Internal Revenue Service

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Department of the Treasury
Washington, DC 20224

Third Party Communication: None
Date of Communication: Not Applicable

Person To Contact:

Telephone Number:

Refer Reply To:
CC:TEGE:EB:EC
PLR-147863-05

Date:
January 17, 2006

In Re:

LEGEND:

Taxpayer =
Date 1 =
Plan 1 =

Plan 2 =

Target =
Parent =
x =
y =
z =

Dear :

This letter ruling is a response to a request for a private letter ruling, filed on behalf of Taxpayer on Date 1, requesting a ruling regarding an adjustment in the number of shares and employee stock options.

As of Date 1, Taxpayer has X nonqualifed employee stock options outstanding. These options were granted over a period of years with various exercise prices, but were always granted with an exercise price equal to the fair market value of the underlying stock. These options were issued under two plans, Plan 1 and Plan 2 (collectively, “the Plans”). Each plan provides that the Compensation Committee of Taxpayer’s Board of Directors may adjust the exercise price and number of options to reflect the impact of certain corporate transactions, or a change in capitalization, that the committee determines, in its sole discretion, are necessary or desirable to reflect such event.

Taxpayer represents that the stock options issued under the Plans meet the requirements of "performance based compensation" under section 162(m) of the Internal Revenue Code.

Taxpayer has reached an agreement to acquire all of the stock of Target (a subsidiary of Parent) in exchange for stock of Taxpayer plus y cash. In connection with this transaction Taxpayer is contemplating making a one-time Extraordinary Dividend of z per share. Holders of Taxpayer's non-qualified employee stock options will not be entitled to receive this Extraordinary Dividend. In order to prevent the economic value of the options from being adversely affected, Taxpayer proposes to adjust the exercise price and number of options issued under the Plans. The adjustments to the outstanding nonqualified options will be made in accordance with the methodology of section 424(a) of the Code and the regulations thereunder so as to equalize the economic value of the options before and after the Extraordinary Dividend. Other than small differences due to rounding, the aggregate value of the adjusted options will equal the aggregate value of the original options. Taxpayer intends to equalize the value of the pre- and post-adjustment options utilizing an "intrinsic value" approach producing adjustments that will meet the "ratio test" and the "spread test" as described in section 1.424-1 of the regulations. Taxpayer will adjust all outstanding non-qualified options, including those held by rank-and-file employees as well as top executives of Taxpayer.

Taxpayer has requested rulings that options granted under the Plans will continue to meet the requirements under section 162(m) of the Code for qualified performance-based compensation if they are adjusted to reflect the Extraordinary Dividend and such adjustment is consistent with the methodology prescribed in section 424(a); and that such an adjustment will not be considered a cancellation and grant of a new option under section 1.162-27(e)(2)(vi)(B).

Section 162(a)(1) allows as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 162(m)(1) provides that in the case of any publicly-held corporation, no deduction is allowed for applicable employee remuneration with respect to any covered employee to the extent that the amount of the remuneration for the taxable year exceeds $1,000,000.

Section 162(m)(4) provides that applicable employee remuneration does not include any remuneration payable solely on account of the attainment of one or more performance goals, but only if (i) the performance goals are determined by a compensation committee of the board of directors of the taxpayer which is comprised solely of 2 or more outside directors; (ii) the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to the shareholders and approved by a majority of the vote in a separate shareholder vote

before the payment of such remuneration, and (iii) before any payment of such remuneration, the compensation committee referred to in clause (i) certifies that the performance goals and any other material terms were in fact certified.

Under section 1.162-27(e)(2)(vi)(A) of the regulations, compensation attributable to a stock option is deemed to satisfy the performance goal requirement of section1.62-27(e)(2) if the grant is made by the compensation committee; the plan under which the option is granted states the maximum number of shares with respect to which options may be granted during a specified period to any employee; and, under the terms of the option, the amount of compensation the employee could receive is based solely on an increase in the value of the stock after the date of the grant.

Under section 1.162-27(e)(2)(vi)(B) of the regulations, if an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan.

Section 1.162-27(e)(2)(iii)(C) provides that compensation attributable to a stock option, stock appreciation right, or other stock-based compensation does not cease to be treated as performance-based compensation to the extent that a change in the grant or award is made to reflect a change in corporate capitalization, such as a stock split or dividend, or a corporate transaction, such as any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any separation of a corporation (including a spinoff or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation.

Based on the information submitted and on Taxpayer's representations, we rule as follows:

1. Stock options granted under the Plans will continue to meet the requirements of section 162(m) for qualified performance-based compensation if the stock options are adjusted to reflect the Extraordinary Dividend and that adjustment is made consistent with the methodology provided in section 424(a).

2. Such an adjustment will not be considered the cancellation and grant of a new option under section 1.162-27(e)(2)(vi)(B) of the regulations.

The ruling contained in this letter is based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed

by an appropriate party. While this office has not verified any of the material submitted in support of the request for a ruling, it is subject to verification on examination. Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

A copy of this letter must be attached to any income tax return to which it is relevant.

Sincerely,

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Robert B. Misner
Senior Technician Reviewer Executive Compensation Branch
Office of the Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities)

Enclosure: Copy for 6110 purposes