INTERNAL REVENUE SERVICE
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Attention:

Company =

Employee A =

Employee B =

Employee C =

date d =

date e =

date f =

year g =

$h =

$i =

$j =

$k =

$l =

$m =

This is in reply to a request for a ruling concerning whether proposed accelerated payments to be made by Company of all amounts due to Employees A, B, and C (Employees)

pursuant to stock option agreements constitute "applicable employee remuneration" under section 162(m)(4) of the Internal Revenue Code.

Company entered into nonqualified stock option agreements on date d with Employees. These agreements were amended and restated on date e and are in effect today. Under the option agreements, Employees were granted nonqualified stock options entitling each Employee to purchase a specified number of shares of Company stock. It is represented that the options did not have a readily ascertainable fair market value at the time of their grant.

Employees exercised the options once in year g. It is represented that each of the Employees included in their income for year g an amount equal to the market price of the optioned stock at the time of exercise less the exercise price of the options and the amounts the Employees paid for the options.

Under the option agreements, Company is obligated to make an imputed interest payment and a tax indemnification payment to each of the Employees as described below.

Under the option agreements, upon exercising the options each Employee was entitled to and did borrow from Company an amount equal to the tax liability the Employee would have as a result of recognizing ordinary income upon exercising the options. Pursuant to the terms of the option agreements, these loans were recourse to the Employees and were interest free. The principal amount of the loan becomes due in full on the date on which the Employee transfers the beneficial ownership of all of the shares of optioned stock, with all proceeds of any sale of less than all of the shares, as well as any dividends paid by Company with respect to the shares, applied as pre-payments of the loan. As of date f, the balance of the loans to Employees A, B, and C were $g, $h, and $i, respectively.

While the loans to the Employees are interest-free, under the imputed interest rules of section 7872 of the Code, an amount of interest is imputed as income to the Employees. Further, for each year that the loans are outstanding, the Employees are treated as receiving taxable compensation income from Company equal to the amount of the imputed interest. And, in connection with this imputed interest income, under the option agreements, for each year during which the loans are outstanding, Company is obligated to pay each Employee an amount equal to the sum of

(1) income tax the Employees would have to pay on the imputed interest income; and

(2) any tax the Employees would have to pay as a result of recognizing the income in (1).

Also under the terms of the option agreements, at the time that each Employee sells any shares of optioned stock, Company is obligated to pay the Employee an amount (tax indemnification payment) equal to the sum of

(1) the excess of (a) the tax at ordinary income rates that the Employee has paid upon exercising the option, plus the tax at capital gains rates the Employee would pay on the sale of the optioned stock, over (b) the amount of tax at capital gains rates the Employee would have paid on the sale of the optioned stock had the Employee instead purchased that stock for the amount paid to purchase the option; and

(2) the grossed-up amount of tax the Employee would have to pay as a result of recognizing the income described in (1).

While Company cannot accurately ascertain the amount of the imputed interest payments it will have to make each year to the Employees, Company can determine the amount of the tax indemnification payments it will be obligated to make when the Employees sell optioned stock, if Company assumes that the capital gains tax rate at the time the Employees sell the optioned stock is the same as the current capital gains tax rate.

Company proposes to terminate its obligation to make the payments and, instead, make an accelerated payment of all amounts due to the Employees under the option agreements. This accelerated payment would equal in amount the tax indemnification payment Company is obligated to currently make under the option agreements based on existing tax rates. All obligations to make the imputed interest payments would be eliminated and the Employees would be required to pay the loans they received to purchase the stock.

Company represents that it would make payments to A, B and C of approximately $k, $l and $m respectively. Assuming the annual imputed interest payments Company would have made to each Employee were equal in amount to the amount paid each Employee for the tax year ended date f, if the accelerated payment Company makes to each Employee is equal in amount to the tax indemnification payment the Employee would have received in the future, it would mean that Company had discounted all the payments due under the option agreements using an interest rate of between 6% and 7.3% which is similar to the applicable federal rate for the year ended date f.

Company contends that because of unknown factors such as the future capital gains tax rate, the future applicable federal interest rates, and the time at which the Employees will sell the optioned stock, the amount of the future payments Company is trying to discount cannot be determined with certainty and, therefore, Company believes that an accelerated payment in the amount of the tax indemnification payment and the elimination of the imputed interest payment

constitutes a reasonably discounted value of the sum of the stream of imputed interest payments and the tax indemnification payment.

Section 162(m)(1) of the Code generally provides a limit of $1 million on the deduction for compensation paid during any taxable year for the chief executive officer and the other four highest compensated officers of any publicly held corporation. Section 162(m)(2) defines "publicly held corporation" to mean any corporation issuing any class of common equity securities required to be registered under section 12 of the Securities Exchange Act of 1934. Section 162(m)(3) defines a covered employee to include any employee of the taxpayer if as the close of the taxable year, such employee is the chief executive officer of the taxpayer or is an individual acting in such capacity, or the total compensation of such employee for the taxable year is required to be reported to shareholders under the Securities Exchange Act of 1934 by reason of such employee being among the 4 highest compensated officers for the taxable year (other than the chief executive officer).

Section 162(m)(4) of the Code defines applicable employee remuneration, with respect to any covered employee for any taxable year, generally as the aggregate amount allowable as a deduction for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by the employee (whether or not during the taxable year). However, remuneration payable under a written binding contract in effect on February 17, 1993, and not modified thereafter in any material respect before the remuneration is paid is excepted from the definition of "applicable employee remuneration."

Section 1.162-27(h)(1) of the Income Tax Regulations sets forth rules for what constitutes a written binding contract that was in effect on February 17, 1993. It provides, in relevant part, that the corporation must be obligated to pay the compensation if the employee performs the services and that the exception for written binding contracts in effect on February 17, 1993 does not apply to a written binding contract that is materially modified. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a binding written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. A modification of the contract that accelerates the payment of the compensation will be treated as a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a binding, written contract where the facts and circumstances show that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract.

In this case, assuming the stock option agreements that were entered into on date d, and amended and restated on date e constitute written binding contracts under applicable state law in

effect on February 17, 1993, the imputed interest payments and tax indemnification payments will not be subject to the deduction disallowance rules of section 162(m) of the Code, unless Company's proposal to accelerate the payments of compensation constitutes a material modification of the existing stock option agreements. Under the regulations, a modification of a binding written contract that accelerates the payment of compensation will not be treated as a material modification if the amount of compensation paid is discounted to reasonably reflect the time value of money.

Based on the facts submitted and, provided that under applicable state law Company is obligated to pay the compensation in question, we rule that the proposed accelerated payments will not constitute "applicable employee remuneration" within the meaning of section 162(m)(4) of the Code.

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

Sincerely yours,

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ROBERT B. MISNER
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Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosure:
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