

INTERNAL REVENUE SERVICE

Number: **200009013**

Release Date: 3/3/2000

Index No: 404.10-00

CC:EBEO:1 - PLR-114243-99

November 26, 1999.

X =

This is in response to your request for a ruling on behalf of X, concerning the federal income tax consequences under § 404 of the Internal Revenue Code of the payment of certain amounts to participants in a stock appreciation (SAR) plan. X, a calendar year S corporation, established the Stock Appreciation Rights Plan For Key Employees of X in 1989 ("Plan"). Pursuant to the plan, key employees of X and its subsidiaries are granted SAR's in order to advance the interests of X through motivation, attraction and retention of those key employees. Under the terms of the Plan, employees who are awarded SAR's must remain employed by X or its subsidiaries for at least one year. All SAR's are nontransferable and can only be surrendered by the employees to whom they are awarded.

Under the terms of the Plan, an SAR entitles an employee to receive, at the time specified in the award, a cash payment equal to the excess of the book value of one share of X authorized common and capital stock on the date the SAR is surrendered over the date of grant value of the surrendered SAR, as established by the X Board of Directors Compensation Committee ("Committee"). The Plan provides that the value set by the Committee upon grant of an SAR may not be less than 100 percent of the book value of one share.

The Plan provides that SAR's may be exercised from time to time over a period commencing one year from the date of the award and ending upon termination of the award. To the extent that it has not been exercised, each SAR terminates upon the first to occur of: (1) the expiration of the period specified in the award, which may not be less

than 24 months, or more than 126 months from the date of the award, or (2) when the employment of the employee by X or its subsidiaries terminates. The Plan also provides that in the event of a sale or other change of control of X representing 80 percent or more of the Company's outstanding voting shares, participants have the right to surrender all SAR's immediately prior to the sale, at which time the SAR's would otherwise terminate.

On June 30, 1999, a change of control and recapitalization of X, resulted in X becoming a C corporation. Thus, January 1, 1999 - June 29, 1999, constituted a short tax year for X as an S corporation ("the S Short Year") and June 30, 1999 - December 31, 1999, will constitute a short tax year for X as a C corporation ("the C Short Year").

The last awards under the Plan were made on June 15, 1998 ("the 1998 SARs"). All other awards of SARs were made more than one year before the awarding of the 1998 SARs. Thus, as of June 15, 1999, all outstanding SAR's had been awarded more than a year earlier and were therefore immediately exercisable. By resolution of the X Board of Directors, all SAR's were deemed and treated as surrendered and all participants were paid for their SAR's on the day immediately preceding the change of control: June 29, 1999. Participants will include the SAR payments in income for the taxable year ending December, 1999.

Section 404(a)(5) of the Code provides the general deduction timing rules applicable to any plan or arrangement for the deferral of compensation, regardless of the Code section under which the amounts might otherwise be deductible. Pursuant to § 1.404(a)-12(b)(2) of the Income Tax Regulations, and provided that they otherwise meet the requirements for deductibility, contributions or compensation deferred under a nonqualified plan or arrangement are deductible in the taxable year in which they are paid or made available, whichever is earlier.

Section 1.404(b)-1T Q/A-1 of the Regulations provides generally that under §404(a)(5), if an amount is otherwise deductible under §§ 162 or 212, a contribution paid or incurred with respect to a nonqualified plan, method or arrangement, providing for deferred benefits is deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the amount attributable to the contribution is includible in the gross income of the employee. Section 1.404(b)-1T Q/A-2(a) provides that a plan, or method or arrangement, defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed. The determination of whether a plan, or method or arrangement, defers the receipt of compensation or benefits is made separately with respect to each employee and each amount of compensation or benefit.

Section 1.404(b)-1T Q/A-2(b)(1) provides that a plan, or method or arrangement, shall presume to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered ("the 2 ½ month period"). Section 1.404(b)-1T Q/A-2(c) provides that a plan, or method or arrangement, shall not be considered as deferring the receipt of compensation or benefits for more than a brief period of time after the end of the employer's taxable year to the extent that compensation or benefits are received by the employee on or before the end of applicable 2 ½ month period.

Provided that participation in the Plan did not previously cause participants reporting income on the cash receipts and disbursements method of accounting to be in constructive receipt of income, within the meaning of § 451 of the Code, before the time SARs were surrendered and based on the information submitted and representations made, we conclude that:

1. The amount paid to participants upon surrender of the 1998 SARs on the last day of the S Short Year does not constitute deferred compensation within the meaning of § 1.404(b)-1T Q/A-2 and is therefore deductible by X in the S Short Year in accordance with X's method of accounting, to the extent the requirements of § 162 are met.
2. The amount paid to participants upon the surrender of SARs awarded prior to June 15, 1998, on the last day of the S Short Year constitutes deferred compensation within the meaning of § 1.404(b)-1T Q/A-2, and is deductible only in the C Short Year, in accordance with § 404(a)(5) of the Code and the Regulations thereunder, to the extent the requirements of § 162 are met.

Except as specifically ruled on above, no opinion is expressed as to the federal tax consequences of the above transaction under any other provision of the Code. Specifically, no opinion is expressed as to the income tax consequences of participation in the arrangements by any individual who is a controlling shareholder of X, or regarding the validity of X's election under § 1362(a) of the Code.

This ruling is directed only to the taxpayer who requested it, is effective as of the date of this ruling. If the transaction is otherwise altered, this ruling may not necessarily remain in effect. Section 6110(j)(3) of the Code provides that this ruling may not be used or cited as precedent.

Sincerely yours,

CHARLES T. DELIEE
Chief, Branch 1
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosure:

Copy for § 6110 purposes