

Bankruptcy; golden parachute payments. This ruling provides rules for the application of section 280G of the Code, concerning golden parachute payments, in the context of a bankruptcy. Specifically, this ruling addresses whether the acquisition of stock by the former creditors results in a change in ownership or control, whether a corporation whose stock is de-listed is eligible for the exemption for certain corporations whose stock is not readily tradeable on an established securities market if the shareholder approval and disclosure requirements described in the final regulations are satisfied, and whether stock that is de-listed from a securities market is considered readily tradeable if it is traded on an over-the-counter market (such as the pink sheets).

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ISSUE

In the situations described below, has there been a change in ownership or control for purposes of §§ 280G and 4999 of the Internal Revenue Code? If so, are any contingent payments potentially exempt under § 280G(b)(5)(A)(ii) (concerning payments from certain corporations that are approved by its shareholders)?

FACTS

Situation 1. On March 1, 2005, Corporation A, files a voluntary petition for

relief under Chapter 11 of the Bankruptcy Code. See 11 U.S.C. § 1101, *et seq.* Corporation A common stock is widely held and actively traded on the New York Stock Exchange. There are no other shares of Corporation A outstanding. Committees of creditors holding unsecured claims and equity security holders are appointed pursuant to 11 U.S.C. § 1102.

After negotiations between the unsecured creditors' committee, the equity committee, and Corporation A, a plan of reorganization is presented to the bankruptcy court and approved. Under the plan of reorganization, all of the existing shares of Corporation A common stock are cancelled and new shares of common stock are authorized. Under the plan of reorganization, the unsecured creditors of Corporation A will receive 75% of the new common stock, distributed in proportion to their claims. Certain shareholders will receive 25% of the new common stock, distributed in proportion to their pre-reorganization stock holdings. No single unsecured creditor will receive 20% or more of the outstanding shares of Corporation A after the reorganization.

Under the plan of reorganization, the existing Board of Directors is replaced by a new Board of Directors that is endorsed by the pre-reorganization Board of Directors.

Situation 2. Assume the same facts as in *Situation 1* except that after the reorganization the largest creditor of Corporation A will receive 25% of the outstanding shares of Corporation A.

Situation 3. Common stock of Corporation B is widely-held and actively traded on the New York Stock Exchange. No other shares of Corporation B are outstanding. Since January 2000, Corporation B has experienced financial difficulties.

On June 15, 2005, Corporation B determines that it is insolvent and files a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. Committees of creditors holding unsecured claims and equity security holders are appointed pursuant to 11 U.S.C. § 1102.

On January 15, 2006, Corporation B's stock is de-listed from the New York Stock Exchange and is thereafter no longer tradeable on any established securities market

(as defined in § 1.897-1(m)). No trading occurred with respect to stock in Corporation B on any other market, including any over-the-counter market (*e.g.*, the pink sheets, the over-the-counter-bulletin board (OTCBB), the automated confirmation transaction service (ACT), or any similar market).

In March 2006, Corporation C proposes to purchase more than one-third of the total gross fair market value of the assets of Corporation B. Corporation B files a motion in the bankruptcy court for approval of the sale. Pursuant to an employment contract, the sale would trigger certain payments to Executive E, a disqualified individual with respect to Corporation B. E files a request in the bankruptcy court to allow Corporation B to make the payments as administrative expenses of the bankruptcy estate under 11 U.S.C. § 503(a). The request specifies that the payments will be made because of the sale of assets to Corporation C, the total amount of each payment, and a brief description of each payment. The request also explains why the payments are actual, necessary costs and expenses of preserving the bankruptcy estate.

After notice and hearing, the bankruptcy court approves the sale of assets and the request for payment of administrative expense by orders dated September 15, 2006.

On October 1, 2006, Corporation C acquires the assets from Corporation B, and the payments are made to E.

Situation 4. Assume the same facts as in *Situation 3* except that the stock of Corporation B is tradeable on an over-the-counter market after de-listing from the New York Stock Exchange.

LAW

Section 280G of the Code was enacted to discourage substantial payments to top executives and other personnel of a target corporation in connection with an acquisition. In some situations, the existence of golden parachute arrangements could encourage executives and other key personnel to favor a proposed takeover that may not be in the best interests of the shareholders. To the extent amounts must be paid

to executives and other key personnel of the target corporation because of golden parachutes or similar arrangements, there is less for the shareholders of that corporation. See, S. Prt. No. 98-169, at 195 (1984); JOINT COMMITTEE ON TAXATION, 98th CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 199-200 (1984).

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

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

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

Section 280G(b)(5)(A)(ii) of the Code provides, in part, that a parachute payment does not include any payment to a disqualified individual with respect to a corporation (other than a small business corporation as defined in § 1361(b) but without regard to paragraph (1)(C) thereof) if (I) immediately before the change described in § 280G(b)(2)(A) no stock in such corporation was readily tradeable on an established securities market or otherwise, and (II) the shareholder approval requirements of § 280G(b)(5)(B) are met with respect to such payment.

Section 280G(b)(5)(B)(ii) of the Code provides that the shareholder approval requirements of § 280G(b)(5) are met with respect to any payment if (i) such payment was approved by a vote of the persons who owned, immediately before the change described in § 280G(b)(2)(A)(i), more than 75 percent of the voting power

of all outstanding stock of the corporation, and (ii) there was adequate disclosure to shareholders of all material facts concerning all payments which (but for this paragraph) would be parachute payments with respect to a disqualified individual.

Under § 1.280G-1 of the Income Tax Regulations, Q/A-6(a), a parachute payment does not include any payment to a disqualified individual with respect to a corporation if (1) immediately before the change in ownership or control, no stock in such corporation was readily tradeable on an established securities market or otherwise, and (2) the shareholder approval requirements of Q/A-7 are met with respect to such payment. Under § 1.280G-1, Q/A-6(e) of the regulations, stock is treated as readily tradeable if it is regularly quoted by brokers or dealers making a market in such stock. Section 1.280G-1 of the regulations, Q/A-6(f) provides that an established securities market means an established securities market as defined in § 1.897-1(m) of the regulations.

Section 1.280G-1, Q/A-7(a), of the regulations provides that the shareholder approval requirements are met with respect to the payment if (1) the payment is approved by more than 75% of the voting power of all outstanding stock entitled to vote (as described in Q/A-7) immediately before the change in ownership or control, and (2) before the vote there is adequate disclosure to all persons entitled to vote (as described in Q/A-7) of all material facts concerning all material payments which (but for Q/A-6) would be parachute payments with respect to the disqualified individual.

Section 1.280G-1 of the regulations, Q/As 27, 28, and 29 provides guidance concerning when a corporation is considered to have undergone a change in ownership of a corporation, a change in effective control of a corporation, or a change in the ownership of a substantial portion of the assets of a corporation (a change in ownership or control).

Q/A-27(a) provides that a change in the ownership of a corporation occurs on the date that any one person, or more than one person acting as a group, acquires ownership of stock of the corporation that, together with stock held by such person (or more than one person acting as a group under Q/A-27(b)) possesses more than 50 percent of the total fair market value or to-

tal voting power of the stock of such corporation. Q/A-27(b) provides that persons will not be considered to be acting as a group merely because they happen to purchase or own stock of the same corporation at the same time, or as a result of the same public offering.

Q/A-28(a) provides, in part, that 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 (as defined in Q/A-28(d)), 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 the 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. The presumption may be rebutted by showing that the acquisition of stock or replacement of the board does not transfer the power to control (directly or indirectly) from any one person (or more than one person acting as a group) to another person (or group). Q/A-28(d) contains the same language as Q/A-27(b) concerning when more than one person is considered to be acting as a group.

Q/A-29 provides that a change in the ownership of a substantial portion of a corporation's assets occurs on the date that any one person, or more than one person acting as a group (as defined in Q/A-29(c)) acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or persons) assets from the corporation that have a total gross fair market value equal to or more than one-third of the total gross fair market value of all of the assets of the corporation immediately prior to such acquisition or acquisitions. For this purpose, gross fair market value means the value of the assets of the corporation, or the value of the assets being disposed of, determined without regard to any liabilities associated with such assets. Q/A-29(c) contains the same language as Q/A-27(b) concerning when person will be considered to be acting as a group.

In a bankruptcy case, an entity may file a request for payment of an administrative expense of the bankruptcy estate. See 11 U.S.C. § 503(a). Pursuant to 11 U.S.C. § 503(b)(1)(A), after notice and hearing, the bankruptcy court shall allow the payment of administrative expenses which were actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case. 11 U.S.C. § 503(b)(1)(A).

ANALYSIS — Situation 1

The receipt of stock by a creditor under a bankruptcy plan of reorganization is often involuntary in that the creditors of a bankrupt estate typically would prefer that the debt be paid in cash rather than in stock of the debtor. The fact that unsecured creditors are represented by a committee and that the plan of reorganization of the debtor provides for the creditors to receive stock instead of cash is ordinarily a function of the financial resources of the estate and is not necessarily indicative of any intention of the creditors to act as a group to acquire control of the debtor. In this situation, Corporation A filed a voluntary petition for relief in the bankruptcy court and the pre-bankruptcy creditors did not act together to force Corporation A into bankruptcy. The fact that the pre-bankruptcy creditors were appointed to a committee of creditors and received stock in proportion to their pre-bankruptcy debt does not indicate that the creditors acted together to acquire stock in Corporation A. Thus, the creditors are not acting as a group, within the meaning of Q/A-27(b) or Q/A-28(d), to acquire the stock of Corporation A.

ANALYSIS — Situation 2

Because one creditor acquired 20 percent or more of Corporation A's stock within a 12-month period, Corporation A is presumed, under Q/A-28(a), to have experienced a change in effective control. However, this presumption may be rebutted by a showing that the largest creditor will not act to control the management and policies of Corporation A.

ANALYSIS — Situation 3

Because Corporation C acquired more than one third of the total gross fair market

value of all of the assets of Corporation B, there is a change in ownership of Corporation B under Q/A-29. However, if Corporation B qualifies as a corporation described in § 280G(b)(5)(A)(ii)(I), concerning payments from corporations that meet certain shareholder approval and disclosure requirements, and the requirements of § 280G(b)(5)(A)(ii)(II) are satisfied, the payments are exempt from the definition of parachute payment.

Under these facts, the stock of Corporation B was de-listed from an established securities market and was not otherwise readily tradeable on the date of the change in control. Further, no trading occurred on any market (including any over-the-counter market). Thus, Corporation B is a corporation described in § 280G(b)(5)(A)(ii)(I) on the date of the change in control.

In order to satisfy the requirements of § 280G(b)(5)(A)(ii)(II) outside of the bankruptcy context, generally, Q/A-7(a) of the regulations requires that the payment must be adequately disclosed to shareholders and then approved by more than 75% of the voting power of all outstanding stock entitled to vote immediately before the change in ownership or control. However, for a corporation in bankruptcy, the continuing interests of equity owners can be difficult to determine or predict. Through the bankruptcy process, the pre-bankruptcy shareholders may end up with a continuing equity interest in the company or the equity may end up partially or fully transferred to creditors. Correspondingly, the pre-bankruptcy shareholders may lack a material continuing equity interest in the affairs of the corporation and therefore also lack the corresponding motivation to appropriately evaluate the payments at issue.

In Situation 3, the payments to E were approved by the bankruptcy court pursuant to 11 U.S.C. § 503(b)(1)(A). The bankruptcy court therefore made a factual finding that the payments were actual, necessary costs and expenses of preserving the bankruptcy estate. The legislative history of § 280G indicates that the golden parachute rules were enacted to discourage excessive payments to executives and other key personnel in order to protect the shareholders. See S. Rpt. No. 98-169 at 195. The bankruptcy court approval serves to protect the estate and

the ultimate owners from unnecessary or excessive payments made to executives. Consequently, for purposes of § 280G, the shareholder approval and disclosure requirements of § 280G(b)(5)(A)(i)(II) and Q/A-7 are deemed satisfied, and the payments to E are not parachute payments.

ANALYSIS — Situation 4

Similar to *Situation 3*, there has been a change in ownership of Corporation B under Q/A-29. Additionally, if Corporation B qualifies as a corporation described in § 280G(b)(5)(A)(ii)(I) (concerning payments from corporations that meet certain shareholder approval and disclosure requirements) on the date of the change in control and the requirements of § 280G(b)(5)(A)(ii)(II) are satisfied, the payments are exempt from the definition of parachute payment.

The trading of stock on an over-the-counter market (*e.g.*, the pink sheets, the OTCBB, the ACT, or any similar market) when the corporation is a debtor in a case under the Bankruptcy Code is impaired, and therefore, the stock is not considered "readily tradeable" for purposes of § 280G.

Accordingly, for the reasons discussed in *Situation 3*, the payments to E are not parachute payments.

HOLDINGS — Situation 1

In *Situation 1*, because no person (or persons acting as a group) acquired more than 50 percent of the total fair market value or total voting power of Corporation A (Q/A-27); because no person (or persons acting as a group) acquired within a 12-month period 20% or more of the outstanding stock of Corporation B and the new Board of Directors is approved by the pre-reorganization Board of Directors (Q/A-28); and because there is no acquisition of the assets of Corporation A (Q/A-29), Corporation A did not undergo a change in ownership or control under § 280G.

HOLDINGS — Situation 2

Corporation A is presumed to have experienced a change in effective control under § 280G. The presumption may be rebutted in accordance with Q/A-28(b).

HOLDINGS — Situation 3

Because Corporation C acquired more than one third of the total gross fair market value of all of the assets of Corporation B, there is a change in ownership of Corporation B under Q/A-29. However, Corporation B is eligible for the exemption provided in § 280G(b)(5)(A)(ii). Under these facts, the shareholder approval and disclosure requirements described in § 280G(b)(5)(B) and Q/A-7 are deemed to be satisfied, and thus, the payments to E are exempt from the definition of parachute payment.

HOLDINGS — Situation 4

For purposes of § 280G, the trading of stock on an over-the-counter market when the corporation is a debtor in a case under the Bankruptcy Code is impaired, and therefore, the stock is not considered “readily tradeable.” Thus, Corporation B is eligible for the exemption provided in § 280G(b)(5)(A)(ii). Under these facts, the shareholder approval and disclosure requirements described in § 280G(b)(5)(B) and Q/A-7 are deemed to be satisfied, and the payments to E are exempt from the definition of parachute payment.

EFFECTIVE DATE

This revenue ruling applies to any payment that is contingent on a change in ownership or control if the change of ownership or control occurs on or after July 19, 2004. Notwithstanding the foregoing, where a corporation is a debtor in a case under the Bankruptcy Code, its securities traded on an over-the-counter market also are not considered “readily tradeable” for purposes of § 280G(b)(5)(A)(ii) with respect to a change in ownership or control that occurred before July 19, 2004.

COMMENTS REQUESTED

Comments are requested concerning whether, or to what extent, the definition of “readily tradeable” under § 280G(b)(5)(A)(ii) should exclude stock of a corporation that is tradeable on an over-the-counter market (e.g., the pink sheets, the OTCBB, the ACT, or any similar market).

Comments should be submitted by October 18, 2004, to CC:PA:LPD:PR (Rev-

enue Ruling 2004-87), Room 5203, Internal Revenue Service, POB 7604 Ben Franklin Station, Washington, D.C. 20044. Comments may be hand delivered between the hours of 8 a.m. and 4 p.m., Monday through Friday to CC:PA:LPD:PR (Revenue Ruling 2004-87), Courier’s Desk, Internal Revenue Service, 1111 Constitution Ave., NW, Washington, D.C. Alternatively, comments may be submitted via the Internet at *Notice.Comments@irs.counsel.treas.gov*. All comments will be available for public inspection.

DRAFTING INFORMATION

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