

control that is a *tax-exempt organization*. As defined in the 2002 proposed regulations, a *tax-exempt organization* is any organization described in section 501(c) that is subject to any express statutory prohibition against inurement of net earnings to the benefit of any private shareholder or individual, an organization described in sections 501(c)(1) or 501(c)(21), any religious or apostolic organization described in section 501(d), or any qualified tuition program described in section 529. Second, the organization must meet the definition of *tax-exempt organization*, as defined in the 2002 proposed regulations, both immediately before and immediately after the change in ownership or control.

One commentator requested the elimination of the requirement that the payment must be made by a tax-exempt organization. Instead, the commentator suggested that the regulations require only that the payment be approved by the tax-exempt organization. The exemption included in Q/A-6 of the 2002 proposed regulations for certain tax-exempt entities described in section 501(c) is premised on the fact that those entities are subject to a statutory prohibition on private inurement. Requiring merely the approval of a tax-exempt organization would allow corporations not subject to the inurement prohibition to make the payments and, thus, to avoid the application of section 280G. Thus, these regulations retain the requirements contained in the 2002 proposed regulations.

2. Small Corporation Exemption

Under section 280G and the 2002 proposed regulations, the term *parachute payment* does not include any payment to a disqualified individual with respect to a corporation which (immediately before the change in ownership or control) was a small business corporation (as defined in section 1361(b) but without regard to section 1361(b)(1)(C) thereof). *See also*, Q/A-6(a)(1).

Commentators indicated that the 2002 proposed regulations do not clearly address whether a corporation that does not elect to be treated as an S Corporation, but could make the election (because aside from the election the corporation otherwise meets the requirements to be treated as an S corporation), may use the exemption under Q/A-6(a)(1). These regulations clarify that a corporation that could elect to be treated as an S Corporation under the Code, but does not do so, may nevertheless use the exemption of Q/A-

6(a)(1) for any payments to a disqualified individual.

In addition, commentators recommended that the final regulations provide that a corporation domiciled outside the United States can qualify for both the small business corporation exception and the shareholder approval exception. With respect to the small business corporation exception, Treasury and the IRS do not have the authority to expand this exception to include foreign corporations. Section 280G(b)(5)(A)(i) refers to "a small business corporation (as defined in section 1361(b) but without regard to paragraph (1)(C) thereof)." A small business corporation as defined in section 1361(b) must be a domestic corporation, and section 1361(b)(1)(C) merely addresses the existence of a nonresident alien as a shareholder. It is clear from the statute that the small business corporation exception cannot apply to a foreign corporation.

On the other hand, Treasury and the IRS believe that a foreign corporation may qualify for the shareholder approval exception, discussed below, if all of the applicable requirements are satisfied. Because the statute and regulations permit this result, it is not necessary to specify the treatment in the final regulations.

3. Shareholder Approval

Additionally, under section 280G and the 2002 proposed regulations, the term *parachute payment* does not include any payment to a disqualified individual with respect to a corporation 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) certain shareholder approval requirements are met.

Section 280G(b)(5)(B) provides that the shareholder approval requirements are met if two conditions are satisfied. First, the payment is approved by a vote of the persons who owned, immediately before the change in ownership or control, more than 75 percent of the voting power of all outstanding stock of the corporation. Second, there is adequate disclosure to shareholders of all material facts concerning all payments which (but for this rule) would be parachute payments with respect to a disqualified individual.

Q/A-7(b) of the 2002 proposed regulations provides rules to determine the shareholders who are entitled to vote. In response to comments, Q/A-7(b)(1) is revised to clarify that only stock that would otherwise be entitled to vote is considered outstanding and is entitled to vote for purposes of Q/A-

7(b). Thus, for example, because an individual who only holds options generally would not be entitled to vote, such individual will not be considered to hold outstanding stock entitled to vote for purposes of Q/A-7.

Q/A-7(b)(2) of the 2002 proposed regulations includes a rule of administrative convenience allowing the corporation to identify shareholders eligible to vote for this purpose using the shareholders of record at the time of any vote taken in connection with a transaction or event giving rise to the change in ownership or control within the three-month period ending on the date of the change in ownership or control.

Several commentators suggested that the final regulations permit corporations to determine the shareholders of record at any time during the three months prior to the change in ownership or control. Other commentators requested that the time be expanded in the final regulations. In response to these comments, these regulations expand this rule to allow corporations to determine the shareholders of record on any day during the six-month period ending on the date of the change in ownership or control, regardless of whether there was a vote on that day.

Q/A-7(b)(4) is revised to clarify that stock held (directly or indirectly) by a disqualified individual who would receive a parachute payment if the shareholder approval requirements of Q/A-7 are not met is not entitled to vote with respect to a payment to be made to any disqualified individual. For example, assume E is a disqualified individual with respect to Corporation X. E's base amount is \$100,000, and on a change in ownership or control of X, E will receive contingent payments of \$295,000. Corporation X undergoes a change in ownership or control. In determining the persons who are entitled to vote under Q/A-7(b), any stock held by E is considered outstanding and E is entitled to vote. If E would receive contingent payments of \$305,000 on the change in ownership or control, any stock held by E is not considered outstanding and is not entitled to vote under Q/A-7 with respect to payments to any disqualified individual.

An entity shareholder is not entitled to vote stock that it holds that is constructively owned by a disqualified person who would receive a parachute payment if the shareholder approval requirements of Q/A-7 are not met. Additionally, these regulations provide in Q/A-7(b)(4) that if the person authorized to vote the stock of an entity shareholder is a disqualified individual