

who would receive a parachute payment if the requirements of Q/A-7 are not met, such person is not permitted to vote any of the shares held by the entity shareholder. However, the entity shareholder is permitted to authorize another equity interest holder in the entity shareholder to vote the otherwise eligible shares or, in the case of a trust, another person eligible to vote on behalf of the trust. Thus, for example, assume a partner owns one-third of a partnership; the partner is authorized to vote on behalf of the partnership; the partnership owns stock in a corporation; the partner is a disqualified individual with respect to the corporation; and the corporation undergoes a change in ownership or control. Under these circumstances, none of the stock held by the partnership is entitled to vote under Q/A-7. However, the partnership is permitted to appoint an equity interest holder in the entity shareholder (who is not a disqualified individual who would receive parachute payments if the shareholder approval requirements of Q/A-7 are not met) to vote two-thirds of the stock.

More generally, several commentators requested significant revisions to Q/A-7 to reflect certain business practices. The revisions suggested by commentators include, among other things, treating approval of a compensation agreement when the agreement is executed as sufficient for Q/A-7 or deeming shareholders who acquire stock after approval of any compensation agreements to consent to any parachute payments contained in these agreements. While the Treasury Department and IRS understand that the requirements of Q/A-7 may not coincide with certain business practices, the requirements of Q/A-7 are based on the statutory framework provided by Congress. The golden parachute provisions are intended to protect equity shareholders whose interest in the corporation could be impaired by parachute payments to disqualified individuals by discouraging these types of payments. The basic structure of section 280G does not permit any approval or shareholder vote for a publicly traded corporation. The exception for corporations that are not publicly traded is based on a vote of those persons who hold shares immediately before the change in ownership or control after adequate disclosure. The suggested revisions to the shareholder approval requirements are inconsistent with these requirements and, accordingly, no changes are made in these regulations.

Payment of the Excise Tax Under Section 4999

Q/A-11(c) of the 2002 proposed regulations provided a mechanism to allow a disqualified individual to prepay the excise tax under section 4999 in certain circumstances. Thus, the requirements of section 4999 may be satisfied in the year of the change in ownership or control (or the first year for which a payment contingent on a change in ownership or control is certain to be made) even though the payment is not yet includible in income (or otherwise received).

These regulations continue to allow the prepayment of the excise tax in the year of the change in ownership or control. These regulations also provide that a taxpayer may prepay the excise tax in a later year. For purposes of prepayment, these regulations require the payor and disqualified individual to treat the payment of the excise tax consistently and require the payor to satisfy its obligations under section 4999. These regulations clarify that the prepayment of the excise tax is based on the present value of the excise tax that would be due in the year the excess parachute payment would actually be paid. For purposes of determining the present value of the excise tax due, the discount rate is determined in accordance with Q/A-32.

Thus, for example, assume that E is a disqualified individual with respect to Corporation X, that X undergoes a change in ownership or control, and that E receives parachute payments, including a series of annual payments to be made for the next 10 years. Assume further that all other parachute payments to E are made in the year of the change in ownership or control (with payment of the excise tax and compliance by X with section 4999(c)). Under these regulations, if three years after a change in ownership or control, X and E agree that E will prepay the excise tax related to the remaining annual payments, and that X will satisfy its obligations under section 4999(c) related to these payments, E is permitted to prepay the excise tax with respect to the remaining payments.

The 2002 proposed regulations provided that the prepayment of the excise tax would not be available with respect to certain payments, including payments related to health benefits or coverage. Commenters requested that the prepayment option be expanded to include health benefits or coverage. Treasury and the IRS do not consider the available valuation methods sufficient to allow projections of individual payments related to health

coverage or health benefits for this purpose. In the event that valuation methods change or there is otherwise greater certainty with respect to the valuation of such benefits, Treasury and the IRS may consider additional guidance that would make prepayment of the excise tax with respect to such benefits available.

Treatment of Options

Q/A-13 of the 2002 proposed regulations provides that the transfer of an option is treated as a payment when the option becomes substantially vested without regard to whether the option has an ascertainable fair market value under § 1.83-7(b) of the regulations. Thus, the vesting of an option is treated as a payment in the nature of compensation for purposes of section 280G. Vested is defined in these regulations as 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).

The 2002 proposed regulations, and the 1989 proposed regulations, provided that options must be valued under the facts and circumstances of a particular case. Factors relevant to the determination include, but are not limited to: The difference between the option's exercise price and the value of the option property, the probability of the value of the option property increasing or decreasing, and the length of the period during which the option can be exercised.

In coordination with the issuance of the 2002 proposed regulations, the Commissioner issued two revenue procedures under section 280G providing additional guidance on the valuation of options, Rev. Proc. 2002-13, 2002-8 I.R.B. 549, and Rev. Proc. 2002-45, 2002-27 I.R.B. 40. These revenue procedures provide guidance on the use of option valuation methods, and provide that using only the spread between the exercise price and the value of the option property is not an adequate method for valuing an option. The revenue procedures also provide a safe harbor method of valuation based on a table. Comments received in response to these revenue procedures raised issues related to the difficulty of valuing options in the context of a change in ownership or control, particularly with respect to assumptions regarding the term of the option and the volatility. In coordination with the issuance of these regulations, the IRS is issuing a revenue procedure restating the previous revenue procedures and addressing these comments.