Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LMSB:NR:DEN:POSTU-152072-01
AMHarbutte

date: November 8, 2001

to: David Yager, Acting Team Manager
LMSB:NR:1416, Denver, Colorado
Attn: Robert Main, Employment Tax Specialist

from: Alice M. Harbutte, Attorney
LMSB, Area 4, Denver, Colorado

---

subject: [redacted]
Taxable Year [redacted]

This memorandum is a supplemental memo to the response provided to you by our office dated June 29, 2001 regarding the question of whether severance payments made to the former CEO of [redacted] are subject to the provisions of I.R.C. § 280G. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

In our June 29, 2001, memorandum we concluded that the severance payment made by [redacted] to its former CEO, [redacted], pursuant to the terms of a severance agreement entered into on [redacted], constituted a parachute payment under I.R.C. § 280G(b)(2). This memorandum was sent to the Office of Chief Counsel for post review. The post review reached a contrary conclusion with respect to this issue. As a result, this office is revising the conclusion reached with respect to issue #1 in our June 29, 2001, memorandum.

The post-review advice concluded that there was no change in ownership or change in control under the Treasury Regulations. The exception in 29(b)(4) applies to the facts of this case. As a result, there was not a change in ownership or control under Prop. Reg. § 1.280G-1, Q/A-29.

In addition, Prop. Reg. § 1.280G-1, Q/A 28, only applies when there is a change in the board and stock ownership. This did not occur in this case. For the foregoing reasons, the severance payment made to [redacted] should not be treated as a parachute payment. There was not a change in ownership or control which would trigger § 280G or § 4999.

If you have any question regarding this advice, please call Attorney Alice M. Harbutte at (303) 844-2214 ext. 224.

Alice M. Harbutte

ALICE M. HARBUTTE
Attorney, LMSB Area 4
Denver, Colorado

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LMSB:NR:DEN:TL-N-3109-01
AMHarbutte

date: June 29, 2001

to: David Yager, Acting Team Manager
LMSB:NR:1416, Denver, Colorado

from: Alice M. Harbutte, Attorney
LMSB, Area 4, Denver, Colorado

---

subject: [redacted]
Taxable Year [redacted]

This memorandum is in response to your request for advice dated May 10, 2001, concerning the question of whether severance payments made to the former CEO of [redacted] are subject to the provisions of I.R.C. § 280G. This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

ISSUES

1. Whether the severance payment made by [redacted] to its former CEO, [redacted] pursuant to the terms of a severance agreement entered into on [redacted], was a parachute payment under I.R.C. § 280G(b)(2).

2. Whether the other deductions included in [redacted]'s claim for refund, relating to amounts paid to other executives for buyouts related to the merger and other merger related costs that were formerly capitalized for which [redacted] now seeks a deduction, are currently deductible expenses under I.R.C. § 162.

CONCLUSION

1. Yes. The severance payment made to former CEO [redacted] was a parachute payment as defined by I.R.C. § 280G. The

taxpayer's claim for refund which is based upon their position that this payment did not constitute a parachute payment should be denied.

2. Maybe. In order to be currently deductible under I.R.C. § 162, costs incurred relating to a merger must be ordinary and necessary expenses and only indirectly related to the merger.

FACTS

On [redacted], [redacted] and [redacted] entered into a merger agreement (the "Merger Transaction"). The merger was final on [redacted]. Pursuant to the terms of the merger agreement, a new entity, [redacted] was formed. In order to effect the merger, [redacted] formed two new subsidiaries. [redacted] merged into one of the [redacted] subsidiaries and [redacted] merged into the other. After the merger, [redacted] shareholders owned approximately [redacted]% of [redacted] stock and [redacted] shareholders owned approximately [redacted]% of [redacted] stock. With respect to the value of the assets transferred by each of these entities to [redacted], of the total fair market value of all of the assets, [redacted]% were attributable to former [redacted] assets and [redacted]% to former [redacted] assets.

In addition to transferring assets to [redacted], changes in the management of [redacted] and [redacted] also occurred. Prior to the merger the [redacted] of [redacted] was [redacted]. On [redacted], [redacted] and [redacted] had entered into a severance agreement. This agreement was subsequently amended on [redacted] and again on [redacted]. The severance agreement provided that if [redacted]'s employment with [redacted] was terminated, then [redacted] would pay him a lump sum cash amount equal to [redacted] years of his Executive Compensation. A copy of the [redacted] agreement is attached as **Exhibit A**. As a result of the [redacted] Merger Transaction, [redacted]'s employment with [redacted] was terminated and he was paid a lump sum amount under the terms of the severance agreement. This payment was originally treated as a golden parachute payment under I.R.C. § 280G by [redacted] and no deduction was claimed for the portion of the payment that was considered to be an excess parachute payment. Additionally, an excise tax under I.R.C. § 4999 was paid by [redacted].

On [redacted], a refund claim was filed with the Service with respect to the excise tax paid under I.R.C. § 4999, stating that there was an administrative error and that the payment to [redacted] was mischaracterized as a golden parachute payment. The claim requests a refund of $[redacted]. [redacted] has issued [redacted] an amended W-2c. A second claim was filed, requesting an income tax

deduction on the [redacted] consolidated return filed by the [redacted] group. The additional deductions relate to payments made to executives (including [redacted] and other costs that were previously capitalized. The claim states that since there was not a change in ownership or control which would trigger § 280G or § 4999, an adjustment to taxable income of [redacted] is required (a consolidated return was filed by the [redacted] group for [redacted] and these merger costs relate to this return) to allow the deductions not previously taken. [redacted] is requesting a reduction to taxable income in the amount of $[redacted] relating to costs that they previously classified as non-deductible. These include severance costs totaling $[redacted] and other merger related costs that had been previously capitalized totaling $[redacted]. This later amount relates to amounts paid to executives for buyouts related to the merger. Your question is whether any portion of these claims should be allowed.

DISCUSSION

Issue 1, severance payment to Hock

Overview of Section 280G

Section 280G disallows a deduction for any excess parachute payment paid or accrued. Section 4999 imposes a 20-percent excise tax on an "excess parachute payment" received by a corporate executive as the result of a change in ownership or control of his employer. Sections 4999 and 280G apply to contracts entered into or renewed after June 14, 1984, as well as contracts existing on June 14, 1984, which are thereafter amended in any significant relevant aspect. Powell v. Commissioner, 100 T.C. 77 (1993). In this case the 20% excise tax under I.R.C. § 4999 was paid by [redacted] relating to a severance payment made to former CEO [redacted]. [redacted] now asserts that this amount was paid in error and that the severance payment was not a parachute payment. In addition, [redacted] is claiming entitlement to a deduction for the full amount of the payment it made to former CEO [redacted].

In order to have an excess parachute payment, the payment must first qualify as a parachute payment. I.R.C. § 280G(b)(2)(A) defines the term "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 ("change in ownership or control"); and

(d) the payment has (together with other payments described above in (a), (b), and (c) with respect to the same individual) an aggregate present value of at least 3 times the individual's base amount.

Once a payment is determined to be a parachute payment, it is then necessary to determine whether any portion is an "excess" parachute payment. I.R.C. § 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. The issue in the present case does not involve a determination of any "excess" payment. The taxpayer asserts that subparagraph (c) above, which requires that there be a change in ownership or control in order to have any parachute payment, did not occur with respect to [redacted] as a result of the merger with [redacted]. The taxpayer now states that there was no change in ownership or control in [redacted] so that the payment to [redacted] was not contingent upon a change in ownership or control, as required by I.R.C. § 280G and no excess tax was required to be paid.

Contingent upon a change in ownership or control:

In order for a payment made to a disqualified individual to be classified as a parachute payment it must be contingent upon a change in the ownership or effective control of the corporation. Prop. Reg. § 1.280G-1, Q/A-22.

On [redacted], [redacted] and [redacted] entered into a merger agreement, ultimately resulting in the severance payment at issue here being made to [redacted]. The merger was finalized on [redacted]. [redacted]'s former [redacted], [redacted], had a severance agreement that was initially entered into on [redacted]. The last date this severance agreement was amended was on [redacted]. In order for the payment in question to be considered a parachute payment, there must have been a change in ownership or control of [redacted] and the severance payment must have been contingent upon that change in ownership or control.

1. Change in Ownership:

The term change in ownership or effective control is not defined in the section 280G. Proposed regulations were issued in May 1989 and provide guidance as to when a change in ownership or effective control has occurred for purposes of applying section 280G. Under the proposed regulations there can be a change in the ownership of a corporation that occurs when 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, has more than 50 percent of the total fair market value or voting power of all of the corporation's outstanding stock[1]. In addition a change in ownership may occur when there is a change in the ownership of a substantial portion of a corporation's assets. See Prop. Reg. 1.280G-1, Q/A 29. Under the facts in the Merger Transaction in question, there appears to have been a change in ownership of a substantial portion of the assets of [redacted].

a. Change in the ownership of assets

The proposed regulations provide that a change in the ownership of a substantial portion of the assets of a corporation occurs when any one person, or more than one person acting as a group, acquires.... assets from the corporation that have a total fair market value **equal to or more than one third** of the total fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. Example 2 of Q/A-29 sets forth an example of when this occurs. In Example 2, the facts pattern assumes that Corporation M and N are unrelated prior to the acquisitions in question. Corporation M acquires from Corporation N assets totaling $1.2 million within a 12 month period. The total fair market value of N's assets

---

[1] [redacted], a new entity, was formed in order to acquire [redacted]% of the assets of both [redacted] and [redacted]. Each [redacted] shareholder received one share of [redacted] and each [redacted] shareholder received [redacted] share of [redacted] for each share owned. [redacted] shares of [redacted] shares were exchanged and [redacted] shares were exchanged for [redacted] common stock. With total shares issued being approximately [redacted] shares [[redacted]]. Subsequent to the initial Merger Transaction, in [redacted] an additional [redacted] shares were issued resulting in net proceeds after issuance costs of $[redacted]. The total number of shares outstanding of [redacted] stock as of [redacted] was [redacted] shares. Based upon these facts it does not appear that a change in ownership under this portion of the proposed regulations occurred.

immediately before the acquisition was $3 million. The example concludes that since the value of the assets acquired by M were more than one-third of the total fair market value of all of Corporation N's assets immediately prior to the acquisitions, a change in the ownership of a substantial portion of Corporation N's assets occurred. Prop. Reg. § 1.280G, Q/A-29.

With respect to the acquisition in question, [redacted]% of the total value of assets owned by [redacted] immediately prior to merger were transferred to the newly formed entity [redacted]. Similarly, [redacted]% of the assets owned by [redacted] immediately prior to the merger were also transferred to the newly formed entity [redacted]. All of the combined assets of both [redacted] and [redacted] were no longer owned by the same shareholders after the merger. The assets were combined together and held by [redacted]. The former shareholders of [redacted] now owned stock in [redacted] and the former shareholders of [redacted] now owned stock in [redacted]. In looking at the total value of all assets held by [redacted] after the merger, approximately [redacted]% of the total fair market value of these [redacted] assets were attributable to former [redacted] assets and [redacted]% of the fair market value of these assets were attributable to former [redacted] assets. Based upon this analysis it appears that there is a change in ownership, as defined by the proposed regulations and as required by I.R.C. § 280G(b)(2)(A)(i)(II) and that the payments in question are parachute payments.

b. <u>Change in Effective Control</u>

Even if there is not a change in ownership of a substantial portion of the assets of [redacted], the payment in question still may be classified as a parachute payment if there is a change in effective control of the corporation.

Under Prop. Reg § 1.280G-1, Q/A 28 a change in the effective control of a corporation is presumed to occur when:

> (a) 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) ownership of stock of the corporation possessing **20 percent** or more of the **total voting power** of the stock of the corporation.

Under the proposed regulations, a taxpayer may rebut the presumption described in the preceding paragraph 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 group to another person or group.

In the present case, after the Merger Transaction, former [redacted] shareholders owned approximately [redacted]% of [redacted] stock while [redacted] shareholders acquired [redacted]% of the [redacted] stock. Both entities, acting as a group, acquired [redacted]% or more of the total voting power of [redacted]. Thus, there appears to have been a change in effective control of both [redacted] and [redacted], which became subsidiaries of the new entity [redacted].

2. Contingent Payment

Q&A 22 of the proposed regulations provides guidance concerning when a payment will be "contingent" on the change in ownership or control of a corporation. Under Q&A 22(a), 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 is generally to be 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.

In addition, Q&A 22(b) provides that a payment is also treated as contingent on a change in ownership or control if (1) the payment is contingent on an event that is closely associated with a change in control, (2) the change in control actually occurs, and (3) the event is materially related to the change in control. 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 control.

Q&A 22(b) provides a nonexclusive list of events that are considered closely associated with a change in control: the onset of a tender offer; a substantial increase in the market price of the corporation's stock within a short period prior to the change; the cessation of the listing of the corporation's stock on an established securities exchange; the acquisition of more than five percent of the corporation's stock by a person or group not in control of the corporation; the voluntary or involuntary termination of the disqualified individual's employment; and a significant reduction in the disqualified individual's job responsibilities. An event will be presumed to be materially related to a change of control if the event occurs within one year before or after the change of control, and not so related if

it occurs more than one year before or after the change.

Under the facts of this case, the severance payment made to [redacted] was contingent upon a change in control of [redacted]. The payment was closely associated a change in control of [redacted]. The payment was a direct result of the merger of [redacted] and [redacted]. The initial Merger Agreement was signed by the parties on [redacted]. The severance agreement between [redacted] and [redacted] was amended on [redacted] and again on [redacted]. Thus, it appears that the severance payment to [redacted] will be presumed to be materially related to the change of control of [redacted].

Issue 2, other merger costs:

In your request for advice you state that the taxpayer's is now claiming that certain costs it had previously capitalized are deductible under I.R.C. § 162. Some of these costs relate to salaries paid to corporate executives. This issue was recently addressed by the Eighth Circuit in Wells Fargo & Co. v. Commissioner, 224 F.3d 874 (8th Cir. 2000). In Well Fargo, the taxpayer attempted to deduct salaries paid to officers of a subsidiary attributable to services performed in merging the companies. The taxpayer also sought to deduct legal and investigatory expenses. The Service disallowed the deductions, determining that the salaries and legal expenses were not ordinary and had to be capitalized. The Eighth Circuit determined that the officers' salaries in dispute were fully deductible because there was only an indirect relation between the salaries and the acquisition, which provided the long-term benefit.

The Eighth Circuit further determined that the legal and investigatory expenses that were incurred prior to the subsidiary's "final decision" regarding the acquisition were fully deductible, but the remaining legal and investigatory expenses were incurred after the "final decision" and therefore had to be capitalized.

With respect to the officer's salaries, the Court held that they were ordinary and necessary expenses under I.R.C. § 162. The Court held that where an expenditure creates or enhances a separate and distinct asset, it is a capital item which (by its very nature) provides long term benefits and must be capitalized, citing, Commissioner v. Lincoln Savings & Loan, 403 U.S. 345, 354 (1971) and INDOPCO, Inc. v. Commissioner 503 U.S. 79, 86-88 (1992).

The Eighth Circuit held that it is incorrect to require capitalization of the officer's salaries that were at issue simply because they were incidentally connected with a future benefit. The Court stated that it is necessary to perform an independent and appropriate legal analysis to determine whether each of the expenditures at issue were 'ordinary' and if so capitalization is not required.

One characteristic of an 'ordinary' expense, is that "the expense must relate to a transaction 'of common or frequent occurrence in the type of business involved.'" INDOPCO, 503 U.S. at 85, 86 (quoting Deputy v. Du Pont, 308 U.S. 488, 495 (1940)). The Eighth Circuit held that payments made by an employer are deductible when they are made to employees, are compensatory in nature, and are directly related to the employment relationship (and only indirectly related to the capital transaction, which provides the long term benefit). Wells Fargo 224 F.3d at 886. The Court further stated that a deductible expense is not converted into a capital expenditure solely because the expense is incurred as part of the terms of a corporate reorganization. Rather, the important consideration in determining the nature of an expenditure for tax purposes is the origin and character of the claim for which the expenditure is incurred.

Last, the Eighth Circuit pointed out that the distinction between the taxpayer before the Court in Wells Fargo and the INDOPCO case was the relationship between the expense at issue and the long term benefit. In INDOPCO, the expenses in question were directly related to the transaction which produced the long term benefit. Accordingly, the expenses had to be capitalized. See INDOPCO, 503 U.S. 79. The Court concluded that where the expense is directly related to the capital transaction (and therefore, the long term benefit), then it should be capitalized. But where there is only an indirect relation between the salaries (which originate from the employment relationship) and the acquisition (which provides the long term benefit) the expense is currently deductible. Wells Fargo 224 F.3d at 887.

The facts presented in your write-up do not discuss the nature of the payments in question but refer to them as "buy-out" payments. A "buy-out" payment appears to be directly related to the Merger Transaction, the capital transaction in question. The payments in question do not appear to be day-to-day salary payments that are indirectly related to the Merger Transaction. As a result, it appears that they should remain classified as capital in nature. If there are any additional facts you would like this office to consider concerning these other costs, please let us know.

If you have any question regarding this advice, please call Attorney Alice M. Harbutte at (303) 844-2214 ext. 224.

ALICE M. HARBUTTE
Attorney, LMSB Area 4
Denver, Colorado