S. Armed Forces. The U.S. Armed Forces include all regular and reserve components of the uniformed services that are under the control of the Secretaries of Defense, Army, Navy, and Air Force, and the Secretary of Transportation with respect to the Coast Guard.

Q-9: My husband is a member of the U.S. Armed Forces performing services as part of Operation Enduring Freedom in Turkmenistan. He is not receiving hostile fire/imminent danger pay. Is he entitled to the military pay exclusion?

A-9: No. U.S. Armed Forces personnel serving outside the combat zone are not entitled to the military pay exclusion, unless they are serving in direct support of military operations in the combat zone for which they receive hostile fire/imminent danger pay. On December 14, 2001, the following countries were certified by the Department of Defense for combat zone tax benefits due to their direct support of military operations in the Afghanistan combat zone: Pakistan, Tajikistan, Jordan, Uzbekistan, and Kyrgyzstan. For a more detailed discussion of the tax treatment of military personnel, see Publication 3.

Q-10: How do I certify my entitlement to the military pay exclusion?

A-10: Your service branch must certify your entitlement on the Form W-2 it provides you. If you believe you are entitled to the exclusion, but it is not reflected on your Form W-2, ask your service branch to issue a corrected Form W-2.

PART 2 — EXTENSION OF DEADLINES

Q-11: I have been serving in Afghanistan since November 10, 2001. I understand that the deadline for performing certain actions required by the internal revenue laws is extended as a result of my service. On what date did these deadline extensions begin?

A-11: The deadline extension provisions apply to most tax actions required to be performed on or after September 19, 2001, or the date you began serving in the combat zone, whichever is later. In your case, the date that the deadline extensions began is November 10, 2001.

Q-12: My son is a member of the U.S. Armed Forces who is now serving in the

combat zone. Is he entitled to an extension of time for filing and paying his federal income taxes? Are any assessment or collection deadlines extended?

A-12: For both questions, the answer is yes. In general, the deadlines for performing certain actions applicable to his federal taxes are extended for the period of his service in the combat zone on or after September 19, 2001, plus 180 days thereafter. During this extension period, assessment and collection deadlines will be extended, and interest and penalties attributable to the extension period will not be charged.

Q-13: Assuming the same facts as in question 12, does the extension for filing and paying his federal individual income taxes apply to unearned income from my son's investments?

A-13: Yes. The extensions apply without regard to the source of your son's income.

Q-14: Assuming the same facts as in question 12, will the deadline extension provisions continue to apply if my son is hospitalized as a result of an injury sustained in the combat zone?

A-14: Yes. The deadline extension provisions will apply for the period that your son is continuously hospitalized outside of the United States as a result of injuries sustained while serving in the combat zone, including 180 days thereafter. For hospitalization inside the United States, the extension period cannot be more than 5 years.

Q-15: Do the deadline extension provisions apply only to members of the U.S. Armed Forces serving in the combat zone?

A-15: No. The deadline extension provisions also apply to individuals serving in the combat zone in support of the U.S. Armed Forces, such as Red Cross personnel, accredited correspondents, and civilian personnel acting under the direction of the U.S. Armed Forces in support of those forces. In addition, members of the U.S. Armed Forces who perform military service in an area outside the combat zone qualify for the suspension of time provisions if their service is in direct support of military operations in the combat zone, and they receive special pay for duty subject to hostile fire or imminent danger as certified by the Department of Defense. See Q & A 9 for countries certified as of the date of this publication.

Q-16: My son is a civilian explosive specialist who is in the combat zone training U.S. Armed Forces personnel serving in the combat zone. Do the deadline extension provisions apply to my son?

A-16: Yes. The deadline extension provisions apply to your son because he is serving in the combat zone in support of the U.S. Armed Forces.

Q-17: My husband is a private businessman working in Afghanistan on nonmilitary projects. Do the deadline extension provisions apply to my husband?

A-17: No. Other than military personnel, the only individuals working in the combat zone that are entitled to the deadline extension provisions are those serving in support of the U.S. Armed Forces.

Q-18: I am a member of the U.S. Armed Forces serving in the combat zone. Do the deadline extension provisions apply to my husband who is in the United States?

A-18: Yes. The deadline extension provisions apply not only to members serving in the U.S. Armed Forces (or individuals serving in support thereof) in the combat zone, but to their spouses as well, with two exceptions. First, if you are hospitalized in the United States as a result of injuries received while serving in the combat zone, the deadline extension provisions would not apply to your husband. Second, the deadline extension provisions for your husband do not apply for any tax year beginning more than 2 years after the date of the termination of the combat zone designation.

Q-19: Assuming the same facts as in question 18, will my husband have to file a joint tax return in order to benefit from the deadline extension provisions?

A-19: No. The deadline extension provisions apply to both spouses whether joint or separate returns are filed. If your husband chooses to file a separate return, he will have the same extension of time to file and pay his taxes that you have.

Q-20: My husband is serving in the U.S. Armed Forces in the combat zone. In 2001, our son, who is 12 years old, received $700 of interest income. Our daughter, who is 17 years old, received $2,000 of earned income from part-time work and $900 of interest income. We claim both children as dependents on our federal individual income tax return. Are federal individual income tax returns required to be filed for our children while my husband is in the combat zone?

A-20: No. Federal individual income tax returns for your dependent children are not required to be filed while your husband is in the combat zone. Instead, these returns will be considered timely if filed on or before the deadline for filing your federal individual income tax return under the deadline extension provisions. When your children's 2001 federal income tax returns are filed, you should write "Enduring Freedom" at the top of those returns. Because your older child may be entitled to a refund of tax, she may want to file her federal individual income tax return and obtain her refund.

Q-21: I am a member of the U.S. Armed Forces serving in the combat zone. My spouse and our three children live in our home in the United States. During 2001, a child care provider took care of our children in our home. We are required to file a Schedule H, *Household Employment Taxes*, as an attachment to our federal individual income tax return to report the federal employment taxes on wages we paid to our child care provider. Do the deadline extension provisions apply to the filing of Schedule H as an attachment to our federal individual income tax return?

A-21: Yes. The deadline extension provisions apply to all schedules and forms that are filed as attachments to the federal individual income tax return.

Q-22: I am a member of the U.S. Armed Forces who served in the combat zone beginning on September 28, 2001. If I serve in the combat zone until May 23, 2002, when will I be required to file my federal individual income tax return for 2001?

A-22: You must file your 2001 federal individual income tax return on or before March 4, 2003, 285 days after you left the

combat zone. The deadline extension period consists of the sum of the following:

(1) 180 days from the date you left the area 180

(2) The number of days remaining (as of the date you entered the area) to perform the required act (in your case, filing your 2001 federal individual income tax return, January 1, 2002 to April 15, 2002) 105

Total 285

See Publication 3, *Armed Forces' Tax Guide*, for additional extension examples.

Q-23: My wife is a member of the U.S. Armed Forces serving in the combat zone. Can she make a timely qualified retirement contribution for 2001 to her individual retirement account (IRA) after April 15, 2002, and on or before the due date of her 2001 federal individual income tax return after applying the deadline extension provisions?

A-23: Yes. Your wife can make a timely qualified retirement contribution for 2001 to her IRA on or before the extended deadline for filing her 2001 income tax return under the deadline extension provisions.

Q-24: My brother, who began serving in the U.S. Armed Forces in the combat zone on November 18, 2001, did not make his fourth estimated tax payment for 2001 which was due January 15, 2002. Will my brother be liable for estimated tax penalties?

A-24: No. Your brother is covered by the deadline extension provisions and will not be liable for any penalties if he files and pays any tax due by his extended filing due date. When your brother files his 2001 federal income tax return, he should write "Enduring Freedom" at the top of that return.

Q-25: My son, who is a member of the U.S. Armed Forces, was on an installment payment plan with the IRS for back income taxes before he was assigned to the combat zone. What should be done now that he is in the combat zone?

A-25: The IRS office where your son was making payments should be contacted. Because your son is serving in the combat zone, he will not have to make payments on his past due taxes for his period of service in the combat zone plus 180 days. No additional penalties or interest will be charged during the deadline extension period.

Q-26: My son, who is a member of the U.S. Armed Forces serving in the combat zone, will file his federal individual income tax return for 2001 after April 15, 2002, but on or before the end of the deadline extension for filing that return. He expects to receive a refund. Will the IRS pay interest on the refund?

A-26: Yes. The IRS will pay interest from April 15, 2002, on a refund issued to your son if he files his 2001 federal individual income tax return on or before the due date of that return after applying the deadline extension provisions. When your son files his 2001 federal income tax return, he should write "Enduring Freedom" at the top of that return. If his 2001 return is not timely filed on or before the due date after applying the deadline extension provisions, no interest will be paid on the refund except as provided under the normal refund rules. Even though the deadline is extended, your son may file a return earlier to receive any refund due.

Q-27: Do the deadline extension provisions apply to federal tax returns other than the federal individual income tax return?

A-27: Yes. The deadline extension provisions also apply to federal estate and gift tax returns. However, the deadline extension provisions do not apply to other federal tax and information returns, such as those for corporate income tax or employment taxes.

Q-28: My husband and I are civilian employees of defense contractors. I work in the United States and my husband temporarily works in Germany. Our jobs involve the production of equipment used by the U.S. Armed Forces for Operation Enduring Freedom. Do the deadline extension provisions apply to either of us?

A-28: No. The deadline extension provisions do not apply to civilian employees of defense contractors unless they are serving in the combat zone in support of the U.S. Armed Forces.

PART 3 — MISCELLANEOUS PROVISIONS

Q-29: My daughter is a member of the U.S. Armed Forces serving in the combat zone. She makes calls to me here in the United States. Are these calls exempt from the federal excise tax on toll telephone service?

A-29: Yes. Telephone calls that originate within the combat zone and that are made by members of the U.S. Armed Forces serving there are exempt from the federal excise tax on toll telephone service, provided a properly executed certificate of exemption is furnished to the telephone service provider receiving payment for the call. The exemption certificate should be in substantially the following form:

EXEMPTION CERTIFICATE

(Overseas Telephone Calls)

(Date)_____ 20_____

I certify that the toll charges of $_____ are for telephone or radio telephone messages originating at _____ (Point of origin) within a combat zone from _____ (Name) a member of the Armed Forces of the United States performing service in such combat zone; that the transmission facilities were furnished by _____ (Name of carrier); and that the charges are exempt from tax under section 4253(d) of the Internal Revenue Code.

_____

(Signature of Subscriber)

_____

(Address)

Note: Penalty for fraudulent use: fine or imprisonment or both.

Q-30: If the federal excise tax has already been paid on the toll telephone service in Q & A 29, can a refund be obtained?

A-30: Yes. If the federal excise tax has already been paid on that toll telephone service, a refund may be obtained either from the telephone service provider that collected the tax, or from the IRS by filing Form 8849, *Claim for Refund of Excise Taxes*.

Q-31: How will my military pay for active service in the U.S. Armed Forces in the combat zone be reported on my 2001 Form W-2, *Wage and Tax Statement*?

A-31: Military pay attributable to your active service in the combat zone that is excluded from gross income will not be reported on your 2001 Form W-2 in the box marked "Wages, tips, other compensation." However, military pay for such service is subject to social security and medicare taxes and will be reported on your 2001 Form W-2 in the boxes marked "Social security wages" and "Medicare wages and tips." If you believe you are entitled to the exclusion, but it is not reflected on your W-2, ask your service to issue a corrected Form W-2.

Q-32: I'm an officer who served in the Desert Storm combat zone from December 2000 to September 2001 and Enduring Freedom combat zone from October 2001 to January 2002. I have made monthly contributions to an individual retirement account (IRA) for 2001. In view of the military pay exclusion for my service in the combat zone, I may have little or no taxable compensation for 2001 and may not be eligible to make an IRA contribution for 2001. If my taxable compensation is less than $2000, should I withdraw the portion of my contributions that exceeds my taxable compensation?

A-32: Yes. In general, any amount contributed to your IRA that is more than the smaller of (1) your taxable compensation; or (2) $2000, is an excess contribution and must be withdrawn to avoid a 6 percent excise tax. If you are married and file a joint return, you may still be eligible to make an IRA contribution, see Publication 590 for more information on spousal contribution limits. Once you are sure that your taxable compensation will be less than $2000, you should withdraw the portion of your contributions that exceeds your taxable compensation. You will not be taxed on the distributed amount if you receive the distribution on or before the deadline for filing your 2001 federal individual income tax return after applying the deadline extension provisions. You may not take a deduction with respect to these distributed contributions. You must also withdraw the amount of net income attributable to the distributed contributions while they were assets of the IRA. That portion of the net income is includible in your gross income for 2001. For further information, see Publication 590, *Individual Retirement Arrangements (IRAs)*.

Q-33: Assuming the same facts as question 32, how will the financial institution that distributes my 2001 IRA contributions to me report this distribution?

A-33: The financial institution will report the entire amount of the distribution (2001 distributed contributions and attributable net income) on Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc*. However, it should report only the amount of any net income attributable to the distributed contributions as the "Taxable amount" on Form 1099–R.

PART 4 — INQUIRIES

Taxpayers within the United States may seek assistance by calling the IRS at 1–800–829–1040. Taxpayers outside the United States may call the IRS in Philadelphia, PA, at (215) 516–2000 or via fax at (215) 516–2555 (these are not toll-free numbers).

The IRS offices in Italy, Germany, France, England, Singapore, and Japan can also assist you with your federal income tax questions. You may contact the Rome office by calling [39] (06) 4674–2560, or via fax at [39] (06) 4674–2223; the Berlin office at [49] (30) 8305–

1140, or via fax at [49] (30) 8305–1145; the Paris office at [33] (1) 4312–2555, or via fax at [33] (1) 4312–4758; the London office at [44] (207) 408–8077, or via fax at [44] (207) 495–4224; the Singapore office at [65] 476–9413, or via fax at [65] 476–9030; and the Tokyo office at [81] (3) 3224–5466, or via fax at [81] (3) 3224–5274.

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26 CFR 601.105: Examination of returns and claims for refund, credit, or abatement; determination of correct tax liability.
(Also Part I, §§ 103, 702, 706, 707, 851, 852; 1.706–1.)

Rev. Proc. 2002–16

SECTION 1. PURPOSE

This revenue procedure allows certain partnerships that invest in assets exempt from taxation under § 103 of the Internal Revenue Code to make an election that enables money market fund partners to take into account monthly the inclusions required under §§ 702 and 707(c).

SECTION 2. BACKGROUND

Certain money market funds seek investments with a yield that reflects current short-term exempt interest rates and that is treated for federal income tax purposes as being composed of interest exempt from tax under § 103. For purposes of this revenue procedure, a money market fund is a fund described in the Securities and Exchange Commission's Rule 2a–7 (Rule 2a–7), 17 CFR 270.2a–7, issued under the Investment Company Act of 1940, 15 U.S.C. 80a–1 *et seq*. One investment that offers these advantages is an instrument that might be described as a synthetic tax-exempt variable-rate bond. To create such an instrument, a sponsor or an affiliate (the Sponsor) purchases (either at original issue or on the secondary market) an obligation the interest income on which is excluded under § 103 (§ 103 obligation) and transfers the § 103 obligation to an entity that qualifies as a partnership for federal tax purposes (tax-exempt bond partnership). The tax-exempt bond partnership issues two classes of equity interests: a preferred interest that is entitled to a variable return on its capital contribution (preferred interest), and a second class of ownership interest that is entitled to all of the remaining income of the partnership (residual interest). The variable return on the preferred interest tracks current short-term exempt yields.

Under § 702(b), if a partnership receives income that is exempt from tax under § 103, the income retains its character when the partnership allocates it to a partner. Under § 706(a), a partner includes in taxable income for a taxable year the partner's allocable share of items of partnership income, gain, loss, deduction, and credit for the partnership's taxable year ending within or with the partner's taxable year.

Section 852(a) provides generally that a regulated investment company (RIC), including a RIC that is a money market fund, must distribute each taxable year at least 90 percent of its net interest income that is excludible from gross income under § 103(a). Section 852(b)(5) provides that if, at the close of each quarter of the RIC's taxable year, at least 50 percent of the value (as defined in § 851(c)(4)) of the total assets of the RIC consists of obligations described in § 103(a), the RIC is qualified to pay exempt-interest dividends (as defined in § 852(b)(5)(A)) to its shareholders. Under § 852(b)(5)(A), an exempt-interest dividend means any dividend or part thereof paid by a RIC and designated by the RIC as an exempt-interest dividend in a written notice mailed to its shareholders not later than 60 days after the close of the RIC's taxable year.

To maintain a constant net asset value for each share of stock, as is described in Rule 2a–7, money market funds commonly declare dividends daily and pay dividends monthly. (In this paragraph and the next, the word "dividend" refers to a distribution that is treated as a dividend for purposes of state corporate law and federal securities law, whether or not the distribution is also treated as a dividend for purposes of the Code.) In the case of a money market fund that intends to pay exempt interest dividends, substantially all of the fund's income typically will be exempt from tax under § 103. If, however, such a money market fund has a taxable year that differs from that of a tax-exempt bond partnership in which it holds an interest, there may be a mismatch between the money market fund's monthly distribution of income and the money market fund's inclusion of its distributive share of partnership income under § 706(a). As a result, the money market fund's distribution of tax-exempt income may be treated as a return of capital. Alternatively, the money market fund may distribute less than its entire distributive share of partnership income for the taxable year.

For example, assume that on January 2, 2002, a money market fund with a taxable year ending June 30 acquires a preferred interest in a tax-exempt bond partnership with a taxable year ending December 31. Under § 706(a), the money market fund's distributive share of the tax-exempt bond partnership's income for the money market fund's taxable year ending June 30, 2002, is zero. If the money market fund's daily dividends do not reflect its portion of the interest that the partnership earns between January 2 and June 30, the fund will be unable to maintain a constant net asset value for each share of its stock. (Whether or not the tax-exempt bond partnership distributes the exempt interest to the money market fund as that interest is earned, the per share net asset value of the fund will rise if the fund does not make continual distributions to its shareholders to reflect those partnership earnings.) On the other hand, if the money market fund's daily dividends are based in part on the income earned by the partnership between January 2, 2002, and June 30, 2002, the distributions made by the money market fund during its taxable year ending June 30, 2002, will exceed the includible tax-exempt income for the year, causing all or a portion of those distributions to be characterized as a return of capital.

The Treasury Department and the Internal Revenue Service have determined that it is in the best interest of sound tax administration to allow certain money market funds to take into account on a monthly basis their distributive shares of partnership items if the partnership makes a proper election under this revenue procedure.

SECTION 3. SCOPE

This revenue procedure applies to eligible partnerships (described in section 3.01 of this revenue procedure) that elect to close their books monthly (the Monthly Closing Election) and to eligible partners (described in section 3.02 of this revenue procedure) that consent to take into account their distributive shares of partnership income on a monthly basis (the Monthly Closing Consent).

.01 *Eligible Partnership.*

(1) *Generally*. An entity is an eligible partnership if all of the following conditions are met as of the test date:

(a) The entity is a partnership for federal tax purposes;

(b) All allocations of income, gain, loss, deduction, and credit of the partnership have substantial economic effect; and

(c) At least 95 percent of the partnership's income for the test period was (or is reasonably expected to be) income that is exempt from tax under § 103.

(i) If, on the test date, the partnership has been in existence for at least 6 full calendar months, then the test period is the 6 full calendar months preceding the test date; and

(ii) If, on the test date, the partnership has not been in existence for at least 6 full calendar months, then the test period is the first 6 full calendar months of the partnership's existence.

(2) *Test Date*. The test date is the first day of the month for which the Monthly Closing Election is effective.

.02 *Eligible Partner*. A partner is an eligible partner if it is a RIC, as defined in § 851, that is entitled to hold itself out as a money market fund, or the equivalent of a money market fund, in accordance with the provisions of Rule 2a–7(b).

SECTION 4. MONTHLY CLOSING ELECTION AND CONSENT

.01 *Effect of Election and Consent*. If, at the end of any calendar month, an eligible partnership has a Monthly Closing Election in effect and one or more eligible partners of the partnership has a Monthly Closing Consent in effect, then, with respect to each such partner, the partnership must close its books as described in § 1.706 1(c)(2) of the Income Tax Regulations as if the partner had sold its entire interest in the partnership on the last day of that month. The partner must include in its taxable income for that month the partner's distributive share of items described in § 702(a) earned by the partnership since the last closing of the books with respect to that partner and any guaranteed payments under § 707(c) to the partner that are deductible by the partnership since the last closing of the books with respect to that partner. If the partner is on a 52–53 week taxable year, then the provisions of § 1.441–2T(e) apply as if the last day of the month was the last day of the partnership's taxable year.

.02 *Reporting Requirements*. In connection with this monthly closing of the books, the partnership must provide each consenting eligible partner information with respect to the partner's distributive share of items described in § 702(a) and any guaranteed payments under § 707(c). To satisfy this requirement, the partnership may use a Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.*, or any other document or electronic communication that provides substantially equivalent information (monthly statements). The partnership and each consenting eligible partner must maintain the monthly statements but should not file them with the Service. At the end of its taxable year the partnership must provide a single Schedule K-1 (Form 1065) to each of its partners (both the consenting and the nonconsenting partners). In the case of a consenting eligible partner, this single annual Schedule K-1 must include all amounts shown on the monthly statements issued to the partner.

SECTION 5. MONTHLY CLOSING ELECTION

.01 *Manner of Partnership Making the Election*. An eligible partnership may make a Monthly Closing Election by filing a statement with the appropriate service center. The statement must be titled "ELECTION UNDER REVENUE PROCEDURE 2002–16," and must include:

(1) Identification of the partnership by name, address, and EIN, and the name and phone number of a contact person for the partnership;

(2) A statement that the partnership elects a monthly closing of the books for all present and future consenting eligible partners;

(3) The signature of a person with authority to sign the partnership's Form 1065, *U.S. Return of Partnership Income*; and

(4) The effective month of the election. The election is effective for the calendar month in which the election is filed, unless the partnership requests the election to be effective for either of the two immediately preceding calendar months. For example, if a calendar year partnership states that the monthly closing system is to begin for June, the partnership will close its books June 30. Consenting eligible partners must include their shares of partnership items and guaranteed payments for the period from the last closing of the books (generally December 31 of the prior year) through June 30. There will be a closing of the books and a monthly inclusion of the partner's share of these items and guaranteed payments at the end of each future month.

.02 *Time for Making the Election*. The partnership's Monthly Closing Election may be made at any time. See, however, section 6.03 of this revenue procedure for limitations on the time for a partner to effect a Monthly Closing Consent.

SECTION 6. MONTHLY CLOSING CONSENT

.01 *Manner of Partner Effecting the Consent.*

(1) An eligible partner effects a Monthly Closing Consent by providing a statement of consent to the custodian or manager of the partnership. The statement of consent should also be attached to the partner's Form 1120RIC, *U.S. Income Tax Return for Regulated Investment Companies*, for the first taxable year in which the consent is effective. Failure to attach the partner's statement of consent to the partner's Form 1120RIC does not invalidate the partner's consent, however.

(2) The statement of consent must be titled "STATEMENT OF CONSENT TO ELECTION UNDER REVENUE PROCEDURE 2002–16" and must include:

(a) Identification of both the consenting partner and the partnership by

name, address, and EIN, and the name and phone number of a contact person for each;

(b) A statement that the partner consents to the partnership's election to a monthly closing of the books and that the partner will include in its taxable income its distributive share of partnership items described in § 702(a) and any guaranteed payments under § 707(c) in a manner that is consistent with the election;

(c) The signature of an officer of the partner who is authorized to act on behalf of the partner; and

(d) The effective month of the consent. The consent is effective for the calendar month in which the partner acquires the partnership interest, unless the partner requests that the consent be effective for either of the two immediately following calendar months.

.02 *Additional Requirements for Making a Valid Monthly Closing Consent*. An eligible partner does not qualify for the treatment described in section 4 of this revenue procedure unless:

(1) The partner provides the statement of consent described in section 6.01 of this revenue procedure to the custodian or manager of the partnership no later than the last day of the second calendar month after the calendar month in which the partner acquires the partnership interest; and

(2) The partnership's Monthly Closing Election is effective no later than the second calendar month after the calendar month in which the partner acquires the partnership interest.

SECTION 7. TERMINATION OF MONTHLY CLOSING ELECTION OR MONTHLY CLOSING CONSENT

.01 A Monthly Closing Election or Monthly Closing Consent may be revoked only with the consent of the Commissioner.

.02 Each month after the first calendar quarter in which a partnership's Monthly Closing Election is effective, the definition of eligible partnership in section 3.01 of this revenue procedure is reapplied to the partnership, using the last day of the month as the test date and that month and the preceding 2 months as the test period. If for any month the partnership fails to satisfy the test mandated by the preceding sentence, then the partnership's Monthly Closing Election is terminated as of first day of the month. Even if the partnership subsequently qualifies as an eligible partnership, it may not make another Monthly Closing Election without the Commissioner's consent.

.03 If a consenting partner's status as an eligible partner (as defined in section 3.02 of this revenue procedure) changes at any time, the partner's Monthly Closing Consent is ineffective on any day when that definition is not satisfied and is effective on any day when it is. Therefore, no new Monthly Closing Consent is required when a consenting partner sells one interest in an electing partnership and acquires another interest in the same partnership at a time when the partnership continues to have its Monthly Closing Election in effect.

SECTION 8. TRANSITION RULES FOR SOME ELECTIONS AND CONSENTS THAT ARE REQUESTED TO BECOME EFFECTIVE DURING 2002

.01 *Certain Monthly Closing Elections Filed During 2002*. If, using March 1, 2002, as the test date, a partnership is an eligible partnership, or is an existing but ineligible partnership, and, at any time during 2002, the partnership files the statement described in section 5.01 of this revenue procedure, then, in addition to the permissible effective dates described in section 5.01(4) of this revenue procedure, the partnership may request that the Monthly Closing Election become effective for any month in 2002 in which the partnership is an eligible partnership.

.02 *Certain Monthly Closing Consents Provided to an Eligible Partnership During 2002*. In the case of any eligible partnership that is described in section 8.01 of this revenue procedure and that files its Monthly Closing Election during 2002, any RIC that is an eligible partner of that partnership at any time during 2002 may effect a Monthly Closing Consent by either:

(1) Complying with the procedures set forth in section 6 of this revenue procedure; or

(2) Satisfying section 6.01 of this revenue procedure at any time during 2002. In this case, the consent is effective for the month in which the partner provides the statement of consent to the custodian or manager of the partnership, unless the partner requests that the consent be effective for any other calendar month of 2002.

SECTION 9. EFFECTIVE DATE

This revenue procedure is effective on January 1, 2002. However, for the period prior to January 1, 2003, the Service will not challenge a money market fund's monthly inclusion of its distributive share of partnership items described in § 702(a) and guaranteed payments described in § 707(c) in a manner similar to that described in section 4 of this revenue procedure, provided that, had this revenue procedure been in effect at the time of the inclusion, (1) the partnership to which the items and payments are attributable would have been an eligible partnership, and (2) the partner would have been an eligible partner.

SECTION 10. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1768. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information is in sections 4, 5, and 6 of this revenue procedure. This information is required to inform the Service which partners and partnerships are making the designated election and to report income appropriately. The collection of information is required to obtain a benefit. The likely respondents are businesses.

The estimated total annual reporting and recordkeeping burden is 12000 hours.

The estimated annual burden per respondent/recordkeeper is 12 hours. The estimated number of respondents and recordkeepers is 1000.

The estimated annual frequency of responses (used for reporting requirements only) is once.

Books or records relating to a collection of information must be retained as

long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 11. DRAFTING INFORMATION

The principal author of this revenue procedure is David A. Shulman of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure, contact David A. Shulman at 202-622-3080 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Golden Parachute Payments

REG–209114–90

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to golden parachute payments to provide guidance to taxpayers who must comply with section 280G. Proposed regulations under section 280G (PS–217–84, 1989–1 C.B. 1038) were previously published in the **Federal Register** on May 5, 1989, and corrected in 54 FR 25879 (June 20, 1989) and 54 FR 29061 (July 11, 1989) (the 1989 proposed regulations). These proposed regulations are proposed to apply to any payments that are contingent on a change in ownership or control that occurs on or after January 1, 2004. Taxpayers may rely on these proposed regulations until the effective date of the final regulations. Alternatively, taxpayers may rely on the 1989 regulations for any payment contingent on a change in ownership or control that occurs prior to January 1, 2004.

DATES: Written or electronic comments must be received by June 5, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for June 26, 2002, must be received by June 5, 2002.

ADDRESSES: Send submissions to CC:ITA:RU (REG–209114–90), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU (REG–209114–90), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC or sent electronically, via the IRS Internet site *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Erinn Madden at (202) 622–6060 (not a toll-free number). To be placed on the attendance list for the hearing, please contact LaNita M. Vandyke at (202) 622–7180.

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to 26 CFR part 1 under section 280G of the Internal Revenue Code (Code). Sections 280G and 4999 of the Code were added to the Code by sec. 67 of the Deficit Reduction Act, Public Law 98–369 (98 Stat. 585). Section 280G was amended by sec. 1804(j) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2807), sec. 1018(d) of the Technical and Miscellaneous Revenue Act of 1988, Public Law 100–647 (102 Stat. 3581) and sec. 1421 of the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755).

Section 280G denies a deduction to a corporation for any excess parachute payment. Section 4999 imposes a 20-percent excise tax on the recipient of any excess parachute payment. Related provisions include section 275(a)(6), which denies the recipient a deduction for the section 4999 excise tax, and section 3121(v)(2)(A), which relates to the Federal Insurance Contributions Act. Proposed regulations (PS–217–84) under section 280G were previously published in the **Federal Register** at 54 FR 19390 on May 5, 1989, and corrected in 54 FR 25879 (June 20, 1989) and 54 FR 29061 (July 11, 1989) (the 1989 proposed regulations).

Explanation of Provisions

Overview

Section 280G denies a deduction to a corporation for any excess parachute payment. Section 4999 imposes a 20-percent excise tax on the recipient of any excess parachute payment. The disallowance of the deduction under section 280G is not contingent on the imposition of the excise tax under section 4999, and the imposition of the excise tax under section 4999 is not contingent on the disallowance of the deduction under section 280G. For example, an individual may be subject to the 20-percent excise tax under section 4999 even though the payor is a foreign corporation not subject to United States income tax.

Section 280G(b)(2)(A) defines a *parachute payment* as any payment that meets all of the following four conditions: (a) the payment is in the nature of compensation; (b) the payment is to, or for the benefit of, a disqualified individual; (c) the 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 (d) the payment has (together with other payments described in (a), (b), and (c) of this paragraph with respect to the same individual) an aggregate present value of at least 3 times the individual's base amount. Section 280G(b)(2)(B) provides that the term *parachute payment* also includes any payment in the nature of compensation to, or for the benefit of, a disqualified individual if the payment is pursuant to an agreement that violates any generally enforced securities laws or regulations (securities violation 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 disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to a parachute payment is the amount that bears the same ratio to the base amount as the present value of the parachute payment bears to the aggregate present value of all such payments to the same disqualified individual.

Generally, excess parachute payments may be reduced by certain amounts of reasonable compensation. Section 280G(b)(4)(B) provides that, except in the case of securities violation parachute payments, the amount of an excess parachute payment is reduced by any portion

of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of change in ownership or control. Such reasonable compensation is first offset against the portion of the base amount allocated to the payment.

The 1989 proposed regulations provided guidance regarding the application of section 280G to corporations and individuals. Although many aspects of the 1989 proposed regulations were well-received, the IRS has received numerous comments requesting modification and clarification of the 1989 proposed regulations. In response, these proposed regulations clarify and revise, as described below, the 1989 proposed regulations. Many aspects of the 1989 proposed regulations are preserved, and these proposed regulations retain the same organizational structure as the 1989 proposed regulations. Major modifications to the 1989 proposed regulations are described below.

Disqualified Individuals

A payment constitutes a parachute payment only if the payment is made to (or for the benefit of) a disqualified individual. Section 280G(c) defines the term *disqualified individual* to include any individual who (a) is an employee or independent contractor who performs personal services for a corporation, and (b) is an officer, shareholder, or highly-compensated individual.

The determination of whether an individual is a disqualified individual under these proposed regulations is substantially the same as under the 1989 proposed regulations, with three significant changes. First, Q/A-17 of the 1989 regulations provides a *de minimis* rule for purposes of identifying which shareholders of a corporation are disqualified individuals. Under the 1989 proposed regulations, an individual is a shareholder for purposes of section 280G if the individual, at any time during the disqualified individual determination period, owns stock of a corporation with a fair market value exceeding 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. Since the issuance of the 1989 proposed regulations, it has become apparent that this rule may include individuals who do not possess significant influence over the corporation. Therefore, under Q/A-17 of these proposed regulations, the $1 million test is eliminated. Under these proposed regulations, an individual is a shareholder only if, during the disqualified individual determination period, the individual owns stock of a corporation with a fair market value that exceeds 1 percent of the total fair market value of the outstanding shares of all classes of the corporation's stock. The constructive ownership rules of section 318(a) continue to apply for purposes of determining the amount of stock owned by the individual. Under these rules, for example, to determine the amount of stock owned by an individual, the stock underlying vested stock options is considered constructively owned by that individual.

Second, these proposed regulations modify the annualized compensation method for determining who is a highly-compensated individual under Q/A-19. Under the 1989 proposed regulations, no individual whose annualized compensation during the disqualified individual determination period is less than $75,000 is treated as a highly-compensated individual, even if the individual otherwise satisfies the definition of a highly-compensated individual. Q/A-19 is modified to provide that an individual must have annualized compensation equal to at least the amount described in section 414(q)(1)(B)(i). This amount for 2002 is $90,000 and is adjusted periodically for cost-of-living increases. This modification both updates the amount provided in the 1989 proposed regulations and provides a mechanism to update this amount periodically without further amendment of these regulations.

Finally, these proposed regulations change the disqualified individual determination period under Q/A-20. Under the 1989 proposed regulations, 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 and the immediately preceding twelve months (with an option to use the calendar year or the corporation's fiscal year). Q/A-20 of these proposed regulations is modified to change this period to the twelve months prior to and ending on the date of the change in ownership or control of the corporation. Under this rule, the disqualified individual determination period is the same length for any change in ownership or control and is not affected by the date of the change in ownership or control.

Payment in the Nature of Compensation

A payment may be a parachute payment only if it is a payment in the nature of compensation. All payments, in whatever form, are payments in the nature of compensation if the payments arise out of the employment relationship or are associated with the performance of services. In Q/A-11, these proposed regulations clarify that payments in the nature of compensation include cash, the right to receive cash, or a transfer of property.

Q/A-13 of the 1989 proposed regulations provides that the transfer of a nonstatutory option is treated as a payment in the nature of compensation (even if the option does not have a readily ascertainable fair market value within the meaning of § 1.83–7(b)). The 1989 proposed regulations reserve the issue of the treatment of statutory options (*i.e.*, options to which section 421 applies). These proposed regulations revise Q/A-13 to address the treatment of statutory stock options to provide that nonstatutory stock options and statutory stock options are treated the same. Because both the transfer of a statutory option and the transfer of a nonstatutory stock option are payments in the nature of compensation, there is no basis for distinguishing between these two types of options for purposes of section 280G.

In addition, these proposed regulations revise Q/A-13 with respect to the valuation of both statutory and nonstatutory stock options. Under the 1989 proposed regulations, the value of an option with an ascertainable fair market value is determined under all the facts and circumstances, including the difference between the option's exercise price and the value of the property at the time of vesting, the probability of an increase or decrease in the value of such property, and the length of the option exercise period.

Since the issuance of the 1989 proposed regulations, commentators have indicated that Q/A-13 does not provide

sufficient guidance about the determination of the value of a stock option. In particular, commentators question whether the intrinsic value of the option (the difference between the exercise price and the value of the property, or spread) determined at the time of the change in ownership or control, or a value determined under a valuation model such as Black-Scholes, should be used for purposes of section 280G. Using the factors listed in the 1989 proposed regulations results in a value different from the value obtained from using only the difference between the exercise price and the value of the property. Commentators have also noted that valuation methods other than spread are often complicated and difficult to apply in some circumstances, particularly when the stock underlying the option is not publicly traded.

These proposed regulations continue to provide for the use of the factors described in the 1989 proposed regulations. To provide further guidance on acceptable and administrable methods for valuing stock options, these proposed regulations delegate authority to the Commissioner to provide methods for valuation of stock options through published guidance. Rev. Proc. 2002–13 (2002–8 I.R.B. 549) (February 25, 2002) published in conjunction with these proposed regulations, provides several valuation methods. One of the methods permitted under this revenue procedure is a simplified safe harbor approach modeled after the Black-Scholes valuation method. The safe harbor allows a corporation to establish a value for stock options based on spread at the time of the change in ownership or control, the remaining term of the option, and a basic assumption regarding the volatility of the underlying stock. Other factors relevant to the Black-Scholes valuation model, including a risk-free rate of return and dividend yield, are addressed in the table contained in the revenue procedure. The safe harbor valuation method provided in the revenue procedure may be used without regard to whether the underlying stock is publicly traded.

Contingent on Change

To be a parachute payment, a payment in the nature of compensation to a disqualified individual must be contingent on a change in ownership or control. Q/A-22 of the 1989 proposed regulations provides guidance on when a payment is contingent on a change in ownership or control. Generally, a payment is treated as contingent on a change in ownership or control if the payment would not in fact have been made had no change in ownership or control occurred. A payment generally is treated as one which would not in fact have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change in ownership or control occurred.

These proposed regulations clarify in Q/A-22 that a payment is contingent on a change in ownership or control if the payment would not have been made absent the change in ownership or control, even if the payment is also contingent on a second event, such as termination of employment within a period following the change in ownership or control. In addition, as under the 1989 proposed regulations, a payment generally is treated as contingent on a change in ownership or control if (a) the payment is contingent on an event that is closely associated with such a change, (b) a change in ownership or control actually occurs, and (c) the event is materially related to the change in ownership or control. The fact that a payment that is contingent on an event closely associated with a change in ownership or control is also conditioned on the occurrence of a second event does not affect the determination that the payment is contingent on a change in ownership or control as the result of the occurrence of the first event.

Under Q/A-24 of the 1989 proposed regulations, the entire amount of a payment is generally treated as contingent on a change in ownership or control. These proposed regulations clarify that the general rule of Q/A-24(a) (and not the special rules in either Q/A-24(b) or (c), discussed below) applies to the payment of amounts due under an employment agreement on a termination of employment or change in ownership or control that, without regard to the change, would have been paid for the performance of services after the termination of employment or change in ownership or control, as applicable. Also, the general rules of Q/A-24(a) apply to the accelerated payment of an amount that is otherwise payable only on the attainment of a performance goal or contingent on an event or condition other than the continued performance of services for a specified period of time. In situations governed by Q/A-24(a), the determination of whether a portion of the payment is reasonable compensation for services rendered before, on, or after the change in ownership or control is determined under Q/As-38 through 44. With respect to amounts due under an employment agreement, however, in most situations, a reduction for reasonable compensation for services rendered before the change in ownership or control is inappropriate, given the general expectation that an individual is not undercompensated for services rendered before a change in ownership or control. See Conf. Rep. No. 98–861, at 852 (1984).

Q/A-24(b) and (c) provide an objective method for determining the portion of a payment that is treated as contingent on a change in ownership or control for certain types of payments. These rules are not appropriate in situations such as the acceleration of salary payments under an employment agreement, when the periodic nature of the payments for services means that there is no issue in determining the amount of the payment that is accelerated, or in situations where a payment is conditioned on achievement of a performance goal or other event.

As under the 1989 proposed regulations, these proposed regulations provide that a payment is treated as contingent on a change in ownership or control if the change accelerates the time at which the payment is made or accelerates the vesting of a payment. Q/A-24(b) and (c) provide rules for determining the portion of such payment that is treated as contingent on the change in ownership or control. These proposed regulations clarify when Q/A-24(b) and (c) apply to a contingent payment.

These proposed regulations clarify that Q/A-24(b) applies if a payment is vested, without regard to the change in ownership or control, and is treated as contingent on a change in ownership or control because the change accelerates the time the payment is made. For example, if an individual has a vested right to a payment at

normal retirement age under a nonqualified deferred compensation plan, but instead that payment is made immediately following a change in ownership or control, Q/A-24(b) applies to determine the portion, if any, of the payment that is treated as contingent on the change in ownership or control.

These regulations clarify that Q/A-24(c) applies to a payment that becomes vested as a result of a change in ownership or control to the extent that (i) without regard to the change, the payment was contingent only on the performance of services for the corporation for a specified period of time and (ii) the payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made. For example, if an individual will receive a bonus if employed at the end of a 3-year period, but the bonus is paid immediately on the date of the change of control, Q/A-24(c) applies to determine the portion of the payment that is treated as contingent on the change in ownership or control.

Q/A-24(b) provides that, when a payment is accelerated, the portion of the payment that is contingent on the change is the amount by which the accelerated payment exceeds the present value of the payment absent acceleration. Q/A-24(b) further provides that if the amount of a payment without acceleration is not reasonably ascertainable, and the acceleration does not significantly increase the value of the payment, then the present value of the payment absent the acceleration is equal to the amount of the accelerated payment. As a result, the value of the accelerated payment is equal to the value of the payment absent acceleration and no portion of the payment is treated as contingent on a change in control. If the value of a payment absent acceleration is not reasonably ascertainable and the acceleration significantly increases the value of the payment, the future value of the payment is equal to the amount of the accelerated payment. When the future value (as opposed to the present value) of the payment is deemed to be the amount of the accelerated payment, then there is an excess and, therefore, a portion of the payment is treated as contingent on the change.

Q/A-24(c) provides that the portion of the payment treated as contingent on the change when both vesting and payment are accelerated is the lesser of (1) the payment or (2) the amount determined under Q/A-24(b) plus an additional amount to reflect the lapse of the obligation to perform additional services. Q/A-24(c) provides that for purposes of determining the amount under paragraph (b), the acceleration of the vesting of a stock option or the lapse of a restriction on restricted stock is considered to increase significantly the value of the payment.

Because Q/A-24(b) and (c) operate to provide an objective basis for determining the portion of a payment that is earned as of the date of a change in ownership or control, and therefore, not contingent on a change in ownership or control, these proposed regulations clarify that the rules in Q/As-38 through 44 (which provide rules related to reasonable compensation for services rendered), are inapplicable if the special rules in Q/A-24(b) or (c) apply to a payment.

Change in Ownership or Control

These proposed regulations follow the same approach as the 1989 proposed regulations for determining when a change in ownership or control occurs. However, these proposed regulations clarify that, for purposes of determining whether two or more persons acting as a group are considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation on the date of a merger, acquisition, or similar transaction involving that corporation, a person who owns stock in both corporations involved in the transaction is treated as acting as a group with respect to the other shareholders in a corporation only to the extent of such person's ownership of stock in that corporation prior to the transaction, and not with respect to his or her ownership in the other corporation. For example, assume individual A owns stock in both Corporations X and Y when Corporation X acquires stock in Y in exchange for X stock. In determining whether Corporation Y has undergone a change in ownership or control, individual A is considered to be acting as a group with other shareholders in Corporation Y only to the extent of A's holdings in Corporation Y prior to the transaction, and not with respect to A's ownership in X. In determining whether Corporation X has undergone a change in ownership or control, individual A is considered to be acting as a group with other shareholders in Corporation X only to the extent of individual A's holdings in Corporation X prior to the transaction, and not with respect to individual A's ownership interest in Corporation Y. This rule applies without regard to the type of shareholder involved (*i.e.*, whether the shareholder is an individual or an institutional shareholder, such as a corporation, mutual fund, or trust).

Comments are requested with respect to whether the change in ownership or control rules in these proposed regulations should be further revised. Comments are also requested with respect to whether additional guidance is necessary regarding the application of the change in ownership or control provisions, and these proposed regulations in general, in the context of specific business situations such as bankruptcy.

Shareholder Approval Requirements

Section 280G specifically exempts from the definition of the term *parachute payment* several types of payments that would otherwise constitute parachute payments. Deductions for payments exempt from the definition of *parachute payment* are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of section 280G(b)(2)(A)(ii).

The most significant revisions made by these proposed regulations with respect to exempt payments are clarifications to the shareholder approval requirements which must be met for payments with respect to a corporation in which no stock is readily tradeable on an established securities market or otherwise immediately before the change in ownership or control.

Section 280G(b)(5)(B) provides that the shareholder approval requirements are met if two conditions are satisfied. First, the payment is approved by a vote of the persons who owned, immediately before the change in ownership or control, more

than 75% of the voting power of all outstanding stock of the corporation. Second, there is adequate disclosure to shareholders of all material facts concerning all payments which (but for this rule) would be parachute payments with respect to a disqualified individual. Since the issuance of the 1989 proposed regulations, commentators have indicated that the 1989 proposed regulations do not fully explain how the shareholder approval requirements operate or accurately reflect business practices connected with a change in ownership or control.

The proposed regulations clarify the process of obtaining shareholder approval within the structure provided by section 280G(b)(5)(B). Under this section, a shareholder approval vote is valid only if (1) it is a vote of more than 75% of the shareholders entitled to vote based on ownership in the corporation immediately before the change in ownership or control, and (2) disclosure is made with respect to all payments that would otherwise be parachute payments for an individual.

The first step in obtaining shareholder approval is to identify the shareholders entitled to vote. Q/A-7 is revised to clarify that stock held by a disqualified individual (or by certain entity shareholders) is not entitled to vote with respect to a payment to be made to any disqualified individual and that this stock is disregarded in determining whether the more than 75% approval requirement has been met. Once the stock entitled to vote is determined, more than 75% of the voting power of such stock must approve the payment. Q/A-7 also includes a rule of administrative convenience providing that a vote to approve the payment does not fail to be a vote of the shareholders who own stock immediately before the change in ownership or control if eligibility to vote is based on the shareholders of record at the time of any vote taken in connection with a transaction or event giving rise to the change in ownership or control within the three-month period ending on the date of the change in ownership or control. This rule only applies if the disclosure requirements are also met.

These proposed regulations further clarify that not all parachute payments must be subject to a shareholder vote to satisfy the shareholder approval requirements with respect to a payment. It is permissible for only a portion of the payments that would otherwise be made to a disqualified individual to be subject to vote. For example, assume that a disqualified individual with a base amount of $150,000 would receive payments that (but for the exemption for a corporation with no readily tradeable stock) would be parachute payments including (i) a bonus payment of $200,000, (ii) vesting in stock options with a fair market value of $500,000, $200,000 of which is contingent on the change in ownership or control, and (iii) severance payments of $100,000. In this situation, assuming all of the payments are disclosed, the corporation may submit to the shareholders for approval (1) all of the payments, (2) any one of the three payments, or (3) $50,001 of any one of the payments (*e.g.*, options with a value of $50,001). The issue submitted to a shareholder vote must be whether the payment will be made to the disqualified individual, not whether the corporation will be able to deduct the payment. In addition, the vote must be a separate vote of the shareholders. Therefore, the merger, acquisition, or other transaction cannot be conditioned on the shareholders' approval of the payment.

These proposed regulations also clarify that the shareholder approval requirements are met by a single vote on all payments submitted to the vote, including payments to more than one disqualified individual (assuming the disclosure requirements, described below, are also met).

The shareholder approval requirements also require adequate disclosure of all material facts concerning the amount of all parachute payments. For this purpose, the proposed regulations clarify that the amount of all parachute payments to be made to each disqualified individual, and not just the amount of the payments subject to vote, is a material fact. These proposed regulations also clarify that shareholders should be provided with basic information about the type of payments involved (*e.g.*, vesting of stock options or severance payments). This disclosure of information must be made to all shareholders entitled to vote, not just to shareholders with 75% of the voting power entitled to vote.

Reasonable Compensation

The determination of whether amounts are reasonable compensation is relevant for two purposes. First, an excess parachute payment is reduced by any portion of the payment that constitutes reasonable compensation for services actually rendered before a change in ownership or control. Second, amounts that are reasonable compensation for services to be rendered after a change in ownership or control are exempt from the definition of parachute payment. In both situations, reasonable compensation for services must be demonstrated by clear and convincing evidence.

These proposed regulations clarify two issues with respect to reasonable compensation for services performed after a change in ownership or control. The proposed regulations clarify that clear and convincing evidence that a payment is reasonable compensation for services rendered after a change in ownership or control exists if the individual's annual compensation after the change in ownership or control (apart from normal increases) is not significantly greater then the individual's annual compensation before the change in ownership or control, provided that the individual's duties and responsibilities are substantially the same after the change in ownership or control as they were before the change in ownership or control. If the individual's duties and responsibilities have changed, then the clear and convincing evidence must demonstrate that the individual's annual compensation after the change in ownership or control is not significantly greater than the compensation customarily paid by the employer, or by comparable employers, to persons performing comparable services.

Payments to an individual under an agreement that requires the individual to refrain from providing services (such as under a covenant not to compete) may also constitute reasonable compensation for services to be rendered on or after the date of the change in ownership or control. Under Q/A-42 of these proposed regulations, an agreement is treated as an

agreement to refrain from services (rather than an agreement for severance pay) if it is demonstrated with clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual. If, under the facts and circumstances, the agreement does not satisfy these criteria, the payments under the agreement are instead treated as severance payments under Q/A-44. If the agreement does satisfy these criteria, then the agreement is treated as an agreement for the performance of services, and the payments are exempt from the definition of *parachute payment* to the extent the payments are shown to be reasonable compensation under Q/A-42(a)(2).

Application to Tax-Exempt Organizations

Commentators have asked whether a payment with respect to a tax-exempt entity is exempt from the definition of the term *parachute payment*. These proposed regulations clarify that a payment with respect to a tax-exempt entity that would otherwise constitute a parachute payment is exempt from the definition of the term *parachute payment* if the following two conditions are satisfied.

First, the payment must be made by a corporation undergoing a change in ownership or control that is a *tax-exempt organization*, as defined in these proposed regulations. A *tax-exempt organization* is defined as any organization described in section 501(c) that is subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, an organization described in subsections 501(c)(1) or 501(c)(21), any religious or apostolic organization described in section 501(d), or any qualified tuition program described in section 529.

Second, the organization must meet the definition of *tax-exempt organization*, as defined in these regulations, both immediately before and immediately after the change in ownership or control. If this second condition is not met, a payment made by a *tax-exempt organization* is not exempt from the definition of *parachute payment*.

As noted above, the term *tax-exempt organization* includes organizations that are described in section 501(c) that already are subject to express statutory rules that prohibit the inurement of the net earnings of such organizations to the benefit of "any private shareholder or individual." Organizations described in the following subsections of 501(c) are *tax-exempt organization*s under application of this rule: 501(c)(3) (including any organization described in subsections 501(e), (f), or (k)), 501(c)(4), 501(c)(6), 501(c)(9), 501(c)(11), 501(c)(13) (but only with respect to those organizations subject to the express anti-inurement provision), 501(c)(19), and 501(c)(26). In light of the existing restrictions on these organizations, the Service and the Treasury Department believe the additional protections of section 280G are unnecessary. In addition, the term *tax-exempt organization* in the proposed regulations includes federal instrumentalities organized under Act of Congress (described in section 501(c)(1)), black lung trusts (described in section 501(c)(21)), certain religious and apostolic organizations (described in section 501(d)) and qualified tuition programs (described in section 529). The Service and the Treasury Department recognize that it may be appropriate to exempt payments made by other types of tax-exempt organizations. Comments are requested on whether any additional categories of organizations should be included in the definition of *tax-exempt organization* for purposes of section 280G.

Definition of Corporation

Under the 1989 proposed regulations, *corporation* is defined by reference to section 7701(a)(3) of the Code. These proposed regulations clarify that the term *corporation*, for purposes of section 280G and the regulations thereunder, includes any entity described in § 301.7701–2(b) such as, for example, a real estate investment trust under section 856(a), a corporation that has mutual or cooperative (rather than stock) ownership, such as a mutual insurance company, a mutual savings bank, or a cooperative bank (as defined in section 7701(a)(32)), and a foreign corporation (as defined in section 7701(a)(5)).

Accordingly, the term *corporation* also includes any entity described in § 301.7701–3(c)(1)(v)(A). That regulation provides, in general, that an entity that claims to be, or is determined to be, an entity that is exempt from taxation under section 501(a) is treated as an association for purposes of the Code. Because the definition of *corporation* includes an association, any entity described in § 301.7701–3(c)(1)(v)(A) is a corporation for purposes of sections 7701 and 280G.

Determination of Excess Parachute Payments

Once all parachute payments are identified, the determination of what portion, if any, of each parachute payment is an excess parachute payment is made. This determination is based on the aggregate present value of all parachute payments. These proposed regulations modify the method described in Q/A-33 of the 1989 proposed regulations for determining the present value of a payment contingent on an uncertain future event or condition. Under Q/A-33 of these proposed regulations, if there is at least a 50-percent probability that the payment will be made, the entire present value of a contingent payment should be included for purposes of determining if there are excess parachute payments. If there is less than a 50-percent probability, then the present value of the contingent payment is not included. Once it is certain whether or not the payment will be made, the 3-times-base amount test in Q/A-30 is reapplied if the initial determination as to whether to include the payment was incorrect. If the inclusion or exclusion of the payment for purposes of Q/A-30 at the time of the change in ownership or control was correct, there is no need to reapply the 3-times-base-amount test. In addition, if it is reasonably estimated that there is a less than 50-percent probability that the payment will be made and the payment is not included in the 3-times-base-amount test, but the payment is later made, the 3-times-base-amount test is not reapplied if the test without regard to the contingent payment resulted in a determination that the individual received (or would receive) excess parachute payments and no base amount is allocated to the contingent payment.

Finally, Q/A-31 provides guidance on determining the present value of an obligation to provide health care over a period of years. Under these proposed

regulations, the determination of the present value of this obligation should be calculated in accordance with generally accepted accounting principles. For purposes of Q/A-31, it is permissible for the obligation to provide health care to be measured by projecting the cost of premiums for purchased health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the corporation makes available to a group, then the premiums used for this purpose may be group premiums. This method only applies for purposes of determining present value. Premiums for health care insurance can be used for purposes of determining a corporation's loss of deduction or the excise tax obligation for a disqualified individual only to the extent such premiums are actually paid for health care insurance used to satisfy the corporation's obligation to provide health care.

Timing of the Payment of Tax under Section 4999

In general, the excise tax under section 4999 is due at the time that the payment is considered made under Q/A-11 through 13. Q/A-11(b) of these proposed regulations clarifies that, except as provided in Q/A-12 or 13, a payment is considered made in the taxable year that it is includible in the disqualified individual's gross income, or for benefits excludible from income, in the year the benefit is received. Q/A-11(c) of these proposed regulations permits a disqualified individual, for purposes of section 4999, to treat certain payments as made in the year of the change in ownership or control (or the first year for which a payment contingent on a change in ownership or control is certain to be made), even though the payment is not yet includible in income (or otherwise received). This treatment is not available, however, for a payment if the present value is not reasonably ascertainable within the meaning of section 3121 (v) and § 31.3121(v)(2)–1(e)(4) or for a payment related to health benefits or coverage. These proposed regulations indicate in Q/A-11(c) that the Commissioner may provide through published guidance that Q/A-11(c) is or is not available with respect to other types of payments.

According to Q/A-11(c) of these proposed regulations, the payment of the excise tax under section 4999 must be made based on the amount calculated for purposes of determining excess parachute payments. Therefore, to the extent that the determination of whether there is an excess parachute payment is based on an incorrect valuation of the payment, the excise tax payment under this provision is also incorrect.

Proposed Effective Date

These regulations are proposed to apply to any payments that are contingent on a change in ownership or control that occurs on or after January 1, 2004. Taxpayers may rely on these proposed regulations until the effective date of the final regulations. Alternatively, taxpayers may rely on the 1989 proposed regulations for any payment contingent on a change in ownership or control that occurs prior to January 1, 2004.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written or electronic comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 26, 2002, beginning at 10 a.m. in the IRS Auditorium of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by June 5, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the schedule of speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Erinn Madden, Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

The proposed amendments to 26 CFR part 1 are as follows:

PART I — INCOME TAX; TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1986.

Paragraph 1. The authority citation for part 1 is amended by adding the following entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.280G–1 also issued under 26 U.S.C. 280G (b) and (e). * * *

Par. 2. Section 1.280G–1 is added to read as follows:

§ 1.280G–1 Golden parachute payments.

The following questions and answers relate to the treatment of golden parachute payments under section 280G of the Internal Revenue Code of 1986, as added by section 67 of the Tax Reform Act of 1984 (Public Law No. 98–369; 98 Stat. 585) and amended by section 1804(j) of the Tax Reform Act of 1986 (Public Law No. 99–514; 100 Stat. 2807), section 1018(d) (6)-(8) of the Technical and Miscellaneous Revenue Act of 1988 (Public Law No. 100–647; 102 Stat. 3581), and section 1421 of the Small Business Job Protection Act of 1996 (Public Law No. 104–188, 110 Stat. 1755). The following is a table of contents for this section:

Overview

Q-1: What is the effect of Internal Revenue Code section 280G?

A-1: (a) Section 280G disallows a deduction for any excess parachute payment paid or accrued. For rules relating to the imposition of a nondeductible 20-percent excise tax on the recipient of any excess parachute payment, see Internal Revenue Code sections 4999, 275(a)(6), and 3121(v)(2)(A).

(b) The disallowance of a deduction under section 280G is not contingent on the imposition of the excise tax under section 4999. The imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G. Thus, for example, because the imposition of the excise tax under section 4999 is not contingent on the disallowance of a deduction under section 280G, a payee may be subject to the 20-percent excise tax under section 4999 even though the disallowance of the deduction for the excess parachute payment may not directly affect the federal taxable income of the payor.

Q-2: What is a parachute payment for purposes of section 280G?

A-2: (a) The term *parachute payment* means any payment (other than an exempt payment described in Q/A-5) that —

(1) Is in the nature of compensation;

(2) Is made or is to be made to (or for the benefit of) a disqualified individual;

(3) Is contingent on a change —

(i) In the ownership of a corporation;

(ii) In the effective control of a corporation; or

(iii) In the ownership of a substantial portion of the assets of a corporation; and

(4) Has (together with other payments described in paragraphs (a)(1), (2), and (3) of this A-2 with respect to the same disqualified individual) an aggregate present value of at least 3 times the individual's base amount.

(b) Hereinafter, a change referred to in paragraph (a)(3) of this A-2 is referred to as a change in ownership or control. For a discussion of the application of paragraph (a)(1), see Q/A-11 through Q/A-14; paragraph (a)(2), Q/A-15 through Q/A-21; paragraph (a)(3), Q/A-22 through Q/A-29; and paragraph (a)(4), Q/A-30 through Q/A-36.

(c) The term *parachute payment* also includes any payment in the nature of compensation to (or for the benefit of) a disqualified individual that is pursuant to an agreement that violates a generally enforced securities law or regulation. This type of parachute payment is referred to in this section as a securities violation parachute payment. See Q/A-37 for the definition and treatment of securities violation parachute payments.

Q-3: What is an excess parachute payment for purposes of section 280G?

A-3: The term *excess parachute payment* means an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment. Subject to certain exceptions and limitations, an excess parachute payment is reduced by any portion of the payment which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. For a discussion of the nonreduction of a securities violation parachute payment by reasonable compensation, see Q/A-37. For a discussion of the computation of excess parachute payments and their reduction by reasonable compensation, see Q/A-38 through Q/A-44.

Q-4: What is the effective date of section 280G and this section?

A-4: In general, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Section 280G also applies to certain payments under agreements entered into on or before June 14, 1984, and amended or supplemented in significant relevant respect after that date. This section applies to any payment contingent on a change in ownership or control which occurs on or after January 1, 2004. For a discussion of the application of the effective date, see Q/A-47 and Q/A-48.

Exempt Payments

Q-5: Are some types of payments exempt from the definition of the term *parachute payment*?

A-5: (a) Yes, the following five types of payments are exempt from the definition of *parachute payment* —

(1) Payments with respect to a small business corporation (described in Q/A-6 of this section);

(2) Certain payments with respect to a corporation no stock in which is readily tradeable on an established securities market (or otherwise) (described in Q/A-6 of this section);

(3) Payments to or from a qualified plan (described in Q/A-8 of this section);

(4) Certain payments made by a corporation undergoing a change in ownership or control that is described in any of the following sections of the Internal Revenue Code: section 501(c) (but only if such organization is subject to an express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, or if the organization is described in section 501(c)(1) or section 501(c)(21)), section 501(d), or section 529, collectively referred to as *tax-exempt organizations* (described in Q/A-6 of this section); and

(5) Certain payments of reasonable compensation for services to be rendered on or after the change in ownership or control (described in Q/A-9 of this section).

(b) Deductions for payments exempt from the definition of *parachute payment* are not disallowed by section 280G, and such exempt payments are not subject to the 20-percent excise tax of section 4999. In addition, such exempt payments are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section.

Q-6: Which payments with respect to a corporation referred to in paragraph (a)(1), (a)(2), or (a)(4) of Q/A-5 of this section are exempt from the definition of *parachute payment*?

A-6: (a) The term *parachute payment* does not include —

(1) Any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) was a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof),

(2) Any payment to a disqualified individual with respect to a corporation (other than a small business corporation described in paragraph (a)(1) of this A-6) if —

(i) Immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise; and

(ii) The shareholder approval requirements described in Q/A-7 of this section are met with respect to such payment; or

(3) Any payment to a disqualified individual made by a corporation which is a tax-exempt organization (as defined in paragraph (a)(4) of Q/A-5 of this section), but only if the corporation meets the definition of a tax-exempt organization both immediately before and immediately after the change in ownership or control.

(b) For purposes of paragraph (a)(1) of this A-6, the members of an affiliated group are not treated as one corporation.

(c) The requirements of paragraph (a)(2)(i) of this A-6 are not met if a substantial portion of the assets of a corporation undergoing a change in ownership or control consists (directly or indirectly) of stock in another entity (or any ownership interest in such entity) and stock of such entity (or any ownership interest in such entity) is readily tradeable on an established securities market or otherwise. For this purpose, such stock constitutes a substantial portion of the assets of an entity if the total fair market value of the stock is equal to or exceeds one third of the total gross fair market value of all of the assets of the entity. If a corporation is a member of an affiliated group (which group is treated as one corporation under A-46 of this section), the requirements of paragraph (a)(2)(i) of this A-6 are not met if any stock in any member of such group is readily tradeable on an established securities market or otherwise.

(d) For purposes of paragraph (a)(2)(i) of this A-6, the term *stock* does not include stock described in section 1504(a)(4) if the payment does not adversely affect the redemption and liquidation rights of any shareholder owning such stock.

(e) For purposes of paragraph (a)(2)(i) of this A-6, stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in such stock.

(f) For purposes of paragraph (a)(2)(i) of this A-6, the term *established securities market* means an established securities market as defined in § 1.897–1(m).

(g) The following examples illustrate the application of this exemption:

Example 1. A small business corporation (within the meaning of paragraph (a)(1) of this A-6) operates two businesses. The corporation sells the assets of one of its businesses, and these assets represent a substantial portion of the assets of the corporation. Because of the sale, the corporation terminates its employment relationship with persons employed in the business the assets of which are sold. Several of these employees are highly-compensated individuals to whom the owners of the corporation make severance payments in excess of 3 times each employee's base amount. Since the corporation is a small business corporation immediately before the change in ownership or control, the payments are not parachute payments.

Example 2. Assume the same facts as in *Example 1*, except that the corporation is not a small business corporation within the meaning of paragraph (a)(1) of this A-6. If no stock in the corporation is readily tradeable on an established securities market (or otherwise) immediately before the change in ownership or control and the shareholder approval requirements described in Q/A-7 of this section are met, the payments are not parachute payments.

Example 3. Stock of Corporation S is wholly owned by Corporation P, stock in which is readily tradeable on an established securities market. The Corporation S stock equals or exceeds one third of the total gross fair market value of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. Corporation S makes severance payments to several of its highly-compensated individuals that are parachute payments under section 280G and Q/A-2 of this section. Because stock in Corporation P is readily tradeable on an established securities market, the payments are not exempt from the definition of *parachute payments* under this A-6.

Example 4. A is a corporation described in section 501(c)(3), and accordingly, its net earnings are prohibited from inuring to the benefit of any private shareholder or individual. A transfers substantially all of its assets to another corporation resulting in a change in ownership or control. Contingent on the change in ownership or control, A makes a payment that, but for the potential application of the exemption described in A-5(a)(4), would constitute a *parachute payment*. However, one or more aspects of the transaction that constitutes the change in ownership or control causes A to fail to be described in section 501(c)(3). Accordingly, A fails to meet the definition of a *tax-exempt organization* both immediately before and immediately after the change in ownership or control, as required by this A-6. As a result, the payment made by A that was contingent on the change in ownership or control is not exempt from the definition of *parachute payment* under this A-6.

Example 5. B is a corporation described in section 501(c)(15). B does not meet the definition of a *tax-exempt organization* because section 501(c)(15) does not expressly prohibit inurement of B's net earnings to the benefit of any private shareholder or individual. Accordingly, if B has a change in ownership or control and makes a payment that would otherwise meet the definition of a *parachute payment*, such payment is not exempt from the definition of the term *parachute payment* for purposes of this A-6.

Q-7: How are the shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A-6 of this section met?

A-7: (a) *General rule*. The shareholder approval requirements referred to in paragraph (a)(2)(ii) of Q/A-6 of this section are met with respect to any payment if —

(1) Such payment was approved by more than 75 percent of the voting power of all outstanding stock of the corporation entitled to vote (as described in this A-7) immediately before the change in ownership or control; and

(2) There was adequate disclosure to all persons entitled to vote (as described in this A-7) of all material facts concerning all material payments which (but for Q/A-6 of this section) would be parachute payments with respect to a disqualified individual.

(b) *Voting requirements* — (1) *General rule*. The vote described in paragraph (a)(1) of this A-7 must determine the right of the disqualified individual to receive the payment, or, in the case of a payment made before the vote, the right of the disqualified individual to retain the payment. For purposes of this A-7, the vote can be on less than the full amount of the payment(s) to be made. The total payment(s) submitted for shareholder approval must be separately approved by the shareholders. Shareholder approval can be a single vote on all payments submitted to vote, including payments to more than one disqualified individual. The requirements of this paragraph (b)(1) are not satisfied if approval of the change in ownership or

control is contingent on the approval of any payment that would be a parachute payment but for Q/A-6 of this section to a disqualified individual.

(2) *Special rule for vote within 3 months before change.* A vote to approve the payment does not fail to be a vote of the outstanding stock of the corporation entitled to vote immediately before the change in ownership or control merely because the determination of the shareholders entitled to vote on the payment is based on the shareholders of record at the time of any shareholder vote taken in connection with a transaction or event giving rise to such change in ownership or control and within the three-month period ending on date of the change in ownership or control, provided the disclosure requirements described in paragraph (c) of this A-7 are met.

(3) *Entity shareholder*. Approval of a payment by any shareholder that is not an individual (an entity shareholder) generally must be made by the person authorized by the entity shareholder to approve the payment. However, if a substantial portion of the assets of an entity shareholder consists (directly or indirectly) of stock in the corporation undergoing the change in ownership or control, approval of the payment by that entity shareholder must be made by a separate vote of the persons who hold, immediately before the change in ownership or control, more than 75 percent of the voting power of the entity shareholder. The preceding sentence does not apply if the value of the stock of the corporation owned, directly or indirectly, by or for the entity shareholder does not exceed 1 percent of the total value of the outstanding stock of the corporation. Where approval of a payment by an entity shareholder must be made by a separate vote of the owners of the entity shareholder, the normal voting rights of the entity shareholder determine which owners shall vote. For purposes of this A-7, stock represents a substantial portion of the assets of an entity shareholder if the total fair market value of the stock held by the entity shareholder in the corporation undergoing the change in ownership or control is equal to or exceeds one third of the total fair market value of all of the assets of the entity shareholder.

(4) *Attribution of stock ownership*. In determining the persons who comprise the "more than 75 percent" group referred to in paragraph (a)(1) or (b)(3) of this A-7, stock is not counted as outstanding stock if the stock is actually owned or constructively owned under section 318(a) by or for a disqualified individual who receives (or is to receive) payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 were not met. Likewise, stock is not counted as outstanding stock if the owner is considered under section 318(a) to own any part of the stock owned directly or indirectly by or for a disqualified individual described in the preceding sentence. In addition, if a partner authorized by a partnership to approve a payment is a disqualified individual with respect to the corporation undergoing a change in ownership or control, none of the stock held by the partnership is considered outstanding stock. However, if all persons who hold voting power in the corporation are disqualified individuals or related persons described in either of the two preceding sentences, then stock owned by such persons is counted as outstanding stock.

(5) *Disqualified individuals*. To satisfy the approval requirements of paragraph (a) of this A-7, the vote of a disqualified individual who receives (or is to receive) a payment that would be a parachute payment if the shareholder approval requirements described in paragraph (a) of this A-7 were not met is not considered in determining whether the more than 75 percent vote has been obtained for purposes of any vote under paragraph (a) of this A-7. However, if all persons who hold voting power in the corporation are disqualified individuals or related persons, then votes by such persons are considered in determining whether the more than 75% vote has been obtained.

(c) *Adequate disclosure*. To be adequate disclosure for purposes of paragraph (a)(2) of this A-7, disclosure must be full and truthful disclosure of the material facts and such additional information as is necessary to make the disclosure not materially misleading at the time the disclosure was made. Disclosure of such information must be made to every shareholder of the corporation entitled to vote under this A-7. For each disqualified individual, material facts that must be disclosed include the total amount of the payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 were not met and a brief description of each payment (*e.g.*, accelerated vesting of options, bonus, or salary). An omitted fact is considered a material fact if there is a substantial likelihood that a reasonable shareholder would consider it important.

(d) *Corporation without shareholders*. If a corporation does not have shareholders, the exemption described in Q/A-6(a)(2) of this section and the shareholder approval requirements described in this A-7 do not apply. For purposes of this paragraph (d), a shareholder does not include a member in an association, joint stock company, or insurance company.

(e) *Examples*. The following examples illustrate the application of this A-7:

Example 1. Corporation S has two shareholders — Corporation P, which owns 76 percent of the stock of Corporation S, and A, a disqualified individual. No stock of Corporation P or S is readily tradeable on an established securities market (or otherwise). Stock of Corporation S equals or exceeds one third of the assets of Corporation P, and thus, represents a substantial portion of the assets of Corporation P. All of the stock of Corporation S is sold to Corporation M. Contingent on the change in ownership of Corporation S, severance payments are made to the officers of Corporation S in excess of 3 times each officer's base amount. If the payments are approved by a separate vote of the persons who hold, immediately before the sale, more than 75 percent of the voting power of the outstanding stock of Corporation P and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Example 2. Corporation M is wholly owned by Partnership P. No interest in either M or P is readily tradeable on an established securities market (or otherwise). Stock of Corporation M equals or exceeds one third of the assets of Partnership P, and thus, represents a substantial portion of the assets of Partnership P. Corporation M undergoes a change in ownership or control. Partnership P has one general partner and 200 limited partners. None of the limited partners are entitled to vote on issues involving the management of the partnership investments. If the payments that would be parachute payments if the shareholder approval requirements of this A-7 are not met are approved by the general partner and the disclosure rules of paragraph (a)(2) of this A-7 are complied with, the shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Example 3. Corporation A has several shareholders including X and Y, who are disqualified individuals with respect to Corporation A. No stock of Corporation A is readily tradeable on an established securities market (or otherwise). Corporation A undergoes a change in ownership or control. Contingent on the change, severance payments are payable to X and Y that are in excess of 3 times each individual's base amount. To determine whether the approval requirements of paragraph (a)(1) of this A-7 are satisfied regarding the payments to X and Y, the stock of X and Y is not considered outstanding, and X and Y are not eligible to vote.

Example 4. Assume the same facts as in *Example 3* except that after adequate disclosure (within the meaning of paragraph (a)(2) of this A-7) to all shareholders entitled to vote, 60 percent of the shareholders who are entitled to vote approve the payments to X and Y. Because more than 75 percent of the shareholders did not approve the payments to X and Y, the shareholder approval requirements of paragraph (a)(1) of this A-7 are not satisfied, and the payments are not made to X and Y.

Example 5. Assume the same facts as in *Example 3* except that disclosure of all the material facts regarding the payments to X and Y is made to two of Corporation A's shareholders, who collectively own 80 percent of Corporation A's stock entitled to vote and approve the payment. Assume further that no disclosure of the material facts regarding the payments to X and Y is made to other Corporation A shareholders who are entitled to vote within the meaning of this A-7. Because disclosure regarding the payments to X and Y is not made to all of Corporation A's shareholders who were entitled to vote, the disclosure requirements of paragraph (a)(2) of this A-7 are not met, and the payments are not exempt from the definition of *parachute payment* pursuant to Q/A-6.

Example 6. Corporation C has three shareholders Partnership, which owns 20 percent of the stock of Corporation C; A, an individual who owns 60 percent of the stock of Corporation C; and B, an individual who owns 20 percent of Corporation C. Stock of Corporation C does not represent a substantial portion of the assets of Partnership. No interest in either Partnership or Corporation C is readily tradeable on an established securities market (or otherwise). P, a one-third partner in Partnership, is a disqualified individual with respect to Corporation C. Corporation C undergoes a change in ownership or control. Contingent on the change, a severance payment is payable to P in excess of 3 times P's base amount. To determine the persons who comprise the "more than 75 percent group" referred to in paragraph (a)(1) of this A-7 who must approve the payment to P, one third of the stock held by Partnership is not considered outstanding stock. If, however, P is the person authorized by Partnership to approve the payment, none of the shares of Partnership are considered outstanding stock.

Example 7. X, an employee of Corporation E, is a disqualified individual with respect to Corporation E. No stock in Corporation E is readily tradeable on an established securities market (or otherwise). X, Y, and Z are all employees and disqualified individuals with respect to Corporation E. Each individual has a base amount of $100,000. Corporation E undergoes a change in ownership or control. Contingent on the change, a severance payment of $400,000 is payable to X; $600,000 is payable to Y; and $1,000,000 is payable to Z. Corporation E provides a ballot to each Corporation E shareholder entitled to vote under paragraph(a)(1) of this A-7 listing the payments of $400,000 to X; $600,000 to Y; and $1,000,000 to Z. Next to each name and corresponding amount on the ballot, Corporation E requests approval (with a "yes" and "no" box) of each total payment to be made to each individual and states that if the payment is not approved, the payment will not be made. Adequate disclosure, within the meaning of this A-7 is made to each shareholder entitled to vote under this A-7. More than 75 percent of the Corporation E shareholders who are entitled to vote under paragraph (a)(1) of this A-7, approve each payment to each individual. The shareholder approval requirements of this A-7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Example 8. Assume the same facts as in *Example 7* except that the ballot does not request approval of each total payment to each individual separately. Instead, the ballot states that $2,000,000 in payments will be made to X, Y, and Z and requests approval of all of the $2,000,000 payments. Assuming the nature of the payments to X, Y, and Z are separately described to the shareholders entitled to vote under this A-7, the shareholder approval requirements of paragraph (a)(1) of this A-7 are met, and the payments are exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Example 9. B, an employee of Corporation X, is a disqualified individual with respect to Corporation X. Stock of Corporation X is not readily tradeable on an established securities market (or otherwise). Corporation X undergoes a change in ownership or control. B's base amount is $205,000. Under B's employment agreement with Corporation X, in the event of a change in ownership or control, B's stock options will vest and B will receive a severance and bonus payment. Contingent on the change, B's stock options immediately vest with a fair market value of $500,000, $200,000 of which is contingent on the change, and B will receive a $200,000 bonus payment and a $400,000 severance payment. Corporation X distributes a ballot to every shareholder of Corporation X who immediately before the change is entitled to vote. The ballot lists the following payments to be made to B: the contingent payment of $200,000 attributable to options, a $200,000 bonus payment, and a $400,000 severance payment. The ballot requests shareholder approval of the $200,000 bonus payment to B and states that whether or not the $200,000 bonus payment is approved, B will receive $200,000 attributable to options and a $400,000 severance payment. More than 75 percent of the shareholders entitled to vote approve the $200,000 bonus payment to B. The shareholder approval requirements of this A-7 are met, and the $200,000 payment is exempt from the definition of *parachute payment* pursuant to A-6 of this section.

Q-8: Which payments under a qualified plan are exempt from the definition of *parachute payment*?

A-8: The term *parachute payment* does not include any payment to or from —

(a) A plan described in section 401(a) which includes a trust exempt from tax under section 501(a);

(b) An annuity plan described in section 403(a);

(c) A simplified employee pension (as defined in section 408(k)); or

(d) A simple retirement account (as defined in section 408(p)).

Q-9: Which payments of reasonable compensation are exempt from the definition of *parachute payment*?

A-9: Except in the case of securities violation parachute payments, the term *parachute payment* does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control. See Q/A-37 of this section for the definition and treatment of securities violation parachute payments. See Q/A-38 through Q/A-44 of this section for rules on determining amounts of reasonable compensation.

Payor of Parachute Payments

Q-10: Who may be the payor of parachute payments?

A-10: Parachute payments within the meaning of Q/A-2 of this section may be paid, directly or indirectly, by —

(i) The corporation referred to in paragraph (a)(3) of Q/A-2 of this section:

(ii) A person acquiring ownership or effective control of that corporation or ownership of a substantial portion of that corporation's assets; or

(iii) Any person whose relationship to such corporation or other person is such as to require attribution of stock ownership between the parties under section 318(a).

Payments in the Nature of Compensation

Q-11: What types of payments are in the nature of compensation?

A-11: (a) *General rule*. For purposes of this section, all payments — in whatever form — are payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available

to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Payments in the nature of compensation include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, and pension benefits and other deferred compensation (including any amount characterized by the parties as interest thereon). A payment in the nature of compensation also includes cash when paid, the value of the right to receive cash, or a transfer of property. However, payments in the nature of compensation do not include attorney's fees or court costs paid or incurred in connection with the payment of any amount described in paragraphs (a)(1), (2), and (3) of Q/A-2 of this section or a reasonable rate of interest accrued on any amount during the period the parties contest whether a payment will be made.

(b) *When payment is considered to be made*. Except as otherwise provided in A-11 through Q/A-13 of this section, a payment in the nature of compensation is considered made (and is subject to the excise tax under section 4999) in the taxable year in which it is includible in the disqualified individual's gross income or, in the case of fringe benefits and other benefits excludible from income, in the taxable year the benefits are received.

(c) *Pre-payment rule*. Notwithstanding the general rule described in paragraph (b) of this A-11, for purposes of section 4999, a disqualified individual is permitted to treat a payment as received in the year of the change in ownership or control or, if later, the first year in which the payment (or payments) is certain to be made without regard to the year in which the payment (or payments) is includible in income (or otherwise received). The payment of the excise tax for purposes of section 4999 must be based on the amount calculated for purposes of determining any excess parachute payments. However, a disqualified individual may not apply this paragraph (c) of this A-11 to a payment to be made in cash if the present value of the payment would be considered not reasonably ascertainable under section 3121(v) and § 31.3121 (v)(2)–1(e)(4) or a payment related to health benefits or coverage. The Commissioner is permitted to provide that this paragraph (c) is or is not available for certain types of payments.

(d) *Transfers of property*. Transfers of property are treated as payments for purposes of this A-11. See Q/A-12 of this section for rules on determining when such payments are considered made and the amount of such payments. See Q/A-13 of this section for special rules on transfers of statutory and nonstatutory stock options.

Q-12: If a property transfer to a disqualified individual is a payment in the nature of compensation, when is the payment considered made (or to be made), and how is the amount of the payment determined?

A-12: (a) Except as provided in this A-12 and Q/A-13 of this section, a transfer of property is considered a payment made (or to be made) in the taxable year in which the property transferred is includible in the gross income of the disqualified individual under section 83 and the regulations thereunder. Thus, in general, such a payment is considered made (or to be made) when the property is transferred (as defined in § 1.83–3(a)) to the disqualified individual and becomes substantially vested (as defined in § 1.83–3(b) and (j)) in such individual. In such case, the amount of the payment is determined under section 83 and the regulations thereunder. Thus, in general, the amount of the payment is equal to the excess of the fair market value of the transferred property (determined without regard to any lapse restriction, as defined in § 1.83–3(i)) at the time that the property becomes substantially vested, over the amount (if any) paid for the property.

(b) An election made by a disqualified individual under section 83(b) with respect to transferred property will not apply for purposes of this A-12. Thus, even if such an election is made with respect to a property transfer that is a payment in the nature of compensation, the payment is generally considered made (or to be made) when the property is transferred to and becomes substantially vested in such individual.

(c) See Q/A-13 of this section for rules on applying this A-12 to transfers of stock options.

(d) The following example illustrates the principles of this A-12:

Example. On January 1, 2006, Corporation M gives to A, a disqualified individual, a bonus of 100 shares of Corporation M stock in connection with the performance of services to Corporation M. Under the terms of the bonus arrangement, A is obligated to return the Corporation M stock to Corporation M unless the earnings of Corporation M double by January 1, 2009, or there is a change in ownership or control of Corporation M before that date. A's rights in the stock are treated as substantially nonvested (within the meaning of § 1.83–3(b)) during that period because A's rights in the stock are subject to a substantial risk of forfeiture (within the meaning of § 1.83–3(c)) and are nontransferable (within the meaning of § 1.83–3(d)). On January 1, 2008, a change in ownership or control of Corporation M occurs. On that day, the fair market value of the Corporation M stock is $250 per share. Because A's rights in the Corporation M stock become substantially vested (within the meaning of § 1.83–3(b)) on that day, the payment is considered made on that day, and the amount of the payment for purposes of this section is equal to $25,000 (100 x $250). See Q/A-38 through 41 for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Q-13: How are transfers of statutory and nonstatutory stock options treated?

A-13: (a) For purposes of this section, an option (including an option to which section 421 applies) is treated as property that is transferred not later than the time at which the option becomes substantially vested (whether or not the option has a readily ascertainable fair market value as defined in § 1.83–7(b)). Thus, for purposes of this section, the vesting of such an option is treated as a payment in the nature of compensation. The value of an option with an ascertainable fair market value at the time the option vests is determined under all the facts and circumstances in the particular case. Factors relevant to such a determination include, but are not limited to: the difference between the option's exercise price and the value of the property subject to the option at the time of vesting; the probability of the value of such property increasing or decreasing; and the length of the period during which the option can be exercised. Valuation may be determined by any method prescribed by the Commissioner in published guidance for purposes of this A-13. See Q/A-33 of this section for the treatment of options the granting or vesting of which is contingent on a change in ownership or control and that do not have an ascertainable fair market value at the time of granting or vesting.

(b) Any money or other property transferred to the disqualified individual on the

exercise, or as consideration on the sale or other disposition, of an option described in paragraph (a) of this A-13 after the time such option vests is not treated as a payment in the nature of compensation to the disqualified individual under Q/A-11 of this section. Nonetheless, the amount of the otherwise allowable deduction under section 162 or 212 with respect to such transfer is reduced by the amount of the payment described in paragraph (a) of this A-13 treated as an excess parachute payment.

Q-14: Are payments in the nature of compensation reduced by consideration paid by the disqualified individual?

A-14: Yes, to the extent not otherwise taken into account under Q/A-12 and Q/A-13 of this section, the amount of any payment in the nature of compensation is reduced by the amount of any money or the fair market value of any property (owned by the disqualified individual without restriction) that is (or will be) transferred by the disqualified individual in exchange for the payment. For purposes of the preceding sentence, the fair market value of property is determined as of the date the property is transferred by the disqualified individual.

Disqualified Individuals

Q-15: Who is a disqualified individual?

A-15: (a) For purposes of this section, an individual is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period* (as defined in Q/A-20 of this section), the individual is an employee or independent contractor of the corporation and is, with respect to the corporation —

(1) A shareholder (but see Q/A-17 of this section);

(2) An officer (see Q/A-18 of this section); or

(3) A highly-compensated individual (see Q/A-19 of this section).

(b) A director is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period* (as defined in Q/A-20 of this section), the director is an employee or independent contractor and is, with respect to the corporation, either a shareholder (see Q/A-17 of this section) or a highly-compensated individual (see Q/A-19 of this section).

Q-16: Is a personal service corporation treated as an individual?

A-16: (a) Yes. For purposes of this section, a personal service corporation (as defined in section 269A(b)(1)), or a non-corporate entity that would be a personal service corporation if it were a corporation, is treated as an individual.

(b) The following example illustrates the principles of this A-16:

Example. Corporation N, a personal service corporation (as defined in section 269A(b)(1)), has a single individual as its sole shareholder and employee. Corporation N performs personal services for Corporation M. The compensation paid to Corporation N by Corporation M puts Corporation N within the group of the highly-compensated individuals of Corporation M as determined under A-19 of this section. Thus, Corporation N is treated as a highly-compensated individual with respect to Corporation M.

Q-17: Are all shareholders of a corporation considered shareholders for purposes of paragraph (a)(1) of Q/A-15 of this section?

A-17: (a) No, only an individual who owns stock of a corporation with a fair market value that exceeds 1 percent of the fair market value of the outstanding shares of all classes of the corporation's stock is treated as a disqualified individual with respect to the corporation by reason of stock ownership. An individual who owns a lesser amount of stock may, however, be a disqualified individual with respect to the corporation if such individual is an officer or highly-compensated individual with respect to the corporation. For purposes of determining the amount of stock owned by an individual, the constructive ownership rules of section 318(a) apply.

(b) The following examples illustrates the principles of this A-17:

Example 1. E, an employee of Corporation A, received options under Corporation A's Stock Option Plan. E's stock options vest three years after the date of grant. E is not an officer or highly compensated individual during the disqualified individual determination period and does not own any other Corporation A stock. Two years after the options are granted to E, all of Corporation A's stock is acquired by Corporation B. Under Corporation A's Stock Option Plan, E's options are converted to Corporation B options and the vesting schedule remains the same. To determine whether E is a disqualified individual based on E's stock ownership, the stock underlying the unvested options held by E on the date of the change in ownership or control is not considered constructively owned by E under section 318(a). Because E does not own, or constructively own, Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A and E is not an officer or highly-compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of A-15 of this section with respect to Corporation A.

Example 2. Assume the same facts as in *Example 1* except that Corporation A's Stock Option Plan provides that all unvested options will vest immediately on a change in ownership or control. To determine whether E is a disqualified individual based on E's stock ownership, the stock underlying the options that vest on the change in ownership or control is considered constructively owned by E under section 318(a). If the stock constructively held by E exceeds 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock, E is a disqualified individual within the meaning of this A-15 of this section with respect to Corporation A.

Example 3. Assume the same facts as in *Example 1* except that E received nonstatutory stock options that are exercisable for stock subject to a substantial risk of forfeiture under section 83. Assume further that under Corporation A's Stock Option Plan, the nonstatutory options will vest on a change in ownership or control. To determine whether E is a disqualified individual based on E's stock ownership, the stock underlying the options that vest on the change in ownership or control is not considered constructively owned by E under section 318(a) because the options are exercisable for stock subject to a substantial risk of forfeiture within the meaning of section 83. Because E does not own, or constructively own, Corporation A stock with a fair market value exceeding 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock and E is not an officer or highly compensated individual during the disqualified individual determination period, E is not a disqualified individual within the meaning of A-15 of this section with respect to Corporation A.

Q-18: Who is an officer?

A-18: (a) For purposes of this section, whether an individual is an officer with respect to a corporation is determined on the basis of all the facts and circumstances in the particular case (such as the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties). Generally, the term *officer* means an administrative executive who is in regular and continued service. The term *officer* implies continuity of service and excludes those employed for a special and single transaction. An individual who merely has the title of officer but not the authority of an officer is not considered an officer for purposes of this section. Similarly, an individual who does not have the title of

officer but has the authority of an officer is considered an officer for purposes of this section.

(b) 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 of this section is treated as an officer of such one corporation.

(c) No more than 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation (in the case of an affiliated group treated as one corporation, each member of the affiliated group) are treated as disqualified individuals with respect to a corporation by reason of being an officer of the corporation. For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). If the number of officers of the corporation exceeds the number of employees who may be treated as officers under the first sentence of this paragraph (c), then the employees who are treated as officers for purposes of this section are the highest paid 50 employees (or, if less, the greater of 3 employees, or 10 percent of the employees (rounded up to the nearest integer)) of the corporation when ranked on the basis of compensation (as determined under Q/A-21 of this section) paid during the disqualified individual determination period.

Q-19: Who is a highly-compensated individual?

A-19: (a) For purposes of this section, a highly-compensated individual with respect to a corporation is any individual who is, or would be if the individual were an employee, a member of the group consisting of the lesser of the highest paid 1 percent of the employees of the corporation (rounded up to the nearest integer), or the highest paid 250 employees of the corporation, when ranked on the basis of compensation (as determined under Q/A-21 of this section) earned during the disqualified individual determination period (as defined in Q/A-20 of this section). For purposes of the preceding sentence, the number of employees of the corporation is the greatest number of employees the corporation has during the disqualified individual determination period (as defined in Q/A-20 of this section). However, no individual whose annualized compensation during the disqualified individual determination period is less than the amount described in section 414(q)(1)(B)(i) for the year in which the change in ownership or control occurs will be treated as a highly-compensated individual.

(b) 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.

(c) In determining the total number of employees of a corporation for purposes of this A-19, employees are not counted if they normally work less than 17 ½ hours per week (as defined in section 414(q)(5)(B) and the regulations thereunder) or if they normally work during not more than 6 months during any year (as defined in section 414(q)(5)(C) and the regulations thereunder). However, an employee who is not counted for purposes of the preceding sentence may still be a highly-compensated individual.

Q-20: What is the disqualified individual determination period?

A-20: The disqualified individual determination period is the twelve-month period prior to and ending on the date of the change in ownership or control of the corporation.

Q-21: How is *compensation* defined for purposes of determining who is a disqualified individual?

A-21: (a) For purposes of determining who is a disqualified individual, the term *compensation* is the compensation which was earned by the individual for services performed for the corporation with respect to which the change in ownership or control occurs (changed corporation), for a predecessor entity, or for a related entity. Such compensation is determined without regard to sections 125, 132(f)(4), 402(e)(3), and 402(h)(1)(B). Thus, for example, compensation includes elective or salary reduction contributions to a cafeteria plan, cash or deferred arrangement or tax-sheltered annuity and amounts credited under a nonqualified deferred compensation plan.

(b) For purposes of this A-21, a predecessor entity is any entity which, as a result of a merger, consolidation, purchase or acquisition of property or stock, corporate separation, or other similar business transaction transfers some or all of its employees to the changed corporation or to a related entity or to a predecessor entity of the changed corporation. The term *related entity* include —

(1) All members of a controlled group of corporations (as defined in section 414(b)) that includes the changed corporation or a predecessor entity;

(2) All trades or business (whether or not incorporated) that are under common control (as defined in section 414(c)) if such group includes the changed corporation or a predecessor entity;

(3) All members of an affiliated service group (as defined in section 414(m)) that includes the changed corporation or a predecessor entity; and

(4) Any other entities required to be aggregated with the changed corporation or a predecessor entity pursuant to section 414(o) and the regulations thereunder (except leasing organizations as defined in section 414(n)).

(c) For purposes of Q/A-18 and Q/A-19 of this section, compensation that was contingent on the change in ownership or control and that was payable in the year of the change is not treated as compensation.

Contingent on Change in Ownership or Control

Q-22: When is a payment contingent on a change in ownership or control?

A-22: (a) In general, a payment is treated as contingent on a change in ownership or control if the payment would not, in fact, have been made had no change in ownership or control occurred, even if the payment is also conditioned on the occurrence of another event. A payment generally is treated as one which would not, in fact, have been made in the absence of a change in ownership or control unless it is substantially certain, at the time of the change, that the payment

would have been made whether or not the change occurred. (But see Q/A-23 of this section regarding payments under agreements entered into after a change in ownership or control.) A payment that becomes vested as a result of a change in ownership or control is not treated as a payment which was substantially certain to have been made whether or not the change occurred. For purposes of this A-22, *vested* means the payment is substantially vested within the meaning of § 1.83–3(b) and (j) or the right to the payment is not otherwise subject to a substantial risk of forfeiture.

(b)(1) For purposes of paragraph (a), a payment is treated as contingent on a change in ownership or control if —

(i) The payment is contingent on an event that is closely associated with a change in ownership or control;

(ii) A change in ownership or control actually occurs; and

(iii) The event is materially related to the change in ownership or control.

(2) For purposes of paragraph (b)(1)(i) of this A-22, a payment is treated as contingent on an event that is closely associated with a change in ownership or control unless it is substantially certain, at the time of the event, that the payment would have been made whether or not the event occurred. An event is considered closely associated with a change in ownership or control if the event is of a type often preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control. For example, the following events are considered closely associated with a change in the ownership or control of a corporation: The onset of a tender offer with respect to the corporation; a substantial increase in the market price of the corporation's stock that occurs within a short period (but only if such increase occurs prior to a change in ownership or control); the cessation of the listing of the corporation's stock on an established securities market; the acquisition of more than 5 percent of the corporation's stock by a person (or more than one person acting as a group) not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; a significant reduction in the disqualified individual's job responsibilities; and a change in ownership or control as defined in the disqualified individual's employment agreement (or elsewhere) that does not meet the definition of a change in ownership or control described in Q/A-27, 28, or 29 of this section. Whether other events are treated as closely associated with a change in ownership or control is based on all the facts and circumstances of the particular case.

(3) For purposes of determining whether an event (as described in paragraph (b)(2) of this A-22) is materially related to a change in ownership or control, the event is presumed to be materially related to a change in ownership or control if such event occurs within the period beginning one year before and ending one year after the date of change in ownership or control. If such event occurs outside of the period beginning one year before and ending one year after the date of change in ownership or control, the event is presumed not materially related to the change in ownership or control. A payment does not fail to be contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control). Similarly, a payment that is treated as contingent on a change because it is contingent on a closely associated event does not fail to be treated as contingent on a change in ownership or control merely because it is also contingent on the occurrence of a second event (without regard to whether the second event is closely associated with or materially related to a change in ownership or control).

(c) A payment that would in fact have been made had no change in ownership or control occurred is treated as contingent on a change in ownership or control if the change in ownership or control (or the occurrence of an event that is closely associated and materially related to a change in ownership or control within the meaning of paragraph (b)(1) of this A-22), accelerates the time at which the payment is made. Thus, for example, if a change in ownership or control accelerates the time of payment of deferred compensation that is vested without regard to the change in ownership or control, the payment may be treated as contingent on the change. See Q/A-24 of this section regarding the portion of a payment that is so treated. See also Q/A-8 of this section regarding the exemption for certain payments under qualified plans and Q/A-40 of this section regarding the treatment of a payment as reasonable compensation.

(d) A payment is treated as contingent on a change in ownership or control even if the employment or independent contractor relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change.

(e) The following examples illustrate the principles of this A-22:

Example 1. A corporation grants a stock appreciation right to a disqualified individual, A, more than one year before a change in ownership or control. After the stock appreciation right vests and becomes exercisable, a change in ownership or control of the corporation occurs, and A exercises the right. Assuming neither the granting nor the vesting of the stock appreciation right is contingent on a change in ownership or control, the payment made on exercise is not contingent on the change in ownership or control.

Example 2. A contract between a corporation and B, a disqualified individual, provides that a payment will be made to B if the corporation undergoes a change in ownership or control and B's employment with the corporation is terminated at any time over the succeeding 5 years. Eighteen months later, a change in the ownership of the corporation occurs. Two years after the change in ownership, B's employment is terminated and the payment is made to B. Because it was not substantially certain that the corporation would have made the payment to B on B's termination of employment if there had not been a change in ownership, the payment is treated as contingent on the change in ownership under paragraph (a) of this A-22. This is true even though B's termination of employment is presumed not to be, and in fact may not be, materially related to the change in ownership or control.

Example 3. A contract between a corporation and C, a disqualified individual, provides that a payment will be made to C if C's employment is terminated at any time over the succeeding 3 years (without regard to whether or not there is a change in ownership or control). Eighteen months after the contract is entered into, a change in the ownership of the corporation occurs. Six months after the change in ownership, C's employment is terminated and the payment is made to C. Termination of employment is considered an event closely associated with a change in ownership or control. Because the termination occurred within one year after the date of the change in ownership, the termination of C's employment is presumed to be materially related to the change in ownership under paragraph (b)(3) of this A-22. If this presumption is not successfully rebutted, the payment will be treated as contingent on the change in ownership under paragraph (b) of this A-22.

Example 4. A contract between a corporation and a disqualified individual, D, provides that a payment will be made to D upon the onset of a tender

offer for shares of the corporation's stock. A tender offer is made on December 1, 2008, and the payment is made to D. Although the tender offer is unsuccessful, it leads to a negotiated merger with another entity on June 1, 2009, which results in a change in the ownership of the corporation. It was not substantially certain, at the time of the onset of the tender offer, that the payment would have been made had no tender offer taken place. The onset of a tender offer is considered closely associated with a change in ownership or control. Because the tender offer occurred within one year before the date of the change in ownership of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership. If no change in ownership or control had occurred, the payment would not be treated as contingent on a change in ownership or control; however, the payment still could be a parachute payment under Q/A-37 of this section if the contract violated a generally enforced securities law or regulation.

Example 5. A contract between a corporation and a disqualified individual, E, provides that a payment will be made to E if the corporation's level of product sales or profits reaches a specified level. At the time the contract was entered into, the parties had no reason to believe that such an increase in the corporation's level of product sales or profits would be preliminary or subsequent to, or otherwise closely associated with, a change in ownership or control of the corporation. Eighteen months later, a change in the ownership of the corporation occurs and within one year after the date of the change, the corporation's level of product sales or profits reaches the specified level. Under these facts and circumstances (and in the absence of contradictory evidence), the increase in product sales or profits of the corporation is not an event closely associated with the change in ownership or control of the corporation. Accordingly, even if the increase is materially related to the change, the payment will not be treated as contingent on a change in ownership or control.

Q-23: May a payment be treated as contingent on a change in ownership or control if the payment is made under an agreement entered into after the change?

A-23: (a) No, payments are not treated as contingent on a change in ownership or control if they are made (or to be made) pursuant to an agreement entered into after the change (a post-change agreement). For this purpose, an agreement that is executed after a change in ownership or control pursuant to a legally enforceable agreement that was entered into before the change is considered to have been entered into before the change. (See Q/A-9 of this section regarding the exemption for reasonable compensation for services rendered on or after a change in ownership or control.) If an individual has a right to receive a parachute payment under an agreement entered into prior to a change in ownership or control (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. To the extent payments under the agreement have the same value as the parachute payments under the pre-change agreement, such payments retain their character as parachute payments subject to this section.

(b) The following examples illustrate the principles of this A-23:

Example 1. Assume that a disqualified individual is an employee of a corporation. A change in ownership or control of the corporation occurs, and thereafter the individual enters into an employment agreement with the acquiring company. Because the agreement is entered into after the change in ownership or control occurs, payments to be made under the agreement are not treated as contingent on the change.

Example 2. Assume the same facts as in *Example 1*, except that the agreement between the disqualified individual and the acquiring company is executed after the change in ownership or control, pursuant to a legally enforceable agreement entered into before the change. Payments to be made under the agreement may be treated as contingent on the change in ownership or control pursuant to Q/A-22 of this section. However, see Q/A-9 of this section regarding the exemption from the definition of parachute payment for certain amounts of reasonable compensation.

Example 3. Assume the same facts as in *Example 1* except that prior to the change in ownership or control, the individual and corporation enter into an agreement under which the individual will receive parachute payments in the event of a change in ownership or control of the corporation. After the change, the individual agrees to give up the right to parachute payments under the pre-change agreement in exchange for compensation under a new agreement with the acquiring corporation. Because the individual gave up the right to parachute payments under the pre-change agreement in exchange for other payments under the post-change agreement, payments in an amount equal to the parachute payments under the pre-change agreement are treated as contingent on the change in ownership or control under this A-23. Because the post-change agreement was entered into after the change, payments in excess of this amount are not treated as parachute payments.

Q-24: If a payment is treated as contingent on a change in ownership or control, is the full amount of the payment so treated?

A-24: (a)(1) *General rule*. Yes, if the payment is a transfer of property, the amount of the payment is determined under Q/A-12 or Q/A-13 of this section. For all other payments, the amount of the payment is determined under Q/A-11 of this section. However, in certain circumstances, described in paragraphs (b) and (c) of this A-24, only a portion of the payment is treated as contingent on the change. Paragraph (b) of this A-24 applies to a payment that is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. Paragraph (c) of this A-24 applies to a payment that becomes vested as a result of the change in ownership or control if, without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time and if the payment is attributable, at least in part, to services performed before the date the payment becomes vested. For purposes of this A-24, for the definition of vested see Q/A-22(a).

(2) *Reduction by reasonable compensation*. The amount of a payment under paragraph (a)(1) of this A-24 is reduced by any portion of such payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services rendered by the disqualified individual on or after the date of the change of control. See Q/A-9 and Q/A-38 through 44 of this section for rules concerning reasonable compensation. The portion of an amount treated as contingent under paragraph (b) or (c) of this A-24 may not be reduced by reasonable compensation.

(b) *Vested payments*. This paragraph (b) applies if a payment is vested, without regard to the change in ownership or control, and is treated as contingent on the change in ownership or control because the change accelerates the time at which the payment is made. In such case, the portion of the payment, if any, that is treated as contingent on the change in ownership or control is the amount by which the amount of the accelerated payment exceeds the present value of the payment absent the acceleration. If the value of such a payment absent the acceleration is not reasonably ascertainable, and the acceleration of the payment does not significantly increase the present

value of the payment absent the acceleration, the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. If the value of the payment absent the acceleration is not reasonably ascertainable, but the acceleration significantly increases the present value of the payment, the future value of such payment is treated as equal to the amount of the accelerated payment. For rules on determining present value, see paragraph (e) of this A-24, Q/A-32, and Q/A-33 of this section.

(c)(1) *Nonvested payments*. This paragraph (c) applies to a payment that becomes vested as a result of the change in ownership or control to the extent that —

(i) Without regard to the change in ownership or control, the payment was contingent only on the continued performance of services for the corporation for a specified period of time; and

(ii) The payment is attributable, at least in part, to the performance of services before the date the payment is made or becomes certain to be made.

(2) The portion of the payment subject to paragraph (c) of this A-24 that is treated as contingent on the change in ownership or control is the lesser of—

(i) The amount of the accelerated payment; or

(ii) The amount described in paragraph (b) of this A-24, plus an amount, as determined in paragraph (c)(4) of this A-24, to reflect the lapse of the obligation to continue to perform services.

(3) For purposes of paragraph (c) of this A-24, the acceleration of the vesting of a stock option or the lapse of a restriction on restricted stock is considered to significantly increase the value of a payment.

(4) The amount reflecting the lapse of the obligation to continue to perform services (described in paragraph (c)(2)(ii) of this A-24) is 1 percent of the amount of the accelerated payment multiplied by the number of full months between the date that the individual's right to receive the payment is vested and the date that, absent the acceleration, the payment would have been vested. This paragraph (c)(4) applies to the accelerated vesting of a payment in the nature of compensation even if the time at which the payment is made is not accelerated.

(d) *Application of this A-24 to certain payments*. — (1) *Benefits under a nonqualified deferred compensation plan*. In the case of a payment of benefits under a nonqualified deferred compensation plan, paragraph (b) of this A-24 applies to the extent benefits under the plan are vested without regard to the change in ownership or control. Paragraph (c) of this A-24 applies to the extent benefits under the plan become vested as a result of the change in ownership or control and are attributable, at least in part, to the performance of services prior to vesting. Any other payment of benefits under a nonqualified deferred compensation plan is a payment in the nature of compensation subject to the general rule of paragraph (a) of this A-24 and the rules in Q/A-11 of this section.

(2) *Employment agreements*. The general rule of paragraph (a) of this A-24 applies to the payment of amounts due under an employment agreement on a termination of employment or a change in ownership or control that otherwise would be attributable to the performance of services (or refraining from the performance of services) during any period that begins after the date of termination of employment or change in ownership or control, as applicable. For purposes of this paragraph (d)(2) of this A-24, an employment agreement means an agreement between an employee or independent contractor and employer or service recipient which describes, among other things, the amount of compensation or remuneration payable to the employee or independent contractor. See Q/A-42(b) and 44 of this section for the treatment of the remaining amounts of salary under an employment agreement.

(3) *Vesting due to an event other than services*. Neither paragraph (b) nor (c) of this A-24 applies to a payment if (without regard to the change in ownership or control) vesting of the payment depends on an event other than the performance of services, such as the attainment of a performance goal, and the event does not occur prior to the change in ownership or control. In such circumstances, the full amount of the accelerated payment is treated as contingent on the change in ownership or control under paragraph (a) of this A-24. However, see Q/A-39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

(e) *Present value*. For purposes of this A-24, the present value of a payment is determined as of the date on which the accelerated payment is made.

(f) *Examples*. The following examples illustrate the principles of this A-24:

Example 1. (i) Corporation maintains a qualified plan and a nonqualified supplemental retirement plan (SERP) for its executives. Benefits under the SERP are not paid to participants until retirement. E, a disqualified individual with respect to Corporation, has a vested account balance of $500,000 under the SERP. A change in ownership or control of Corporation occurs. The SERP provides that in the event of a change in ownership or control, all vested accounts will be paid to SERP participants.

(ii) Because E was vested in $500,000 of benefits under the SERP prior to the change in ownership or control and the change merely accelerated the time at which the payment was made to E, only a portion of the payment, as determined under paragraph (b) of this A-24, is treated as contingent on the change. Thus, the portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment ($500,000) exceeds the present value of the payment absent the acceleration.

(iii) Assume that instead of having a vested account balance of $500,000 on the date of the change in ownership or control, E will vest in E's account balance of $500,000 in 2 years if E continues to perform services for the next 2 years. Assume further that the SERP provides that all unvested SERP benefits vest immediately on a change in ownership or control and are paid to the participants. Because the vesting of the SERP payment, without regard to the change, depends only on the performance of services for a specified period of time and the payment is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the $500,000 payment, as determined under paragraph (c) of this A-24, is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the lesser of the amount of the accelerated payment or the amount by which the accelerated payment exceeds the present value of the payment absent the acceleration, plus an amount to reflect the lapse of the obligation to continue to perform services.

(iv) Assume further that under the SERP E's vested account balance of $500,000 will be paid to E on the change in ownership or control and an additional $70,000 will be credited to E's account. Because the $500,000 was vested without regard to the change in ownership or control, paragraph (b) of this A-24 applies to the $500,000 payment. Because the $70,000 is not vested, without regard to the change, and is not attributable to the performance of

services prior to the change, the entire $70,000 payment is contingent on the change in ownership or control under paragraph (a) of this A-24.

Example 2. As a result of a change in the effective control of a corporation, a disqualified individual with respect to the corporation, D, receives accelerated payment of D's vested account balance in a nonqualified deferred compensation account plan. Actual interest and other earnings on the plan assets are credited to each account as earned before distribution. Investment of the plan assets is not restricted in such a manner as would prevent the earning of a market rate of return on the plan assets. The date on which D would have received D's vested account balance absent the change in ownership or control is uncertain, and the rate of earnings on the plan assets is not fixed. Thus, the amount of the payment absent the acceleration is not reasonably ascertainable. Under these facts, acceleration of the payment does not significantly increase the present value of the payment absent the acceleration, and the present value of the payment absent the acceleration is treated as equal to the amount of the accelerated payment. Accordingly, no portion of the payment is treated as contingent on the change.

Example 3. (i) On January 15, 2006, a corporation and a disqualified individual, F, enter into a contract providing for a retention bonus of $500,000 to be paid to F on January 15, 2011. The payment of the bonus will be forfeited by F if F does not remain employed by the corporation for the entire 5-year period. However, the contract provides that the full amount of the payment will be made immediately on a change in ownership or control of the corporation during the 5-year period. On January 15, 2009, a change in ownership or control of the corporation occurs and the full amount of the payment ($500,000) is made on that date to F. Under these facts, the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the amount of the accelerated payment (*i.e*. $500,000, the amount paid to the individual because of the change in ownership) exceeds the present value of the payment that was expected to have been made absent the acceleration (*i.e.* $406,838, the present value on January 15, 2009, of a $500,000 payment on January 15, 2011), plus $115,000 (1% x 23 months x $500,000) which is the amount reflecting the lapse of the obligation to continue to perform services. Accordingly, the amount of the payment treated as contingent on the change in ownership or control is $208,162, the sum of $93,162 ($500,000 - $406,838) + $115,000). This result is not changed if F actually remains employed until the end of the 5-year period.

(ii) Assume that the contract provides that the retention bonus will vest on a change in ownership or control, but will not be paid until January 15, 2011 (the original date in the contract). Because the payment of $500,000 was contingent only on F's performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control, only a portion of the $500,000 payment is treated as contingent on the change. Because there is no accelerated payment, the portion of the payment treated as contingent on the change is an amount reflecting the lapse of the obligation to continue to perform services which is $115,000 (1% x 23 months x $500,000).

Example 4. (i) On January 15, 2006, a corporation gives to a disqualified individual, in connection with her performance of services to the corporation, a bonus of 1,000 shares of the corporation's stock. Under the terms of the bonus arrangement, the individual is obligated to return the stock to the corporation if she terminates her employment for any reason prior to January 15, 2011. However, if there is a change in the ownership or effective control of the corporation prior to January 15, 2011, she ceases to be obligated to return the stock. The individual's rights in the stock are treated as substantially nonvested (within the meaning of § 1.83–3(b) and (j)) during that period. On January 15, 2008, a change in the ownership of the corporation occurs. On that day, the fair market value of the stock is $500,000.

(ii) Under these facts, the payment was contingent only on performance of services for a specified period and is attributable, in part, to the performance of services before the change in ownership or control. Thus, only a portion of the payment is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change is the amount by which the present value of the accelerated payment on January 15, 2009 ($500,000), exceeds the present value of the payment that was expected to have been made on January 15, 2011, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the stock would have been on January 15, 2011. The acceleration of the lapse of a restriction on stock is treated as significantly increasing the value of the payment. Therefore, the value of such stock on January 15, 2011, is deemed to be $500,000, the amount of the accelerated payment. The present value on January 15, 2009, of a $500,000 payment to be made on January 15, 2011, is $406,838. Thus, the portion of the payment treated as contingent on the change is $208,162, the sum of $93,162 ($500,000 - $406,838), plus $115,000 [1% x 23 months x $500,000], the amount reflecting the lapse of the obligation to continue to perform services.

Example 5. (i) On January 15, 2006, a corporation grants to a disqualified individual nonqualified stock options to purchase 30,000 shares of the corporation's stock. The options do not have a readily ascertainable fair market value at the time of grant. The options will be forfeited by the individual if he fails to perform personal services for the corporation until January 15, 2009. The options will, however, vest in the individual at an earlier date if there is a change in ownership or control of the corporation. On January 16, 2008, a change in the ownership of the corporation occurs and the options become vested in the individual. On January 16, 2008, the options have an ascertainable fair market value of $600,000.

(ii) The payment of the options to purchase 30,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the accelerated payment on January 16, 2008 ($600,000) exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to continue to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $600,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $600,000 payment to be made on January 15, 2009, is $549,964.13. Thus, the portion of the payment treated as contingent on the change is $116,035.87, the sum of $50,035.87 ($600,000 - $549,964.13), plus an amount reflecting the lapse of the obligation to continue to perform services which is $66,000 (1% x 11 months x $600,000).

Example 6. (i) The facts are the same as in *Example 5*, except that the options become vested periodically (absent a change in ownership of control), with one-third of the options vesting on January 15, 2007, 2008, and 2009, respectively. Thus, options to purchase 20,000 shares vest independently of the January 16, 2008, change in ownership and the options to purchase the remaining 10,000 shares vest as a result of the change.

(ii) The payment of the options to purchase 10,000 shares was contingent only on performance of services for the corporation until January 15, 2009, and is attributable, in part, to the performance of services before the change in ownership or control. Therefore, only a portion of the payment is treated as contingent on the change. The portion of the payment that is treated as contingent on the change is the amount by which the accelerated payment on January 16, 2008 ($200,000), exceeds the present value on January 16, 2008, of the payment that was expected to have been made on January 15, 2009, absent the acceleration, plus an amount reflecting the lapse of the obligation to perform services. At the time of the change, it cannot be reasonably ascertained what the value of the options would have been on January 15, 2009. The acceleration of vesting in the options is treated as significantly increasing the value of the payment. Therefore, the value of such options on January 15, 2009, is deemed to be $200,000, the amount of the accelerated payment. The present value on January 16, 2008, of a $200,000 payment to be made on January 15, 2009, is $183,328.38. Thus, the portion of the payment treated as contingent on the change is $38,671.62, the sum of $16,671.62 ($200,000 - $183,328.38), plus an amount reflecting the lapse of the obligation to continue to perform services which is $22,000 (1% x 11 months x $200,000).

Example 7. Assume the same facts as in *Example 5*, except that the option agreement provides that the options will vest either on the corporation's level of profits reaching a specified level, or if earlier, on the date on which there is a change in ownership or control of the corporation. The corporation's level of profits do not reach the specified level prior to January 16, 2008. In such case, the full

amount of the payment, $600,000, is treated as contingent on the change because it was not contingent only on performance of services for the corporation for a specified period. See Q/A-39 of this section for rules relating to the reduction of the excess parachute payment by the portion of the payment which is established to be reasonable compensation for personal services actually rendered before the date of a change in ownership or control.

Example 8. On January 1, 2002, E, a disqualified individual with respect to Corporation X, enters into an employment agreement with Corporation X under which E will be paid wages of $200,000 each year during the 5-year employment agreement. The employment agreement provides that if a change in ownership or control of Corporation X occurs, E will be paid the present value of the remaining salary under the employment agreement. On January 1, 2003, a change in ownership or control of Corporation X occurs, E is terminated, and E receives a payment of the present value of $200,000 for each of the 4 years remaining under the employment agreement. Because the payment represents future salary under an employment agreement (*i.e.*, amounts otherwise attributable to the performance of services for periods that begin after the termination of employment), the general rule of paragraph (a) of this A-24 applies to the payment. See Q/A-42(c) and 44 of this section for the treatment of the remaining payments under an employment agreement.

Presumption That Payment Is Contingent on Change

Q-25: Is there a presumption that certain payments are contingent on a change in ownership or control?

A-25: Yes, for purposes of this section, any payment is presumed to be contingent on such change unless the contrary is established by clear and convincing evidence if the payment is made pursuant to —

(a) An agreement entered into within one year before the date of a change in ownership or control; or

(b) An amendment that modifies a previous agreement in any significant respect, if the amendment is made within one year before the date of a change in ownership or control. In the case of an amendment described in paragraph (b) of this A-25, only the portion of any payment that exceeds the amount of such payment that would have been made in the absence of the amendment is presumed, by reason of the amendment, to be contingent on the change in ownership or control.

Q-26: How may the presumption described in Q/A-25 of this section be rebutted?

A-26: (a) To rebut the presumption described in Q/A-25 of this section, the taxpayer must establish by clear and convincing evidence that the payment is not contingent on the change in ownership or control. Whether the payment is contingent on such change is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to the content of the agreement or amendment and the circumstances surrounding the execution of the agreement or amendment, such as whether it was entered into at a time when a takeover attempt had commenced and the degree of likelihood that a change in ownership or control would actually occur. However, even if the presumption is rebutted with respect to an agreement, some or all of the payments under the agreement may still be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

(b) In the case of an agreement described in paragraph (a) of Q/A-25 of this section, clear and convincing evidence that the agreement is one of the three following types will generally rebut the presumption that payments under the agreement are contingent on the change in ownership or control —

(1) A *nondiscriminatory employee plan or program* as defined in paragraph (c) of this A-26;

(2) A contract between a corporation and an individual that replaces a prior contract entered into by the same parties more than one year before the change in ownership or control, if the new contract does not provide for increased payments (apart from normal increases attributable to increased responsibilities or cost of living adjustments), accelerate the payment of amounts due at a future time, or modify (to the individual's benefit) the terms or conditions under which payments will be made; or

(3) A contract between a corporation and an individual who did not perform services for the corporation prior to the one year period before the change in ownership or control occurs, if the contract does not provide for payments that are significantly different in amount, timing, terms, or conditions from those provided under contracts entered into by the corporation (other than contracts that themselves were entered into within one year before the change in ownership or control and in contemplation of the change) with individuals performing comparable services.

(c) For purposes of this section, the term *nondiscriminatory employee plan or program* means: a group term life insurance plan that meets the requirements of section 79(d); a self insured medical reimbursement plan that meets the requirements of section 105(h); a cafeteria plan (within the meaning of section 125); an educational assistance program (within the meaning of section 127); a dependent care assistance program (within the meaning of section 129); or a no-additional-cost service (within the meaning of section 132(b)) or qualified employee discount (within the meaning of section 132(c)); and an adoption assistance program (within the meaning of section 137). Payments under certain other plans are exempt from the definition of *parachute payment* under Q/A-8 of this section.

(d) The following examples illustrate the application of the presumption:

Example 1. A corporation and a disqualified individual who is an employee of the corporation enter into an employment contract. The contract replaces a prior contract entered into by the same parties more than one year before the change and the new contract does not provide for any increased payments other than a cost of living adjustment, does not accelerate the payment of amounts due at a future time, and does not modify (to the individual's benefit) the terms or conditions under which payments will be made. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section. However, payments under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example 2. Assume the same facts as in *Example 1*, except that the contract is entered into after a tender offer for the corporation's stock had commenced and it was likely that a change in ownership would occur and the contract provides for a substantial bonus payment to the individual upon his signing the contract. The individual has performed services for the corporation for many years, but previous employment contracts between the corporation and the individual did not provide for a similar signing bonus. One month after the contract is entered into, a change in the ownership of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership even though the bonus payment would have been legally required even if no change had occurred. Clear and convincing evidence of these facts rebuts the presumption described in A-25 of this section with respect to all of the payments under

the contract with the exception of the bonus payment (which is treated as contingent on the change). However, payments other than the bonus under the contract still may be contingent on the change in ownership or control pursuant to Q/A-22 of this section.

Example 3. A corporation and a disqualified individual, who is an employee of the corporation, enter into an employment contract within one year of a change in ownership of the corporation. Under the contract, in the event of a change in ownership or control and subsequent termination of employment, certain payments will be made to the individual. A change in ownership occurs, but the individual is not terminated until 2 years after the change. If clear and convincing evidence does not rebut the presumption described in A-25 of this section, because the payment is made pursuant to an agreement entered into within one year of the date of the change in ownership, the payment is presumed contingent on the change under A-25 of this section. This is true even though A's termination of employment is presumed not to be materially related to the change in ownership or control under Q/A-22 of this section.

Change in Ownership or Control

Q-27: When does a change in the ownership of a corporation occur?

A-27: (a) For purposes of this section, a change in the ownership or control of a corporation occurs on the date that any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person or group, owns more than 50 percent of the total fair market value or total voting power of the stock of such corporation. However, if any one person, or more than one person acting as a group, is considered to own more than 50 percent of the total fair market value or total voting power of the stock of a corporation, the acquisition of additional stock by the same person or persons is not considered to cause a change in the ownership of the corporation (or to cause a change in the effective control of the corporation (within the meaning of Q/A-28 of this section)). An increase in the percentage of stock owned by any one person, or persons acting as a group, as a result of a transaction in which the corporation acquires its stock in exchange for property will be treated as an acquisition of stock for purposes of this section.

(b) For purposes of paragraph (a) of this A-27, 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 an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both entities that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in an entity only to the extent of his ownership in that entity prior to the transaction giving rise to the change and not with respect to his ownership interest in the other entity.

(c) For purposes of this A-27, section 318(a) applies to determine stock ownership.

(d) The following examples illustrate the principles of this A-27:

Example 1. Corporation M has owned stock with a fair market value equal to 19 percent of the value of the stock of Corporation N (an otherwise unrelated corporation) for many years prior to 2006. Corporation M acquires additional stock with a fair market value equal to 15 percent of the value of the stock of Corporation N on January 1, 2006, and an additional 18 percent on February 21, 2007. As of February 21, 2007, Corporation M has acquired stock with a fair market value greater than 50 percent of the value of the stock of Corporation N. Thus, a change in the ownership of Corporation N is considered to occur on February 21, 2007 (assuming that Corporation M did not have effective control of Corporation N immediately prior to the acquisition on that date).

Example 2. All of the corporation's stock is owned by the founders of the corporation. The board of directors of the corporation decides to offer shares of the corporation to the public. After the public offering, the founders of the corporation own a total of 40 percent of the corporation's stock, and members of the public own 60 percent. If no one person (or more than one person acting as a group) owns more than 50 percent of the corporation's stock (by value or voting power) after the public offering, there is no change in the ownership of the corporation.

Example 3. Corporation P merges into Corporation O (a previously unrelated corporation). In the merger, the shareholders of Corporation P receive Corporation O stock in exchange for their Corporation P stock. Immediately after the merger, the former shareholders of Corporation P own stock with a fair market value equal to 60 percent of the value of the stock of Corporation O, and the former shareholders of Corporation O own stock with a fair market value equal to 40 percent of the value of the stock of Corporation O. The former shareholders of Corporation P will be treated as acting as a group in their acquisition of Corporation O stock. Thus, a change in the ownership of Corporation O occurs on the date of the merger.

Example 4. Assume the same facts as in *Example 3* except that immediately after the change, the former shareholders of Corporation P own stock with a fair market value of 51 percent of the value of Corporation O stock and the former shareholders of Corporation O own stock with a fair market value equal to 49 percent of the value of Corporation O stock. Assume further that prior to the merger several Corporation P shareholders also owned Corporation O stock (overlapping shareholders) with a fair market value of 5 percent of the value of Corporation O stock. The overlapping shareholders consist of Mutual Company A Growth Fund, which prior to the transaction owns 3 percent of the value of Corporation O stock, Mutual Company A Income Fund, which prior to the transaction owns 1 percent of the value of Corporation O stock, and B, an individual who prior to the transaction owns 1 percent of the value of Corporation O stock. Growth Fund and Income Fund are treated as separate shareholders with respect to their ownership interests in Corporation O and Corporation P. The overlapping shareholders are not treated as acting as a group with the Corporation P shareholders with respect to the Corporation O stock each overlapping shareholder held before the transaction. Instead, the overlapping shareholders are treated as acting as a group separately with respect to Corporation O and Corporation P. Because the former shareholders of Corporation O are treated as acting as a group with respect to other Corporation O shareholders only to the extent of their ownership interest in Corporation O and not with respect to their ownership interest in Corporation P, a change in the ownership of Corporation O occurs on the date of the merger.

Example 5. A, an individual, owns stock with a fair market value equal to 20 percent of the value of the stock of Corporation Q. On January 1, 2007, Corporation Q acquires in a redemption for cash all of the stock held by shareholders other than A. Thus, A is left as the sole shareholder of Corporation O. A change in ownership of Corporation O is considered to occur on January 1, 2007 (assuming that A did not have effective control of Corporation Q immediately prior to the redemption).

Example 6. Assume the same facts as in *Example 5*, except that A owns stock with a fair market value equal to 51 percent of the value of all the stock of Corporation Q immediately prior to the redemption. There is no change in the ownership of Corporation Q as a result of the redemption.

Q-28: When does a change in the effective control of a corporation occur?

A-28: (a) For purposes of this section, a change in the effective control of a corporation is presumed to occur on the date that either —

(1) Any one person, or more than one person acting as a group, acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) ownership of stock of the corporation possessing 20 percent or more of the total voting power of the stock of such corporation; or

(2) A majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the members of the corporation's board of directors prior to the date of the appointment or election.

(b) The presumption of paragraph (a) of this A-28 may be rebutted by establishing that such acquisition or acquisitions of the corporation's stock, or such replacement of the majority of the members of the corporation's board of directors, does not transfer the power to control (directly or indirectly) the management and policies of the corporation from any one person (or more than one person acting as a group) to another person (or group). For purposes of this section, in the absence of an event described in paragraph (a)(1) or (2) of this A-28, a change in the effective control of a corporation is presumed not to have occurred.

(c) If any one person, or more than one person acting as a group, is considered to effectively control a corporation (within the meaning of this A-28), the acquisition of additional control of the corporation by the same person or persons is not considered to cause a change in the effective control of the corporation (or to cause a change in the ownership of the corporation within the meaning of Q/A-27 of this section).

(d) For purposes of this A-28, 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 an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both entities that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in an entity only to the extent of his ownership in that entity prior to the transaction giving rise to the change and not with respect to his ownership interest in the other entity.

(e) Section 318(a) applies to determine stock ownership for purposes of this A-28.

(f) The following examples illustrate the principles of this A-28:

Example 1. Shareholder A acquired the following percentages of the voting stock of Corporation M (an otherwise unrelated corporation) on the following dates: 16 percent on January 1, 2005; 10 percent on January 10, 2006; 8 percent on February 10, 2006; 11 percent on March 1, 2007; and 8 percent on March 10, 2007. Thus, on March 10, 2007, A owns a total of 53 percent of M's voting stock. Because A did not acquire 20 percent or more of M's voting stock during any 12-month period, there is no presumption of a change in effective control pursuant to paragraph (a)(1) of this A-28. In addition, under these facts there is a presumption that no change in the effective control of Corporation M occurred. If this presumption is not rebutted (and thus no change in effective control of Corporation M is treated as occurring prior to March 10, 2007), a change in the ownership of Corporation M is treated as having occurred on March 10, 2007 (pursuant to Q/A-27 of this section), because A had acquired more than 50 percent of Corporation M's voting stock as of that date.

Example 2. A minority group of shareholders of a corporation opposes the practices and policies of the corporation's current board of directors. A proxy contest ensues. The minority group presents its own slate of candidates for the board at the next annual meeting of the corporation's shareholders, and candidates of the minority group are elected to replace a majority of the current members of the board. A change in the effective control of the corporation is presumed to have occurred on the date the election of the new board of directors becomes effective.

Q-29: When does a change in the ownership of a substantial portion of a corporation's assets occur?

A-29: (a) For purposes of this section, 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, 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.

(b) A transfer of assets by a corporation is not treated as a change in the ownership of such assets if the assets are transferred to —

(1) A shareholder of the corporation (immediately before the asset transfer) in exchange for or with respect to its stock;

(2) An entity, 50 percent or more of the total value or voting power of which is owned, directly or indirectly, by the corporation;

(3) A person, or more than one person acting as a group, that owns, directly or indirectly, 50 percent or more of the total value or voting power of all the outstanding stock of the corporation; or

(4) An entity, at least 50 percent of the total value or voting power is owned, directly or indirectly, by a person described in paragraph (b)(3) of this A-29.

(c) For purposes of paragraph (b) and except as otherwise provided, a person's status is determined immediately after the transfer of the assets. For example, a transfer of assets pursuant to a complete liquidation of a corporation, a redemption of a shareholder's interest, or a transfer to a majority-owned subsidiary of the corporation is not treated as a change in the ownership of the assets of the transferor corporation.

(d) For purposes of this A-29, 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 an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both entities that enter into a merger, consolidation, purchase or acquisition of stock, or similar transaction, such shareholder is considered to be acting as a group with other shareholders in an entity only to the extent of his ownership in that entity prior to the transaction giving rise to the change and not with respect to his ownership interest in the other entity.

(e) For purposes of this A-29, section 318(a) applies in determining stock ownership.

(f) The following examples illustrate the principles of this A-29:

Example 1. Corporation M acquires assets having a gross fair market value of $500,000 from Corporation N (an unrelated corporation) on January 1, 2006. The total gross fair market value of Corporation N's assets immediately prior to the acquisition was $3 million. Since the value of the assets acquired by Corporation M is less than one-third of the fair market value of Corporation N's total assets

immediately prior to the acquisition, the acquisition does not represent a change in the ownership of a substantial portion of Corporation N's assets.

Example 2. Assume the same facts as in *Example 1*. Also assume that on November 1, 2006, Corporation M acquires from Corporation N additional assets having a fair market value of $700,000. Thus, Corporation M has acquired from Corporation N assets worth a total of $1.2 million during the 12-month period ending on November 1, 2006. Since $1.2 million is more than one-third of the total gross fair market value of all of Corporation N's assets immediately prior to the earlier of these acquisitions ($3 million), a change in the ownership of a substantial portion of Corporation N's assets is considered to have occurred on November 1, 2006.

Example 3. All of the assets of Corporation P are transferred to Corporation O (an unrelated corporation). In exchange, the shareholders of Corporation P receive Corporation O stock. Immediately after the transfer, the former shareholders of Corporation P own 60 percent of the fair market value of the outstanding stock of Corporation O and the former shareholders of Corporation O own 40 percent of the fair market value of the outstanding stock of Corporation O. Because Corporation O is an entity more than 50 percent of the fair market value of the outstanding stock of which is owned by the former shareholders of Corporation P (based on ownership of Corporation P prior the change), the transfer of assets is not treated as a change in ownership of a substantial portion of the assets of Corporation P. However, a change in the ownership (within the meaning of Q/A-27) of Corporation O occurs.

Three-Times-Base-Amount Test for Parachute Payments

Q-30: Are all payments that are in the nature of compensation, are made to a disqualified individual, and are contingent on a change in ownership or control, parachute payments?

A-30: (a) No, to determine whether such payments are parachute payments, they must be tested against the individual's *base amount* (as defined in Q/A-34 of this section). To do this, the aggregate present value of all payments in the nature of compensation that are made or to be made to (or for the benefit of) the same disqualified individual and are contingent on the change in ownership or control must be determined. If this aggregate present value equals or exceeds the amount equal to 3 times the individual's base amount, the payments are parachute payments. If this aggregate present value is less than the amount equal to 3 times the individual's base amount, no portion of the payment is a parachute payment. See Q/A-31, Q/A-32, and Q/A-33 of this section for rules on determining present value. Parachute payments that are securities violation parachute payments are not included in the foregoing computation if they are not contingent on a change in ownership or control. See Q/A-37 of this section for the definition and treatment of securities violation parachute payments.

(b) The following examples illustrate the principles of this A-30:

Example 1. A is a disqualified individual with respect to Corporation M. A's base amount is $100,000. Payments in the nature of compensation that are contingent on a change in the ownership of Corporation M totaling $400,000 are made to A on the date of the change. The payments are parachute payments since they have an aggregate present value at least equal to 3 times A's base amount of $100,000 (3 X $100,000 = $300,000).

Example 2. Assume the same facts as in *Example 1*, except that the payments contingent on the change in the ownership of Corporation M total $290,000. Since the payments do not have an aggregate present value at least equal to 3 times A's base amount, no portion of the payments is a parachute payment.

Q-31: As of what date is the present value of a payment determined?

A-31: (a) Except as provided in this section, the present value of a payment is determined as of the date on which the change in ownership or control occurs, or, if a payment is made prior to such date, the date on which the payment is made.

(b)(1) For purposes of determining whether a payment is a parachute payment, if a payment in the nature of compensation is the right to receive payments in a year (or years) subsequent to the year of the change in ownership or control, the value of the payment is the present value of such payment (or payments) calculated in accordance with Q/A-32 of this section and based on reasonable actuarial assumptions.

(2) If the payment in the nature of compensation is an obligation to provide health care, then for purposes of this A-31 and for applying the 3-times-base-amount test under Q/A-30 of this section, the present value of such obligation should be calculated in accordance with generally accepted accounting principles. For purposes of Q/A-30 and this A-31, the obligation to provide health care is permitted to be measured by projecting the cost of premiums for purchased health care insurance, even if no health care insurance is actually purchased. If the obligation to provide health care is made in coordination with a health care plan that the corporation makes available to a group, then the premiums used for this purpose may be group premiums.

Q-32: What discount rate is to be used to determine present value?

A-32: For purposes of this section, present value generally is determined by using a discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and the regulations thereunder) compounded semiannually. The applicable Federal rate to be used for this purpose is the Federal rate that is in effect on the date as of which the present value is determined. See Q/A-24 and 31 of this section. However, for any payment, the corporation and the disqualified individual may elect to use the applicable Federal rate that is in effect on the date that the contract which provides for the payment is entered into, if such election is made in the contract.

Q-33: If the present value of a payment to be made in the future is contingent on an uncertain future event or condition, how is the present value of the payment determined?

A-33: (a) In certain cases, it may be necessary to apply the 3-times-base-amount test of Q/A-30 of this section or to allocate a portion of the base amount to a payment described in paragraphs (a)(1), (2), and (3) of Q/A-2 of this section at a time when the aggregate present value of all such payments cannot be determined with certainty because the time, amount, or right to receive one or more such payments is contingent on the occurrence of an uncertain future event or condition. For example, a disqualified individual's right to receive a payment may be contingent on the involuntary termination of such individual's employment with the corporation. In such a case, 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.

(b) If the estimate made under paragraph (a) of this A-33 is later determined to be incorrect, the 3-times-base-amount

test described in Q/A-30 of this section must be reapplied (and the portion of the base amount allocated to previous payments must be reallocated (if necessary) to such payments) to reflect the actual time and amount of the payment. Whenever the 3-times-base-amount test is applied (or whenever the base amount is allocated), the aggregate present value of the payments received or to be received by the disqualified individual is redetermined as of the date described in A-31 of this section, using the discount rate described in A-32 of this section. This redetermination may affect the amount of any excess parachute payment for a prior taxable year. Alternatively, if, based on the application of the 3-times-base-amount test without regard to the payment described in paragraph (a) of this A-33, a disqualified individual is determined to have an excess parachute payment or payments, then the 3-times-base-amount test does not have to be reapplied when a payment described in paragraph (a) of this A-33 is made (or becomes certain to be made) if no base amount is allocated to such payment.

(c) The following examples illustrate the principles of this A-33:

Example 1. A, a disqualified individual with respect to Corporation M, has a base amount of $100,000. Under A's employment agreement with Corporation M, A is entitled to receive a payment in the nature of compensation in the amount of $250,000 contingent on a change in ownership or control of Corporation M. In addition, the agreement provides that if A's employment is terminated within 1 year after the change in ownership or control, A will receive an additional payment in the nature of compensation in the amount of $150,000, payable 1 year after the date of the change in ownership or control. A change in ownership or control of Corporation M occurs and A receives the first payment of $250,000. Corporation M reasonably estimates that there is a 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test (and if the first payment is determined to be a parachute payment, for purposes of allocating a portion of A's base amount to that payment), because M reasonably estimates that there is a 50-percent or greater probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the $150,000 payment will be made to A as a result of the change in ownership or control. The present value of the additional payment is determined under Q/A-31 and Q/A-32 of this section.

Example 2. Assume the same facts as in *Example 1* except that Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change. For purposes of applying the 3-times-base-amount test, because Corporation M reasonably estimates that there is a less than 50-percent probability that, as a result of the change, A's employment will be terminated within 1 year of the date of the change, Corporation M must assume that the $150,000 payment will not be made to A as a result of the change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation P, has a base amount of $200,000. Under B's employment agreement with Corporation P, if there is a change in ownership or control of Corporation P, B will receive a severance payment of $600,000 and a bonus payment of $400,000. In addition, the agreement provides that if B's employment is terminated within 1 year after the change, B will receive an additional payment in the nature of compensation of $500,000. A change in ownership or control of Corporation P occurs, and B receives the $600,000 and $400,000 payments. At the time of the change in ownership or control, Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the change. For purposes of applying the 3-times-base-amount test, because Corporation P reasonably estimates that there is a less than 50-percent probability that B's employment will be terminated within 1 year of the date of the change, Corporation P assumes that the $500,000 payment will not be made to B. Eleven months after the change in ownership or control, B's employment is terminated, and the $500,000 payment is made to B. Because B was determined to have excess parachute payments without regard to the $500,000 payment, the 3-times-base-amount test is not reapplied and the base amount is not reallocated to include the $500,000 payment. The entire $500,000 payment is treated as an excess parachute payment.

Q-34: What is the base amount?

A-34: (a) The base amount of a disqualified individual is the average annual compensation for services performed for the corporation with respect to which the change in ownership or control occurs (or for a predecessor entity or a related entity) which was includible in the gross income of such individual for taxable years in the base period (including amounts that were excluded under section 911), or which would have been includible in such gross income if such person had been a United States citizen or resident. See Q/A-35 of this section for the definition of base period and for examples of base amount computations.

(b) If the base period of a disqualified individual includes a short taxable year or less than all of a taxable year, compensation for such short or incomplete taxable year must be annualized before determining the average annual compensation for the base period. In annualizing compensation, the frequency with which payments are expected to be made over an annual period must be taken into account. Thus, any amount of compensation for such a short or incomplete taxable year that represents a payment that will not be made more often than once per year is not annualized.

(c) Because the base amount includes only compensation that is includible in gross income, the base amount does not include certain items that constitute parachute payments. For example, payments in the form of excludible fringe benefits are not included in the base amount but may be treated as parachute payments.

(d) The base amount includes the amount of compensation included in income under section 83(b) during the base period.

(e) The following example illustrates the principles of this A-34:

Example. A disqualified individual, D, receives an annual salary of $500,000 per year during the 5-year base period. D defers $100,000 of D's salary each year under the corporation's nonqualified deferred compensation plan. D's base amount is $400,000 ($400,000 x (5/5)).

Q-35: What is the base period?

A-35: (a) The base period of a disqualified individual is the most recent 5 taxable years of the individual ending before the date of the change in ownership or control. For this purpose, the date of the change in ownership or control is the date the corporation experiences one of the events described in Q/A-27, Q/A-28, or Q/A-29 of this section. However, if the disqualified individual was not an employee or independent contractor of the corporation with respect to which the change in ownership or control occurs (or a predecessor entity or a related entity as defined in Q/A-21 of this section) for this entire 5-year period, the individual's base period is the portion of such 5-year period during which the individual performed personal services for the corporation or predecessor entity or related entity.

(b) The following examples illustrate the principles of Q/A-34 of this section and this Q/A-35:

Example 1. A disqualified individual, D, was employed by a corporation for 2 years and 4 months preceding the taxable year in which a change in ownership or control of the corporation occurs. D's includible compensation income from the corporation was $30,000 for the 4-month period, $120,000 for the first full year, and $150,000 for the second full year. D's base amount is $120,000, ((3 x $30,000) + $120,000 + $150,000) / 3.

Example 2. Assume the same facts as in *Example 1,* except that D also received a $60,000 signing bonus when D's employment with the corporation commenced at the beginning of the 4-month period. D's base amount is $140,000, (($60,000 + (3 x $30,000)) + $120,000 + $150,000) / 3. Since the bonus will not be paid more often than once per year, the amount of the bonus is not increased in annualizing D's compensation for the 4-month period.

Q-36: How is the base amount determined in the case of a disqualified individual who did not perform services for the corporation (or a predecessor entity or a related entity as defined in Q/A-21 of this section), prior to the individual's taxable year in which the change in ownership or control occurs?

A-36: (a) In such a case, the individual's base amount is the annualized compensation for services performed for the corporation (or a predecessor entity or related entity) which —

(1) Was includible in the individual's gross income for that portion, prior to such change, of the individual's taxable year in which the change occurred (including amounts that were excluded under section 911), or would have been includible in such gross income if such person had been a United States citizen or resident;

(2) Was not contingent on the change in ownership or control; and

(3) Was not a securities violation parachute payment.

(b) The following examples illustrate the principles of this A-36:

Example 1. On January 1, 2006, A, an individual whose taxable year is the calendar year, enters into a 4-year employment contract with Corporation M as an officer of the corporation. A has not previously performed services for Corporation M (or any predecessor entity or related entity as defined in Q/A-21 of this section). Under the employment contract, A is to receive an annual salary of $120,000 for each of the 4 years that he remains employed by Corporation M with any remaining unpaid balance to be paid immediately in the event that A's employment is terminated without cause. On July 1, 2006, after A has received compensation of $60,000, a change in the ownership of Corporation M occurs. Because of the change, A's employment is terminated without cause, and he receives a payment of $420,000. It is established by clear and convincing evidence that the $60,000 in compensation is not contingent on the change in ownership or control, but the presumption that the $420,000 payment is contingent on the change is not rebutted. Thus, the payment of $420,000 is treated as contingent on the change in ownership of Corporation M. In this case, A's base amount is $120,000 (2 X $60,000). Since the present value of the payment which is contingent on the change in ownership of Corporation M ($420,000) is more than 3 times A's base amount of $120,000 (3 X $120,000 = $360,000), the payment is a parachute payment.

Example 2. Assume the same facts as in *Example 1,* except that A also receives a signing bonus of $50,000 from Corporation M on January 1, 2006. It is established by clear and convincing evidence that the bonus is not contingent on the change in ownership. When the change in ownership occurs on July 1, 2006, A has received compensation of $110,000 (the $50,000 bonus plus $60,000 in salary). In this case, A's base amount is $170,000 [$50,000 + (2 X $60,000)]. Since the $50,000 bonus will not be paid more than once per year, the amount of the bonus is not increased in annualizing A's compensation. The present value of the potential parachute payment ($420,000) is less than 3 times A's base amount of $170,000 (3 X $170,000 = $510,000), and therefore no portion of the payment is a parachute payment.

Securities Violation Parachute Payments

Q-37: Must a payment be contingent on a change in ownership or control in order to be a parachute payment?

A-37: (a) No, the term *parachute payment* also includes any payment (other than a payment exempted under Q/A-6 or Q/A-8 of this section) that is in the nature of compensation and is to (or for the benefit of) a disqualified individual, if such payment is a securities violation payment. A securities violation payment is a payment made or to be made —

(1) Pursuant to an agreement that violates any generally enforced Federal or State securities laws or regulations; and

(2) In connection with a potential or actual change in ownership or control.

(b) A violation is not taken into account under paragraph (a)(1) of this A-37 if it is merely technical in character or is not materially prejudicial to shareholders or potential shareholders. Moreover, a violation will be presumed not to exist unless the existence of the violation has been determined or admitted in a civil or criminal action (or an administrative action by a regulatory body charged with enforcing the particular securities law or regulation) which has been resolved by adjudication or consent. Parachute payments described in this A-37 are referred to in this section as securities violation payments.

(c) Securities violation parachute payments that are not contingent on a change in ownership or control within the meaning of Q/A-22 of this section are not taken into account in applying the 3-times-base-amount test of Q/A-30 of this section. Such payments are considered parachute payments regardless of whether such test is met with respect to the disqualified individual (and are included in allocating base amount under Q/A-38 of this section). Moreover, the amount of a securities violation parachute payment treated as an excess parachute payment shall not be reduced by the portion of such payment that is reasonable compensation for personal services actually rendered before the date of a change in ownership or control if such payment is not contingent on such change. Likewise, the amount of a securities violation parachute payment includes the portion of such payment that is reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control if such payment is not contingent on such change.

(d) The rules in paragraph (b) of this A-37 also apply to securities violation parachute payments that are contingent on a change in ownership or control if the application of these rules results in greater total excess parachute payments with respect to the disqualified individual than would result if the payments were treated simply as payments contingent on a change in ownership or control (and hence were taken into account in applying the 3-times-base-amount test and were reduced by, or did not include, any applicable amount of reasonable compensation).

(e) The following examples illustrate the principles of this A-37:

Example 1. A, a disqualified individual with respect to Corporation M, receives two payments in the nature of compensation that are contingent on a change in the ownership or control of Corporation M. The present value of the first payment is equal to A's base amount and is not a securities violation parachute payment. The present value of the second payment is equal to 1.5 times A's base amount and is a securities violation parachute payment. Neither payment includes any reasonable compensation. If the second payment is treated simply as a payment contingent on a change in ownership or control, the amount of A's total excess parachute payments is zero because the aggregate present value of the payments does not equal or exceed 3 times A's base amount. If the second payment is treated as a securities violation parachute payment subject to the rules of paragraph (b) of this A-37, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated as a securities violation parachute payment.

Example 2. Assume the same facts as in *Example 1,* except that the present value of the first payment is equal to 2 times A's base amount. If the

second payment is treated simply as a payment contingent on a change in ownership or control, the total present value of the payments is 3.5 times A's base amount, and the amount of A's total excess parachute payments is 2.5 times A's base amount. If the second payment is treated as a securities violation parachute payment, the amount of A's total excess parachute payments is 0.5 times A's base amount. Thus, the second payment is treated simply as a payment contingent on a change in ownership or control.

Example 3. B, a disqualified individual with respect to Corporation N, receives two payments in the nature of compensation that are contingent on a change in the control of Corporation N. The present value of the first payment is equal to 4 times B's base amount and is a securities violation parachute payment. The present value of the second payment is equal to 2 times B's base amount and is not a securities violation parachute payment. B establishes by clear and convincing evidence that the entire amount of the first payment is reasonable compensation for personal services to be rendered after the change in ownership or control. If the first payment is treated simply as a payment contingent on a change in ownership or control, it is exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section. Thus, the amount of B's total excess parachute payment is zero because the present value of the second payment does not equal or exceed three times B's base amount. However, if the first payment is treated as a securities violation parachute payment, the amount of B's total excess parachute payments is 3 times B's base amount. Thus, the first payment is treated as a securities violation parachute payment.

Example 4. Assume the same facts as in *Example 3*, except that B does not receive the second payment and B establishes by clear and convincing evidence that the first payment is reasonable compensation for services actually rendered before the change in the control of Corporation N. If the payment is treated simply as a payment contingent on a change in ownership or control, the amount of B's excess parachute payment is zero because the amount treated as an excess parachute payment is reduced by the amount that B establishes as reasonable compensation. However, if the payment is treated as a securities violation parachute payment, the amount of B's excess parachute payment is 3 times B's base amount. Thus, the payment is treated as a securities violation parachute payment.

Computation and Reduction of Excess Parachute Payments

Q-38: How is the amount of an excess parachute payment computed?

A-38: (a) The amount of an excess parachute payment is the excess of the amount of any parachute payment over the portion of the disqualified individual's base amount that is allocated to such payment. For this purpose, the portion of the base amount allocated to any parachute payment is the amount that bears the same ratio to the base amount as the present value of such parachute payment bears to the aggregate present value of all parachute payments made or to be made to (or for the benefit of) the same disqualified individual. Thus, the portion of the base amount allocated to any parachute payment is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments. See Q/A-31, Q/A-32, and Q/A-33 of this section for rules on determining present value and Q/A-34 of this section for the definition of *base amount*.

(b) The following example illustrates the principles of this A-38:

Example. An individual with a base amount of $100,000 is entitled to receive two parachute payments, one of $200,000 and the other of $400,000. The $200,000 payment is made at the time of the change in ownership or control, and the $400,000 payment is to be made at a future date. The present value of the $400,000 payment is $300,000 on the date of the change in ownership or control. The portions of the base amount allocated to these payments are $40,000 (($200,000/$500,000) x $100,000) and $60,000 (($300,000/$500,000) x $100,000), respectively. Thus, the amount of the first excess parachute payment is $160,000 ($200,000 - $40,000) and that of the second is $340,000 ($400,000 - $60,000).

Q-39: May the amount of an excess parachute payment be reduced by reasonable compensation for personal services actually rendered before the change in ownership or control?

A-39: (a) Generally, yes, except that in the case of payments treated as securities violation parachute payments or when the portion of a payment that is treated as contingent on the change in ownership or control is determined under paragraph (b) or (c) of Q/A-24 of this section, the amount of an excess parachute payment is reduced by any portion of the payment that the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Services reasonably compensated for by payments that are not parachute payments (for example, because the payments are not contingent on a change in ownership or control and are not securities violation parachute payments, or because the payments are exempt from the definition of parachute payment under Q/A-6 through Q/A-9 of this section) are not taken into account for this purpose. The portion of any parachute payment that is established as reasonable compensation is first reduced by the portion of the disqualified individual's base amount that is allocated to such parachute payment; any remaining portion of the parachute payment established as reasonable compensation then reduces the excess parachute payment.

(b) The following examples illustrate the principles of this A-39:

Example 1. Assume that a parachute payment of $600,000 is made to a disqualified individual, and the portion of the individual's base amount that is allocated to the parachute payment is $100,000. Also assume that $300,000 of the $600,000 parachute payment is established as reasonable compensation for personal services actually rendered by the disqualified individual before the date of the change in ownership or control. Before the reasonable compensation is taken into account, the amount of the excess parachute payment is $500,000 ($600,000 - $100,000). In reducing the excess parachute payment by reasonable compensation, the portion of the parachute payment that is established as reasonable compensation ($300,000) is first reduced by the portion of the disqualified individual's base amount that is allocated to the parachute payment ($100,000), and the remainder ($200,000) then reduces the excess parachute payment. Thus, in this case, the excess parachute payment of $500,000 is reduced by $200,000 of reasonable compensation.

Example 2. Assume the same facts as in *Example 1*, except that the full amount of the $600,000 parachute payment is established as reasonable compensation. In this case, the excess parachute payment of $500,000 is reduced to zero by $500,000 of reasonable compensation. As a result, no portion of any deduction for the payment is disallowed by section 280G, and no portion of the payment is subject to the 20-percent excise tax of section 4999.

Determination of Reasonable Compensation

Q-40: How is it determined whether payments are reasonable compensation?

A-40: (a) In general, whether payments are reasonable compensation for personal services actually rendered, or to be rendered, by the disqualified individual is determined on the basis of all the facts and circumstances of the particular case. Factors relevant to such a determination include, but are not limited to, the following —

(1) The nature of the services rendered or to be rendered;

(2) The individual's historic compensation for performing such services; and

(3) The compensation of individuals performing comparable services in situations where the compensation is not contingent on a change in ownership or control.

(b) For purposes of section 280G, reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete).

Q-41: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services?

A-41: Yes. A showing that payments are made under a nondiscriminatory employee plan or program (as defined in Q/A-26 of this section) generally is considered to be clear and convincing evidence that the payments are reasonable compensation. This is true whether the personal services for which the payments are made are actually rendered before, or to be rendered on or after, the date of the change in ownership or control. Q/A-46 of this section (relating to the treatment of an affiliated group as one corporation) does not apply for purposes of this A-41. No determination of reasonable compensation is needed for payments under qualified plans to be exempt from the definition of *parachute payment* under Q/A-8 of this section.

Q-42: Is any particular type of evidence generally considered clear and convincing evidence of reasonable compensation for personal services to be rendered on or after the date of a change in ownership or control?

A-42: (a) Yes, if payments are made or to be made to (or on behalf of) a disqualified individual for personal services to be rendered on or after the date of a change in ownership or control, a showing of the following generally is considered to be clear and convincing evidence that the payments are reasonable compensation for services to be rendered on or after the date of the change in ownership or control —

(1) The payments were made or are to be made only for the period the individual actually performs such personal services; and

(2) If the individual's duties and responsibilities are substantially the same after the change in ownership or control, the individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments. If the scope of the individual's duties and responsibilities are not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services. 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 contemplated in exchange for the compensation.

(b) Generally, an agreement under which the disqualified individual must refrain from performing services (such as a covenant not to compete) is an agreement for the performance of personal services for purposes of this A-42 to the extent that it is demonstrated by clear and convincing evidence that the agreement substantially constrains the individual's ability to perform services and there is a reasonable likelihood that the agreement will be enforced against the individual. In the absence of clear and convincing evidence, payments under the agreement are treated as severance payments under Q/A-44 of this section.

(c) If the employment of a disqualified individual is involuntarily terminated before the end of a contract term and the individual is paid damages for breach of contract, a showing of the following factors generally is considered clear and convincing evidence that the payment is reasonable compensation for personal services to be rendered on or after the date of change in ownership or control —

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

(2) The compensation the individual would have received under the contract would have qualified as reasonable compensation under section 162;

(3) The damages do not exceed the present value (determined as of the date of receipt) of the compensation the individual would have received under the contract if the individual had continued to perform services for the employer until the end of the contract term;

(4) The damages are received because an offer to provide personal services was made by the disqualified individual but was rejected by the employer; and

(5) The damages are reduced by mitigation. Mitigation will be treated as occurring when such damages are reduced (or any payment of such damages is returned) to the extent of the disqualified individual's earned income (within the meaning of section 911(d)(2)(A)) during the remainder of the period in which the contract would have been in effect. See Q/A-44 of this section for rules regarding damages for a failure to make severance payments.

(c) The following examples illustrate the principles of this A-42:

Example 1. A, a disqualified individual, has a three-year employment contract with Corporation M, a publicly traded corporation. Under this contract, A is to receive a salary for $100,000 for the first year of the contract and, for each succeeding year, an annual salary that is 10 percent higher than the prior year's salary. During the third year of the contract, Corporation N acquires all the stock of Corporation M. Prior to the change in ownership, Corporation N arranges to retain A's services by entering into an employment contract with A that is essentially the same as A's contract with Corporation M. Under the new contract, Corporation N is to fulfill Corporation M's obligations for the third year of the old contract, and, for each of the succeeding years, pay A an annual salary that is 10 percent higher than A's prior year's salary. Amounts are payable under the new contract only for the portion of the contract term during which A remains employed by Corporation N. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the payments under this agreement are exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section.

Example 2. Assume the same facts as in *Example 1* except that A does not perform the services described in the new contract, but receives payment under the new contract. Because services were not rendered after the change, the payments under this contract are not exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section.

Example 3. Assume the same facts as in *Example 1* except that under the new contract A agrees to perform consulting services to Corporation N, when and if, Corporation N requires A's services. Assume further that when Corporation N does not require A's services, the contract provides that A

must not perform services for any other competing company. Corporation N previously enforced similar contracts against former employees of Corporation N. Because A is substantially constrained under this contract and Corporation N is reasonably likely to enforce the contract against A, the agreement is an agreement for the performance of services under paragraph (b) of this A-42. Assuming the requirements of paragraph (a) of this A-42 are met and there is clear and convincing evidence that all payments under the new contract are reasonable compensation for personal services to be rendered on or after the date of the change in ownership, the payments under this contract are exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section.

Example 4. Assume the same facts as in *Example 1*, except that the employment contract with Corporation N does not provide that amounts are payable under the contract only for the portion of the term for which A remains employed by Corporation N. Shortly after the change in ownership, and despite A's request to remain employed by Corporation N, A's employment with Corporation N is involuntarily terminated. Shortly thereafter, A obtains employment with Corporation O. A commences a civil action against Corporation N, alleging breach of the employment contract. In settlement of the litigation, A receives an amount equal to the present value of the compensation A would have received under the contract with Corporation N, reduced by the amount of compensation A otherwise receives from Corporation O during the period that the contract would have been in effect. A showing of the facts described above (and in the absence of contradictory evidence) is regarded as clear and convincing evidence that the amount A receives as damages is reasonable compensation for personal services to be rendered on or after the date of the change in ownership. Therefore, the amount received by A is exempt from the definition of *parachute payment* pursuant to Q/A-9 of this section.

Q-43: Is any particular type of payment generally considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control?

A-43: (a) Yes, payments of compensation earned before the date of a change in ownership or control generally are considered reasonable compensation for personal services actually rendered before the date of a change in ownership or control if they qualify as reasonable compensation under section 162.

Q-44: May severance payments be treated as reasonable compensation?

A-44: (a) No, severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of a change in ownership or control. Moreover, any damages paid for a failure to make severance payments are not treated as reasonable compensation for personal services actually rendered before, or to be rendered on or after, the date of such change. For purposes of this section, the term *severance payment* means any payment that is made to (or for the benefit of) a disqualified individual on account of the termination of such individual's employment prior to the end of a contract term, but does not include any payment that otherwise would be made to (or for the benefit of) such individual on the termination of such individual's employment, whenever occurring.

(b) The following example illustrates the principles of this A-44:

Example. A, a disqualified individual, has a three-year employment contract with Corporation X. Under the contract, A will receive a salary of $200,000 for the first year of the contract, and for each succeeding year, an annual salary that is $100,000 higher than the previous year. In the event of A's termination of employment following a change in ownership or control, the contract provides that A will receive the remaining salary due under the employment contract. At the beginning of the second year of the contract, Corporation Y acquires all of the stock of Corporation X, A's employment is terminated, and A receives $700,000 ($300,000 for the second year of the contract plus $400,000 for the third year of the contract) representing the remaining salary due under the employment contract. Because the $700,000 payment is treated as a severance payment, it is not reasonable compensation for personal services on or after the date of the change in ownership or control. Thus, the full amount of the $700,000 is a parachute payment.

Miscellaneous Rules

Q-45: How is the term *corporation* defined?

A-45: For purposes of this section, the term *corporation* has the meaning prescribed by section 7701(a)(3) and § 301.7701–2(b) of this chapter. For example, a *corporation*, for purposes of this section, includes a publicly traded partnership treated as a corporation under section 7704 (a); an entity described in § 301.7701–3(c)(1)(v)(A) of this chapter; a real estate investment trust under section 856(a); a corporation that has mutual or cooperative (rather than stock) ownership, such as a mutual insurance company, a mutual savings bank, or a cooperative bank (as defined in section 7701(a)(32)), and a foreign corporation as defined under section 7701(a)(5).

Q-46: How is an affiliated group treated?

A-46: For purposes of this section, and except as otherwise provided in this section, all members of the same affiliated group (as defined in section 1504, determined without regard to section 1504(b)) are treated as one corporation. Rules affected by this treatment of an affiliated group include (but are not limited to) rules relating to exempt payments of certain corporations (Q/A-6, Q/A-7 of this section (except as provided therein)), payor of parachute payments (Q/A-10 of this section), disqualified individuals (Q/A-15 through Q/A-21 of this section (except as provided therein)), rebuttal of the presumption that payments are contingent on a change (Q/A-26 of this section (except as provided therein)), change in ownership or control (Q/A-27, 28, and 29 of this section), and reasonable compensation (Q/A-42, 43, and 44 of this section).

Effective Date

Q-47: What is the general effective date of section 280G?

A-47: (a) Generally, section 280G applies to payments under agreements entered into or renewed after June 14, 1984. Any agreement that is entered into before June 15, 1984, and is renewed after June 14, 1984, is treated as a new contract entered into on the day the renewal takes effect.

(b) For purposes of paragraph (a) of this A-47, a contract that is terminable or cancellable unconditionally at will by either party to the contract without the consent of the other, or by both parties to the contract, is treated as a new contract entered into on the date any such termination or cancellation, if made, would be effective. However, a contract is not treated as so terminable or cancellable if it can be terminated or cancelled only by terminating the employment relationship or independent contractor relationship of the disqualified individual.

(c) Section 280G applies to payments under a contract entered into on or before June 14, 1984, if the contract is amended or supplemented after June 14, 1984, in significant relevant respect. For this purpose, a *supplement* to a contract is defined as a new contract entered into after June 14, 1984, that affects the trigger, amount, or time of receipt of a payment under an existing contract.

(d)(1) Except as otherwise provided in paragraph (e) of this A-47, a contract is considered to be amended or supplemented in significant relevant respect if provisions for payments contingent on a change in ownership or control (parachute provisions), or provisions in the nature of parachute provisions, are added to the contract, or are amended or supplemented to provide significant additional benefits to the disqualified individual. Thus, for example, a contract generally is treated as amended or supplemented in significant relevant respect if it is amended or supplemented —

(i) To add or modify, to the disqualified individual's benefit, a change in ownership or control trigger;

(ii) To increase amounts payable that are contingent on a change in ownership or control (or, where payment is to be made under a formula, to modify the formula to the disqualified individual's advantage); or

(iii) To accelerate, in the event of a change in ownership or control, the payment of amounts otherwise payable at a later date.

(2) For purposes of paragraph (a) of this A-47, a payment is not treated as being accelerated in the event of a change in ownership or control if the acceleration does not increase the present value of the payment.

(e) A contract entered into on or before June 14, 1984, is not treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of employment relationship or independent contractor relationship of the disqualified individual. Whether an adjustment in the terms of such a relationship is considered normal for this purpose depends on all of the facts and circumstances of the particular case. Relevant factors include, but are not limited to, the following —

(1) The length of time between the adjustment and the change in ownership or control;

(2) The extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate;

(3) A comparison of the adjustment with historical practices of the corporation;

(4) The extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15, 1984, parachute contracts; and

(5) The size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group receiving the benefits of the adjustment.

Q-48: What is the effective date of this section?

A-48: This section applies to any payments that are contingent on a change in ownership or control that occurs on or after January 1, 2004. Taxpayers can rely on these rules for the treatment of any parachute payment made after February 20, 2002.

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 19, 2002, 8:45 a.m., and published in the issue of the Federal Register for February 20, 2002, 67 F.R. 7630)

Notice of Proposed Rulemaking and Notice of Public Hearing

Unit Livestock Price Method

REG–125626–01

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the use of the *unit-livestock-price method* of accounting. The proposed regulations affect livestock raisers and other farmers that elect to use the unit-livestock-price method. These proposed regulations provide rules relating to the annual reevaluation of unit prices and the depreciation of livestock raised for draft, breeding, or dairy purposes. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by May 6, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for June 12, 2002, at 10 a.m. must be received by May 22, 2002.

ADDRESSES: Send submissions to: CC:IT&A:RU (REG–125626–01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:IT&A:RU (REG–125626–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at *http://www.irs.gov/tax_regs/regslist.html*. The public hearing will be held in the room 4716, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, A. Katharine Jacob Kiss at (202) 622–4920; concerning submissions and the hearing, Sonya M. Cruse at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR Part 1) under section 471 of the Internal Revenue Code (Code). The unit-livestock-price method, contained in § 1.471–6, provides for the valuation of different classes of animals in inventory at a standard unit price for each animal within a class. A taxpayer that elects to use the unit-livestock-price method must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. Once established, unit prices and classifications selected by the taxpayer must be consistently applied in all subsequent years. Prior to 1997, § 1.471–6 did not allow a taxpayer to make any changes in the unit prices without first obtaining the consent of the Commissioner.

Following the enactment of section 263A, the IRS and Treasury Department published Notice 88–24 (1988–1 C.B. 491), which provided guidance to taxpayers regarding the application of the uniform capitalization rules to property produced in the trade or business of farming. Notice 88–24 indicated that forthcoming regulations would modify the rule contained in § 1.471–6 and require that taxpayers adjust their unit prices upward, from time to time as specified by those regulations, to reflect increases in costs taxpayers experience in raising livestock. Notice 88–24 also provided safe-harbor unit prices for the unit-livestock-price method with respect to female cattle raised or purchased by a taxpayer for purposes of breeding (beef cattle) or milk production (dairy cattle).

Contemporaneous with the publication of the section 263A temporary and proposed regulations on August 22, 1997, (T.D. 8729, 1997–2 C.B. 35), the IRS and Treasury Department modified the final regulations under § 1.471–6 to provide, for taxable years beginning after August 22, 1997, a taxpayer using the unit-livestock-price method must annually reevaluate its unit prices and must adjust the prices upward to reflect increases in the costs of raising livestock. The consent of the Commissioner is not required to make such upward adjustments, but no other changes in the classification of animals or unit prices may be made without the consent of the Commissioner.

On September 5, 2000, the IRS and Treasury Department published final regulations under section 263A (T.D. 8897, 2000–2 C.B. 234) in the **Federal Register** (65 FR 50638), which obsoleted Notice 88–24, relating to rules for property produced in a farming business. The preamble to these final regulations discussed comments received regarding the modification made to the unit-livestock-price method and indicated the IRS and Treasury Department's intent to study this method. These proposed regulations are promulgated in response to those comments.

Explanation of Provisions

Commentators expressed concern that if taxpayers are required to annually reevaluate their unit prices, they should be able to both increase and decrease the unit prices to reflect all changes in the costs of raising livestock. The IRS and Treasury Department agree that to the extent the unit-livestock-price method requires an annual reevaluation of the unit prices, a taxpayer should be able to increase and decrease its unit prices without securing the consent of the Commissioner. Such a change is not a change in method of accounting, but an application of the unit-livestock-price method, similar to the application of a standard cost method. Consequently, the proposed regulations allow a taxpayer to both increase and decrease its unit prices without obtaining the consent of the Commissioner.

However, the IRS and Treasury Department also recognize a broader concern that the requirement to annually reevaluate unit prices may have eliminated much of the simplicity of the unit-livestock-price method. In this respect, the IRS and Treasury Department welcome comments on how the rules could be made simpler to apply. For example, the IRS and Treasury Department request comments on whether safe harbor unit prices similar to those announced in Notice 88–24 should be made available again to taxpayers using the unit-livestock-price method. If so, comments specifically are requested as to an index or measure those safe harbor unit prices should be based on and how often those safe harbor unit prices should be adjusted.

Commentators also suggested that the unit-livestock-price method should be clarified to allow a taxpayer to remove from inventory animals that have been raised for use in a taxpayer's trade or business (such as a breeding cow) and depreciate the cost of the animal based on its inventoriable cost. Under § 1.471–6(g), a livestock raiser who uses the unit-livestock-price method is permitted to elect to include animals *purchased* for draft, breeding, or dairy purposes in inventory or to treat those animals as property used in a trade or business subject to depreciation after maturity. In contrast, § 1.471–6(f) does not specifically permit a livestock raiser who uses the unit-livestock-price method to elect to treat animals *raised* for draft, breeding, or dairy purposes as property used in a trade or business subject to depreciation after maturity. There does not appear to be a current rationale for distinguishing between animals *raised* versus animals *purchased* for draft, breeding, or dairy purposes. Accordingly, the proposed regulations clarify that a livestock raiser that uses the unit-livestock-price method may elect to remove from inventory after maturity an animal raised for draft, breeding, or dairy purposes and treat the inventoriable cost of such animal as an asset subject to depreciation.

Effective Date

These regulations are applicable to taxable years ending after the date final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for June 12, 2002, at 10 a.m. in room 4716, Internal Revenue Building, 1111

Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and 8 copies) by May 22, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is A. Katharine Jacob Kiss, Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.471–6 also issued under 26 U.S.C. 471. * * *

Par. 2. Section 1.471–6 is amended as follows:

1. In paragraph (c), the last sentence is removed.

2. Paragraph (f) is revised.

3. In paragraph (g), the first sentence is amended by removing the language "capital assets" and adding "property used in a trade or business" in its place.

The revisions read as follows:

§ 1.471–6 Inventories of livestock raisers and other farmers.

* * * * *

(f) A taxpayer that elects to use the "unit-livestock-price method" must apply it to all livestock raised, whether for sale or for draft, breeding, or dairy purposes. The inventoriable costs of animals raised for draft, breeding, or dairy purposes can, at the election of the livestock raiser, be included in inventory or treated as property used in a trade or business subject to depreciation after maturity. See § 1.263A–4 for rules regarding the computation of inventoriable costs for purposes of the unit-livestock-price method. Once established, the methods of accounting used by the taxpayer to determine unit prices and to classify animals must be consistently applied in all subsequent taxable years. A taxpayer that uses the unit-livestock-price method must annually reevaluate its unit prices and adjust the prices either upward to reflect increases, or downward to reflect decreases, in the costs of raising livestock. The consent of the Commissioner is not required to make such upward or downward adjustments. No other changes in the classification of animals or unit prices may be made without the consent of the Commissioner. See § 1.446–1(e) for procedures for obtaining the consent of the Commissioner. The provisions of this paragraph (f) apply to taxable years ending after the date that final regulations are published in the **Federal Register**.

* * * * *

Robert E. Wenzel,
Deputy Commissioner of Internal Revenue.

(Filed by the Office of the Federal Register on February 1, 2002, 8:45 a.m., and published in the issue of the Federal Register for February 4, 2002, 67 F.R. 5074)

Catch-Up Contributions for Individuals Age 50 or Over; Hearing

Announcement 2002–24

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Change of date of public hearing; extension of time to submit written comments and outlines of oral comments.

SUMMARY: This document changes the date of the public hearing on the proposed regulations (REG–142499–01, 2001–45 I.R.B. 476) that relate to requirements for retirement plans providing catch-up contributions to individuals age 50 or older pursuant to the provisions of section 414(v) and supercedes the notice of public hearing published in the **Federal Register** on October 23, 2001. It also extends the time to submit written comments and outlines of oral comments for the hearing.

DATES: The public hearing will be held April 30, 2002, beginning at 10 a.m. Written comments and outlines of oral comments must be received by April 15, 2002.

ADDRESSES: The public hearing will be held in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Send submissions to CC:ITA:RU (REG–142499–01), Room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG–142499–01), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments directly to the IRS Internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, R. Lisa Mojiri-Azad or John Ricotta (202) 622–6060 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Donna Poindexter (202) 622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

A notice of proposed rulemaking and notice of public hearing that appeared in the **Federal Register** on October 23, 2001, (66 FR 53555), announced that a public hearing on the proposed regulations relating to requirements for retirement plans providing catch-up contributions to individuals age 50 or older pursuant to the provisions of section 414(v) would be held on February 21, 2002, in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Subsequently, the date of the public hearing has changed to April 30, 2002, at 10 a.m., in the IRS Auditorium. Written comments and outlines of oral comments must be received by April 15, 2002.

Cynthia Grigsby,
Chief, Regulations Unit,
Associate Chief Counsel
(Income Tax and Accounting).

(Filed by the Office of the Federal Register on February 14, 2002, 3:44 p.m., and published in the issue of the Federal Register for February 20, 2002, 67 F.R. 7656)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as"rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified,* below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified,* above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Intemal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[2] A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2001–27 through 2001–53 is in Internal Revenue Bulletin 2002–1, dated January 7, 2002.

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Key to Abbreviations:

Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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