

INTERNAL REVENUE SERVICE

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Company =
A =
Parent =
Plan =
date b =

This is in reply to a letter and subsequent correspondence submitted on behalf of Company by its authorized representative requesting rulings under section 162(m) of the Internal Revenue Code concerning whether certain adjustments to Company's stock options will cause them to fail to be performance-based compensation and whether they will be such compensation following the spin-off of Company.

Company is a 99.9% owned subsidiary of A, which is wholly owned by Parent, a publicly held company. Company was wholly owned at the time of all the transactions described herein. A is a single member LLC that is disregarded for income tax purposes. Parent is contemplating selling Company in an initial public offering (IPO).

Company maintains a stock option plan (Plan), which became effective on date b. The Plan however has not been approved by Parent's shareholders. The Plan provides for the granting of stock options to key employees, officers, directors, and consultants of Company, Parent or any of their respective consolidated subsidiaries and affiliates by a performance compensation subcommittee of the board of directors of Parent.

The Plan provides for the grant of a specified number of options as well as the aggregate number of shares for which options may be granted over a specified period to any individual. All options granted under the Plan are intended to be nonqualified stock options subject to the regulations under section 83 of the Internal Revenue Code.

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The Plan provides that the exercise price of each option will be established by the committee and included in the option agreement evidencing the option. The per share exercise price (as defined in the Plan) will not be less than 50% of the fair market value per share as of the date the option is granted. Each option is subject to vesting provisions that are described in the Plan and the applicable option agreement. The term of each option may not exceed ten years (or earlier, in certain circumstances, following the optionee's termination of employment).

The Plan contains a provision with respect to adjustments of outstanding options in certain events and specifies what the committee may do as long as the adjustment makes the outstanding option, as nearly as practicable, equivalent to the option immediately prior to the change and that no adjustment gives an optionee additional benefits under the outstanding option. The provision further provides for cash-based compensation to allow for lost value.

In connection with the sale of a business interest of one of Company's subsidiaries, a one-time dividend of the net cash proceeds of the sale was paid to Parent by Company. In addition, in connection with the refinancing of bank indebtedness of Company and its subsidiaries and of a note due of a subsidiary of A, Company paid a dividend to A, then its sole shareholder, which in turn paid a dividend of such funds to Parent. This payment, along with certain other payments and the transfer of deferred tax assets created a second dividend. Shortly thereafter, a business that Company owned through one of its subsidiaries was contributed to Company by A. A received, and will receive, no consideration from Company in respect of this contribution.

As a result of the two dividends as offset somewhat by the contributed business, the committee determined that the value of Company's shares was significantly reduced. In order to preserve the value of the options, the committee further determined (i) to adjust the exercise price of then outstanding options and (ii) because Company could not increase the number of shares subject to the options due to concerns that Company's equity would then be too diluted, grant certain cash payment rights to holders of options.

In order to make up for any shortfalls and in accordance with the Plan's adjustment provision, the committee granted a cash payment right. The cash right gives each option holder the right to receive a payment in respect of each share acquired pursuant to the exercise of an option equal to the excess of the pre-adjustment spread over the post-adjustment spread. The cash right is to be payable at the time of the sale to Company of shares received from the exercise of an option, if the sale occurs before the IPO. If the IPO occurs prior to the sale, then the cash right will be payable (i) at the IPO, with respect to an option which was exercised prior to the IPO and (ii) at the time of exercise of an option, if such exercise occurs on or after the IPO. The cash right will be payable only if the price at which the stock is purchased by

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Company, or the IPO price or the fair market value of the stock at the time of exercise of the option after the IPO (whichever event triggers the payment obligation) is greater than the exercise price of the applicable option less the amount of the cash right.

Section 162(a)(1) of the Code 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) of the Code 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) of the Code defines "applicable employee remuneration", with respect to any covered employee for any taxable year, generally as the aggregate amount allowable as a deduction for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by the employee (whether or not during the taxable year). However, pursuant to section 162(m)(4), the term does not include 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 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 shareholders and approved by a majority of the vote before the payment of the 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 satisfied.

Section 1.162-27(e)(1) of the regulations provides that the deduction limitation of section 162(m) does not apply to qualified performance-based compensation. Qualified performance-based compensation is compensation that meets all of the requirements of paragraphs (2) through (5) of section 1.162-27(e).

Section 1.162-27(e)(2)(vi) of the regulations provides, in part, that compensation attributable to a stock option is deemed to satisfy the requirements of section 1.162-27(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

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may be granted during a specified period to any employee; and 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. Thus, any compensation paid pursuant to a stock option grant with an exercise price of less than the fair market value of the stock at the date of the grant would not be performance-based compensation under section 1.162-27(e)(2).

According to section 1.162-27 (e)(3)(iii)(C) of the regulations, compensation attributable to a stock option does not fail to satisfy the requirements of section 1.162-27(e)(2) to the extent that change in the grant is made to reflect a change in corporate capitalization, such as a dividend, or a corporate transaction, such as any merger of a corporation into another corporation or any consolidation of two or more corporations.

Section 1.162-27(f)(4) of the regulations provides, in part, that if a subsidiary that is a member of an affiliated group becomes a separate publicly held corporation (whether by spinoff or otherwise), any remuneration paid to covered employees of the new publicly held corporation will satisfy the exception for performance-based compensation if the conditions of section 1.162-27(f)(4)(iii) are satisfied. Remuneration satisfies the requirements of section 1.162-27(f)(4)(iii) if the remuneration satisfies the performance goal, outside director, and compensation committee certification requirements of the regulations. The outside directors of the of the corporation before it becomes a separate publicly held corporation may establish and administer the performance goals for the covered employees of the new publicly held corporation. The certification must be made by the compensation committee of the new publicly held corporation. However, a taxpayer may rely on this paragraph (f)(4)(iii) to satisfy the requirements for stock options granted prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation. Stock options granted on or after the date of that meeting of shareholders must satisfy all requirements for exception for qualified performance-based compensation in order to satisfy the requirements for performance-based compensation.

Therefore, based on the facts as outlined above, we rule that:

1. The adjustment to the stock option described above will not cause the options to fail to satisfy the requirements of section 1.162-27(e)(2).
2. The compensation attributable to the options exercised by covered employees of Company on and after the date on which Company becomes a separate publicly held corporation satisfies the exception for performance-based compensation described in section 1.162-27(e) of the regulations due to the satisfaction of the conditions described in section 1.162-27(f)(4)(iii).

The above rulings apply only to options the exercise price of which was equal to

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the fair market value of Company stock on the date of grant. Also, ruling number 2 applies only to the options granted prior to the first shareholders' meeting occurring more than 12 months after Company is spun off as a separate publicly held corporation.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent. Except as specifically ruled above, no opinion is expressed as to the federal tax consequences of the transaction described above under any other provisions of the Code.

Sincerely yours,

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

Enclosure:

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