

§ 1.280G-1

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(ii) The amount determined under this subdivision (ii) is the product of the following amounts:

(A) The fair market value of the property,

(B) The average of the business/investment use for all taxable years (in

which such property is leased) that precede the first taxable year in which the business use percentage is 50 percent or less, and

(C) The applicable percentage from the following table:

Type of property	First taxable year during lease in which business use percentage is 50% or less											
	1	2	3	4	5	6	7	8	9	10	11	12 and Later
Property with a recovery period of less than 7 years under the alternative depreciation system (Such as computers, trucks and airplanes)	0.0	10.0	22.0	21.2	12.7	12.7	12.7	12.7	12.7	12.7	12.7	12.7
Property with a 7- to 10-year recovery period under the alternative depreciation system (such as recreation property)	0.0	9.3	23.8	31.3	33.8	32.7	31.6	30.5	25.0	15.0	15.0	15.0
Property with a recovery period of more than 10 years under the alternative depreciation system (such as certain property with no class life)	0.0	10.1	26.3	35.4	39.6	40.2	40.8	41.4	37.5	29.2	20.8	12.5

(3) *Example.* The following example illustrates the application of this paragraph (b):

Example. On February 1, 1987, B, a calendar year taxpayer, leases and places in service a computer with a fair market value of \$3,000. The lease is to be for a period of two years. B's qualified business use of the property, which is the only business/investment use, is 80 percent in taxable year 1987, 40 percent in taxable year 1988, and 35 percent in taxable year 1989. B must add an inclusion amount to gross income for taxable year 1988, the first taxable year in which B does not use the computer predominantly for business (*i.e.*, the first taxable year in which B's business use percentage is 50 percent or less). Since 1988 is the second taxable year during the lease, and since the computer has a 5-year recovery period under the General and Alternative Depreciation Systems, the applicable percentage from the table in subdivision (i) of paragraph (b)(2) is -7.2%, and the applicable percentage from the table in subdivision (ii) is 10%. B's inclusion amount is \$154, which is the sum of the amounts determined under subdivisions (i) and (ii) of subparagraph (b)(2) of this paragraph. The amount determined under subdivision (i) is -\$86 [$\$3,000 \times 40\% \times (-7.2\%)$], and the amount determined under subdivision (ii) is \$240 [$\$3,000 \times 80\% \times 10\%$].

[T.D. 8218, 53 FR 29881, Aug. 9, 1988; 53 FR 32821, Aug. 26, 1988, as amended by T.D. 8298, 55 FR 13370, Apr. 12, 1990; Redesignated and amended at T.D. 8473, 58 FR 19060, Apr. 12, 1993; T.D. 9133, 69 FR 35515, June 25, 2004]

§ 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 (Pub. L. No. 98-369; 98 Stat. 585) and amended by section 1804(j) of the Tax Reform Act of 1986 (Pub. L. No. 99-514; 100 Stat. 2807), section 1018(d)(6)-(8) of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. No. 100-647; 102 Stat. 3581), and section 1421 of the Small Business Job Protection Act of 1996 (Pub. L. No. 104-188; 110 Stat. 1755). The following is a table of subjects covered in this section:

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Internal Revenue Service, Treasury

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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 generally 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 that is contingent on a change in ownership or control and the change in ownership or control 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) would qualify as a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof), without regard to whether the corporation had an election to be treated as a

corporation under section 1361 in effect on the date of the change in ownership or control;

(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 with respect to a corporation if a substantial portion of the assets of any entity consists (directly or indirectly) of stock in such corporation and 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. For this purpose, *gross fair market value* means the value of the assets of the entity, determined without regard to any liabilities associated with such assets. 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 in-

clude 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 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 the assets 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 is 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) Before the vote, 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. Except as otherwise provided in this A-7, the normal voting rules of the corporation are applicable. Thus, for example, an optionholder is generally not permitted to vote for purposes of this A-7. For purposes of this A-7, the vote can be on less than the full amount of the payment(s) to be made. Shareholder approval can be a single vote on all payments to any one disqualified individual, or on all payments to more than one disqualified individual. The total payment(s) submitted for shareholder approval, however, must be separately approved by the shareholders. The requirements of this paragraph (b)(1) are not satisfied if approval of the change in ownership or control is contingent, or otherwise conditioned, on the approval of any payment to a disqualified individual that would be a parachute payment but for Q/A-6 of this section.

(2) *Special rule.* 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 as of any day within the six-month period immediately prior to and 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.* (i) 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. See paragraph (b)(4) of this A-7 if the person so authorized by the entity shareholder is a disqualified individual who would receive a parachute payment if the shareholder approval requirements of this A-7 are not met.

(ii) 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 entitled to vote. 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 undergoing a change in ownership or control. 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 (b)(3)(ii), 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 gross fair market value of all of the assets of the entity shareholder. For this purpose, *gross fair market value* means the value of the assets of the entity, determined without regard to any liabilities associated with such assets.

(4) *Disqualified individuals and attribution of stock ownership.* In determining the persons entitled to vote referred to in paragraph (a)(1) or (b)(3) of this A-7, stock that would otherwise be entitled to vote is not counted as outstanding stock and is not considered in determining whether the more than 75 percent vote has been obtained under this A-7 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 are 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 the person authorized to vote the stock of an entity shareholder is a disqualified individual who would

receive a parachute payment if the shareholder approval requirements described in this A-7 are not met, such person is not permitted to vote such shares, but the entity shareholder is permitted to appoint an equity interest holder in the entity shareholder, or in the case of a trust another person eligible to vote on behalf of the trust, to vote the otherwise eligible shares. However, if all persons who hold voting power in the corporation undergoing the change in ownership or control are disqualified individuals or related persons described in this paragraph (b)(4), then such stock is counted as outstanding stock and votes by such persons are considered in determining whether the more than 75 percent 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 is 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, but are not limited to, the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements described in paragraph (a) of this A-7 are 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. Solely 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 who would receive a parachute payment if the shareholder approval requirements of this A-7 are not met. No stock of Corporation P or S is readily tradeable on an established securities market (or otherwise). The value of the stock of Corporation S equals or exceeds one third of the gross fair market value 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 certain 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 entitled to vote 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. (i) Stock of Corporation X, none of which is traded on an established market, is acquired by Corporation Y. In the voting ballot concerning the sale, the Corporation X shareholders are asked to vote either "yes" on the sale and "yes" to paying parachute payments to A, a disqualified individual with respect to Corporation A, or "no" on the sale and "no" to paying parachute payments to A.

(ii) Because the approval of the change in ownership or control is conditioned on the approval of the payments to A, the shareholder approval requirements of this A-7 are not satisfied. If the payments are made to A, the payments are not exempt from the definition of *parachute payment* pursuant to Q/A-6 of this section.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that the acquisition agreement between Corporation X and Corporation Y states that the acquisition is approved only if there are no parachute payments made to A. If the shareholder approval and the disclosure requirements described in this A-7 are met, the payments will not be parachute payments. Alternatively, if the shareholders do not approve the payments, the payments cannot be made (or retained). Thus, the transaction is not conditioned on the approval of the parachute payments. If the payments are made and the requirements of this A-7 are met, the payments are exempt from the definition of *parachute payment* pursuant to Q/A-6 of this section.

Example 3. 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). The value of the stock of Corporation M equals or exceeds one third of the gross fair market value 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. The general partner is not a disqualified individual. 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 4. Corporation A has several shareholders including X and Y, who are disqualified individuals with respect to Corporation A and would receive parachute payments if the shareholder approval requirements of this A-7 are not met. 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 in ownership or control, severance payments are payable to X and Y that are in excess of 3 times each individual's base amount. To determine whether the shareholder 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 entitled to vote.

Example 5. Assume the same facts as in *Example 4*, except that after adequate disclosure of all material facts (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 holding outstanding stock who were entitled to vote did not approve the payments to X and Y, the payments cannot be made.

Example 6. Assume the same facts as in *Example 4* except that disclosure of all the material facts (within the meaning of paragraph (a)(2) of this A-7) 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. Both shareholders approve the payments. Assume further that no adequate 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. Notwithstanding that 80 percent of the shareholders entitled to vote approve

the payments, 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 7. 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 are entitled to vote referred to in paragraph (a)(1) of this A-7, one-third of the stock held by Partnership is not considered outstanding stock. If P is the person authorized by Partnership to approve the payment, none of the shares of Partnership are considered outstanding stock. However, Partnership is permitted to appoint an equity interest holder in Partnership (who is not a disqualified individual who would receive a parachute payment if the requirements of this A-7 are not met), to vote the two-thirds of the shares held by Partnership that are otherwise entitled to be voted.

Example 8. X, Y, and Z are all employees and disqualified individuals with respect to Corporation E. No stock in Corporation E is readily tradeable on an established securities market (or otherwise). 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 each Corporation E shareholder entitled to vote (as determined under this A-7) with a ballot listing and describing the payments of \$400,000 to X; \$600,000 to Y; and \$1,000,000 to Z and the triggering event that generated the payments. 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 indi-

vidual. 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 9. Assume the same facts as in Example 8 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 the \$2,000,000 payments. Assuming the triggering event and amount 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 10. 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 severance and bonus payments. Contingent on the change in ownership or control, B's stock options with a fair market value of \$500,000 immediately vest, \$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 as described in this A-7. The ballot contains adequate disclosure of all material facts and 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 as described by this A-7 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-40 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, life insurance, 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, (including the value of accelerated vesting under Q/A-24(c), 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) *Prepayment rule.* Notwithstanding the general rule described in paragraph (b) of this A-11, a disqualified individual may, in the year of the change in ownership or control, or any later year, prepay the excise tax under section 4999, provided that the payor and disqualified individual treat the payment of the excise tax consistently and the payor satisfies its obligations under section 4999(c) in the year of prepayment. The prepayment of the excise tax for purposes of section 4999 must be based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid (calculated using the discount rate equal to 120 percent of the applicable Federal rate (determined under section 1274(d) and regulations thereunder; see Q/A-32)). For purposes of projecting the future value of a payment that provides for interest to be credited at a variable interest rate, it

is permissible to make a reasonable assumption regarding this variable rate. A disqualified individual is not required to adjust the excise tax paid under this paragraph (c) merely because the interest rates in the future are not the same as the rate used for purposes of projecting the future value of the payment. 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) of this Chapter or to a payment related to health benefits or coverage. The Commissioner may provide additional guidance regarding the applicability of this paragraph (c) to certain payments in published guidance of general applicability under § 601.601(d)(2) of this Chapter.

(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 stock options.

(e) The following example illustrates the principles of this A-11:

Example. D is a disqualified individual with respect to Corporation X. D has a base amount of \$100,000 and is entitled to receive two parachute payments, one of \$200,000 and the other of \$400,000. A change in ownership or control of Corporation X occurs on May 1, 2005, and the \$200,000 payment is made to D at the time of the change in ownership or control. The \$400,000 payment is to be made on October 1, 2010. Corporation X and D agree that D will prepay the excise tax and X will satisfy its obligations under section 4999(c) with respect to the \$400,000 payment. Using discount rate determined under Q/A-32, Corporation X and D determine that 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 ($(\$200,000/\$500,000) \times \$100,000$) and \$60,000 ($(\$300,000/\$500,000) \times \$100,000$), respectively. Thus, the amount of the first excess parachute payment is \$160,000 ($\$200,000 - \$40,000$) and that of the second excess parachute payment is \$340,000 ($\$400,000 - \$60,000$). The excise tax on the \$400,000 payment is \$68,000 ($\$340,000 \times 20$ percent). Assume the present value (calculated in accordance with paragraph (c) of this A-11) of \$68,000 is \$50,000. To prepay the

excise tax due on the \$400,000 payment, Corporation X must satisfy its obligations under section 4999 with respect to the \$50,000, in addition to the \$32,000 withholding required with respect to the \$200,000 payment.

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. 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, for purposes of this section, 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 \times \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 when the option becomes vested (regardless of whether the option has a readily ascertainable fair market value as defined in § 1.83-7(b)). For purposes of this A-13, *vested* means 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 within the meaning of section 83(c). 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 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. Thus, an option is treated as a payment in the nature of compensation on the date of grant or vesting, as applicable, without

regard to whether such option has an ascertainable fair market value. For purposes of this A-13, valuation may be determined by any method prescribed by the Commissioner in published guidance of general applicability under § 601.601(d)(2) of this Chapter.

(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) For purposes of this A-15, a director is a disqualified individual with respect to a corporation if, at any time during the *disqualified individual determination period*, the director is, with respect to the corporation, a shareholder (see Q/A-17 of this section), an officer (see Q/A-18 of this section), or a highly-compensated individual (see Q/A-19 of this section).

(c) For purposes of this A-15, an individual who is an employee or independent contractor of a corporation other than the corporation undergoing a change in ownership or control is disregarded for purposes of determining who is a disqualified individual if such individual is employed by the corporation undergoing the change in ownership or control only on the last day of the disqualified individual determination period. Thus, for example, assume that E is an employee of Corporation X, that Y is acquired by Corporation X, and that Y undergoes a change in ownership or control. If E becomes an employee of Y on the date of the acquisition, in determining the disqualified individuals with respect to Y, E is disregarded under this paragraph (c).

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 noncorporate 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 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 paragraphs (a)(1) and (b) 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 (see Q/A-18) or highly-compensated individual (see Q/A-19) with respect to the corporation.

(b) For purposes of determining the amount of stock owned by an individual for purposes of paragraph (a) of this A-17, the constructive ownership rules of section 318(a) apply. Stock underlying a vested option is considered owned by an individual who holds the vested option (and the stock underlying an unvested option is not considered owned by an individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by §§1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. Solely for purposes of determining the amount of stock owned by an individual for purposes of this A-17, mutual and cooperative corporations are treated as having stock.

(c) The following examples illustrate 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. E does not own, and is not considered to own under section 318, 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. Under paragraph (b) of this A-17, the stock underlying the unvested options held by E on the date of the change in ownership or control is not considered owned by E. Because E is not considered to 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 Q/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. Under paragraph (b) of this A-17, the stock underlying the options that vest on the change in ownership or control is considered owned by E. If the stock considered owned by E exceeds 1 percent of the total fair market value of all of the outstanding shares of all classes of Corporation A stock (including for this purpose, all stock owned or constructively owned by all shareholders, provided that no share of stock is counted more than once), E is a disqualified individual within the meaning of Q/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 non-statutory options will vest on a change in ownership or control. Under paragraph (b) of this A-17, E is not considered to own the stock underlying the options that vest on the change in ownership or control because the options are exercisable for stock subject to a substantial risk of forfeiture within the meaning of section 83. Because E is not considered to 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 Q/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). Any individual who has the title of officer is presumed to be an officer unless the facts and circumstances demonstrate that the individual does not have the authority of an officer. However, an individual who

does not have the title of officer may nevertheless be considered an officer if the facts and circumstances demonstrate that the individual has the authority of an officer. 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.

(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.

(d) In determining the total number of employees of a corporation for purposes of this A-18, employees are not counted if they normally work less than 17½ 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 an officer.

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) The total number of employees of a corporation for purposes of this A-19 is determined in accordance with Q/A-18(d) of this section. 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* means 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 non-qualified 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* includes—

(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 businesses (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 as defined by section 83(c).

(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 the 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 in ownership or control 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 with 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 cor-

poration 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 or control of the corporation occurs. Six months after the change in ownership or control, 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 or control, the termination of C's employment is presumed to be materially related to the change in ownership or control 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 or control 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 or control 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 or control of the corporation, the onset of the tender offer is presumed to be materially related to the change in ownership or control. If this presumption is not rebutted, the payment will be treated as contingent on the change in ownership or control. 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 or control of the corporation occurs and within one year after the date of the change of ownership or control, 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 in ownership or control, 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 are 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 payment that would be a parachute payment if made 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 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 payments under the pre-change agreement that would be parachute payments if made, 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. Paragraph (b) or (c) does not apply to any payment (or portion thereof) if the payment is treated as contingent on the change in ownership or control pursuant to Q/A-25 of this section. For purposes of this A-24, vested has the same meaning as provided in 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 a 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 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. In no event can the portion of the payment treated as contingent on the change in ownership or control under this paragraph (c) exceed the amount of the accelerated payment, or, if the payment is not accelerated, the present value of the payment.

(3) For purposes of this 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) 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. In such a case, the amount reflecting the lapse of the obligation to continue to perform services is 1 percent of the present value of the future 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.

(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 (and not the rules in paragraphs (b) or (c)) 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 the same facts as in paragraph (i) of this *Example 1*, except that E's account balance of \$500,000 is not vested. Instead, assume that 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 the same facts as in paragraph (i) of this *Example 1*, except that in addition to the pay out of the vested account balance of \$500,000 on the change in ownership or control, an additional \$70,000 will be credited to E's account and included in the payment to E. 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.

(v) Assume the same facts as in paragraph (i) of this *Example 1*, except that the benefit under the SERP is calculated using a percentage of final average compensation multiplied by years of service. If, contingent on the change in ownership or control, E is credited with additional years of service, an adjustment to final average compensation, or an increase in the applicable percentage, any increase in the benefit payable under the SERP is not attributable to the performance of services prior to the change, and the entire increase in the benefit 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 D, a disquali-

fied individual with respect to the corporation, 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, 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 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 percent \times 23 months \times \$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 does not change if F actually remains employed until the end of the 5-year period.

(ii) Assume the same facts as in paragraph (i) of this *Example 3*, except that the retention bonus will vest on the 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 in ownership or control as determined under paragraph (c) of this A-24. Because there is accelerated vesting of the bonus, the portion of the payment treated as contingent on the change is the amount described in paragraph (b) of this A-27, which is \$0 under these facts, plus an amount reflecting the lapse of the obligation to continue to perform services which is \$93,573 (1 percent \times 23 months \times \$406,838 (the present value of a \$500,000 payment)).

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, 2009, 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, as determined under paragraph (c) of this A-24, 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 percent \times 23 months \times \$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 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 or control of the corporation occurs and the options become vested in the individual. The value of the options on January 16, 2008, determined in accordance with Q/A-13, is \$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. Thus, the portion of the payment treated as contingent on the change is \$116,036, the sum of \$50,036 (\$600,000 - \$549,964), plus an amount reflecting the lapse of the obligation to continue to perform services which is \$66,000 (1 percent \times 11 months \times \$600,000).

Example 6. (i) Assume the same facts as in *Example 5*, except that the options become vested periodically (absent a change in ownership or 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 or control and the options to purchase the remaining

10,000 shares vest as a result of the change in ownership or control.

(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 as determined under paragraph (c) of this A-24 is treated as contingent on the change in ownership or control. The portion of the payment that is treated as contingent on the change in ownership or control 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 in ownership or control, 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 percent × 11 months × \$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 in ownership or control under paragraph (a) of this A-24. Because the payment was not contingent only on the performance of services for the corporation for a specified period, the rules of paragraph (b) and (c) of this A-24 do not apply. 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, 2005, 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 employ-

ment 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, 2006, 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 and not the rules of paragraphs (b) and (c) of this A-24. 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 a 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 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); a no-additional-cost service (within the meaning of section 132(b)) or qualified employee discount (within the meaning of section 132(c)); a qualified retirement planning services program under section 132(m); an adoption assistance program (within the meaning of section 137); and such other items as provided by the Commissioner in published guidance of general applicability under § 601.601(d)(2). 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 in ownership or control 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 or control 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 or control of the corporation occurs. All payments under the contract are presumed to be contingent on the change in ownership or

control 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 or control 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 or control occurs, but the individual is not terminated until 2 years after the change in ownership or control. 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 or control, 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 of a corporation occurs on the date that any one person, or more than one person acting as a group (as defined in paragraph (b) of this A-27), 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 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. This A-27 applies only when there is a transfer of stock of a corporation (or issuance of stock of a corporation) and stock in such corporation remains outstanding after the transaction. (See Q/A-29 for rules regarding the transfer of assets of a corporation).

(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 a corporation 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 corporations 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 a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(c) For purposes of this A-27 (and Q/A-28 and 29), section 318(a) applies to determine stock ownership. Stock underlying a vested option is considered owned by the individual who holds the vested option (and the stock underlying an unvested option is not considered owned by the individual who holds the unvested option). For purposes of the preceding sentence, however, if the option is exercisable for stock that is not substantially vested (as defined by sections 1.83-3(b) and (j)), the stock underlying the option is not treated as owned by the individual who holds the option. In addition, mutual and cooperative corporations are treated as having stock for purposes of this A-27.

(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. See Q/A-29, *Example 3*, regarding whether there is a change in ownership or control of P.

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 O shareholders also owned Corporation P stock (overlapping shareholders). In the merger, those O shareholders received additional O stock by virtue of their ownership of P stock with a fair market value of 5 percent of the value of Corporation O stock. Including the

O stock attributable to the P shares, the O shareholders hold 54 percent of O after the transaction. However, those overlapping shareholders that owned both Corporation O stock and Corporation P stock prior to the merger are treated as acting as a group with the Corporation O shareholders only with respect to their ownership interest in Corporation O prior to the transaction. Therefore, because the Corporation O shareholders owned 49 percent of the value of Corporation O stock, a change in the ownership of Corporation O occurs on the date of the merger. See Q/A-29, *Example 3*, regarding whether there is a change in ownership or control of P.

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 Q. A change in ownership of Corporation Q 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) Notwithstanding that a corporation has not undergone a change in ownership under Q/A-27, 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 (as determined under paragraph (e) of this A-28), 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) In no event does a change in effective control under this A-28 occur in any transaction in which either of the two corporations involved in the transaction has a change in ownership or control under Q/A-27 or 29 of this section. Thus, for example, assume Corporation P transfers more than one-third of the total gross fair market value of its assets to Corporation O in exchange for 20 percent of O's stock. Because P has undergone a change in ownership of a substantial portion of its assets under Q/A-29 of this section, O does not have a change in effective control under Q/A-28.

(d) 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).

(e) 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 a corporation 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 corporations 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 a corporation only with respect to the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(f) For purposes of determining stock ownership, see Q/A-27(c).

(g) 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 (as determined in paragraph (c) of this A-29), 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. This A-29 applies in any situation other than one involving the transfer of stock (or issuance of stock) in a parent corporation and stock in such corporation remains outstanding after the transaction. Thus, this A-29 applies to the sale of stock in a subsidiary (when that subsidiary is treated as a single corporation with the parent pursuant to Q/A-46) and to mergers involving the creation of a new corporation or with respect to the corporation that is not surviving entity.

(b) (1) There is no change in ownership or control under this A-29 when there is a transfer to an entity that is controlled by the shareholders of the transferring corporation immediately after the transfer, as provided in this paragraph (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—

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

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

(iii) 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

(iv) 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)(1)(iii) of this A-29.

(2) 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 to a corporation in which the transferor corporation has no ownership interest in before the transaction, but which is a majority-owned subsidiary of the transferor corporation after the transaction is not treated as a change in the ownership of the assets of the transferor corporation.

(c) For purposes of this A-29, persons will not be considered to be acting as a group merely because they happen to purchase assets 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 a corporation that enters into a merger, consolidation, purchase or acquisition of assets, or similar business transaction with the corporation. If a person, including an entity shareholder, owns stock in both corporations 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 a corporation only to the extent of the ownership in that corporation prior to the transaction giving rise to the change and not with respect to the ownership interest in the other corporation.

(d) For purposes of determining stock ownership, see Q/A-27(c).

(e) 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 total gross 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. (i) 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.

(ii) The result in paragraph (i) would be the same if 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 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. See Q/A-27, *Example 4*, regarding whether there is a change in ownership or control of O.

Example 4. Corporation P sells all of the stock of its wholly-owned subsidiary, S, to Corporation Y. The fair market value of the affiliated group, determined without regard to its liabilities, is \$210 million. The fair market value of S, determined without regard to its liabilities, is \$80 million. Because there is a change in more than one-third of the gross fair market value of the total assets of the affiliated group, there is a change in the ownership of a substantial portion of the assets of the affiliated group.

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 pay-

ments, 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 or control of Corporation M totaling \$400,000 are made to A on the date of the change in ownership or control. The payments are parachute payments because they have an aggregate present value at least equal to 3 times A's base amount of \$100,000 ($3 \times \$100,000 = \$300,000$).

Example 2. Assume the same facts as in *Example 1*, except that the payments contingent on the change in the ownership or control of Corporation M total \$290,000. Because 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, using the period until the payment would have been made without regard to the change in ownership or control as the term of the debt instrument under section 1274(d). 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 con-

tingent 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) To the extent provided in published guidance of general applicability under §601.601(d)(2) of this Chapter, an initial estimate of the value of an option subject to Q/A-13 of this section is permitted to be made, with the valuation subsequently re-determined, and the 3-times-base-amount test re-applied.

(d) 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 as defined in Q/A-21 of this section) 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. See Q/A-35 for the definition of 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 ($\$400,000 \times (5/5)$).

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 $\$120,000, ((3 \times \$30,000) + \$120,000 + \$150,000)/3$.

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 $\$140,000, ((\$60,000 + (3 \times \$30,000)) + \$120,000 + \$150,000) / 3$. 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.

Example 3. E is a disqualified individual with respect to Corporation X who was not an employee or independent contractor for the full 5-year base period. In 2004 and 2005, E is a director of X and receives \$30,000 per year for E's services. In 2006, E becomes an officer of X. E's includible compensation from Corporation X is \$250,000 for 2006 and 2007, and \$300,000 for 2008. In 2008, X undergoes a change in ownership or control. E's base amount is $\$140,000 ((2 \times \$250,000) + (2 \times \$30,000) / 4)$.

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 or control 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 or control of Corporation M. In this case, A's base amount is \$120,000 ($2 \times \$60,000$). 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 ($3 \times \$120,000 = \$360,000$), 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 or control. When the change in ownership or control 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 ($\$50,000 + (2 \times \$60,000)$). Because 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 ($3 \times \$170,000 = \$510,000$), 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 3 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 $((\$200,000/\$500,000) \times \$100,000)$ and \$60,000 $((\$300,000/\$500,000) \times \$100,000)$, 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 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 are 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) and (c) 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 (*e.g.*, 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 (including involuntary termination or constructive discharge); 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.

(d) 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 instead of agreeing not to compete with Corporation N, under the new agreement A agrees not to disparage either Corporation M or Corporation N. Because the nondisparagement agreement does not substantially constrain A's ability to perform services, no amount of the payments under this contract are reasonable compensation for the nondisparagement agreement.

Example 5. 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: 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 provide 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 if the change in ownership or control occurs on or after

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January 1, 2004. Taxpayers may rely on these regulations after August 4, 2003, for the treatment of any parachute payment.

[T.D. 9083, 68 FR 45750, Aug. 4, 2003; T.D. 9083, 68 FR 59114, Oct. 14, 2003]

§ 1.280H-0T Table of contents (temporary).

This section lists the captions that appear in the temporary regulations under section 280H.

§ 1.280H-1T Limitation on certain amounts paid to employee-owners by personal service corporations electing alternative taxable years (temporary).

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 - (1) In general.
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 - (4) Definition of applicable amount.
 - (i) In general.
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 - (A) In general.
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 - (e) Special rules and definition.
 - (1) Newly organized personal service corporations.
 - (2) Existing corporations that become personal service corporations.
 - (3) Disallowance of NOL carryback.
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- (5) Examples.
- (f) Effective date.

[T.D. 8205, 53 FR 19711, May 27, 1988]

§ 1.280H-1T Limitation on certain amounts paid to employee-owners by personal service corporations electing alternative taxable years (temporary).

(a) *Introduction.* This section applies to any taxable year that a personal service corporation has a section 444 election in effect (an “applicable election year”). For purposes of this section, the term *personal service corporation* has the same meaning given such term in § 1.441-3(c).

(b) *Limitation on certain deductions of personal service corporations—(1) In general.* If, for any applicable election year, a personal service corporation does not satisfy the minimum distribution requirement in paragraph (c) of this section, the deduction otherwise allowable under chapter 1 of the Internal Revenue Code of 1986 (the Code) for applicable amounts, as defined in paragraph (b)(4) of this section, shall not exceed the maximum deductible amount, as defined in paragraph (d) of this section.

(2) *Carryover of nondeductible amounts.* Any amount not allowed as a deduction in an applicable election year under paragraph (b)(1) of this section shall be allowed as a deduction in the succeeding taxable year.

(3) *Disallowance inapplicable for certain purposes.* The disallowance of deductions under paragraph (b)(1) of this section shall not apply for purposes of subchapter G of chapter 1 of the Code (relating to corporations used to avoid income tax on shareholders) nor for determining whether the compensation of employee-owners is reasonable. Thus, for example, in determining whether a personal service corporation is subject to the accumulated earnings tax imposed by section 531, deductions disallowed under paragraph (b)(1) of this section are treated as allowed in computing accumulated taxable income.

(4) *Definition of applicable amount—(i) In general.* For purposes of section 280H and the regulations thereunder, the term *applicable amount* means, with respect to a taxable year, any amount