

Internal Revenue Service

Department of the Treasury

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Person to Contact:

Telephone Number:

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Date:
May 24, 2000

Company =

Buyer =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

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This is in response to your letter of September 16, 1999, requesting rulings under section 280G of the Internal Revenue Code. Specifically, you requested a ruling that the purchase of Company common and preferred stock by Buyer (the Purchase) described below, will not cause a change in the ownership or effective control of Company, or in the ownership of a substantial portion of the assets of Company within the meaning of section 280G(b)(2) of the Code. The facts as submitted are as follows.

Company is a widely-held publicly traded corporation that is managed by its founders. On Date 1, representatives of Company met with representatives of Buyer, a closely-held corporation, to discuss the possibility of an investment in Company by Buyer.

On Date 2, Company and Buyer agreed on the basic structure of the transaction, which involved the acquisition by Buyer of \$b of a new convertible preferred stock as well as a tender offer by Buyer for a portion of the outstanding shares of common stock. Company and Buyer tentatively agreed that Buyer would have the right to designate c of d nominees for election to the Board of Directors. On Date 3, Company and Buyer executed various documents, including the Stock Purchase Agreement and the Management Agreement.

Pursuant to the Stock Purchase Agreement, Buyer commenced a tender offer to purchase shares of Company common stock. No shares were tendered to Buyer under the tender offer and the tender offer expired. On Date 4, Company and Buyer executed a first amendment to the Stock Purchase Agreement which reduced the number of individuals Buyer was permitted to designate as nominees for the Board of Directors from c to e (less than a majority). While Buyer may designate e nominees, the election of all the nominated directors must be approved by a majority vote of the shareholders.

Under the Stock Purchase Agreement, Buyer and Company agreed that Buyer would purchase the Company's Series A Convertible Preferred Stock in two separate issuances of f and g shares respectively. Each share of Series A Convertible Preferred Stock has the right to one vote for each share of common stock into which it could be converted. Pursuant to the Management Agreement, Buyer purchased h% of each director's interest (as of Date 3) in Company.

On Date 5, Company's shareholders approved the second Issuance of Series A Preferred Stock, the sale of common stock under the Management Agreement, and the election of the Board of Directors of Company.

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Following the Purchase described above, Buyer owned approximately j% of Company's common stock, including common stock issuable upon conversion of the preferred stock. Buyer owned k% on a diluted basis based on the number of stock options outstanding on Date 5. This ownership interest represented a greater than 20% interest in Company's outstanding stock.

The Stock Purchase Agreement provides buyer with limited anti-dilution protection. The anti-dilution protection does not apply to certain transactions, including shares issued to employees, officers and directors pursuant to stock purchase plans, option plans, or other similar arrangements. Company has historically issued a large percentage of its stock to employees in the form of stock options. It has been represented that Company will continue to issue similar amounts of stock options to employees in the future. Since the time of the Purchase, Buyer's ownership interest has declined to l% of Company's common stock (m% on a fully diluted basis). Buyer's interest will continue to decline as more options are granted to and exercised by Company's employees.

Following the Purchase, the Chief Executive Officer and the President of Company will hold n% and o%, respectively. None of Buyer's management or shareholders were appointed to any management positions in Company following the Purchase.

Section 280G of the Code provides that no deduction will be allowed for any excess parachute payment. Section 280G(b)(1) defines the term "excess parachute payment" as an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.

Section 280G(b)(2)(A) of the Code defines the term "parachute payment" as any payment in the nature of compensation to (or for the benefit of) a disqualified individual if (i) such payment is contingent on a change (I) in the ownership or effective control of the corporation, or (II) in the ownership of a substantial portion of the assets of the corporation; and (ii) the aggregate present value of the payments in the nature of compensation to (or for the benefit of) such individual which are contingent on such change equals or exceeds an amount equal to three times the base amount.

Section 4999(a) of the Code imposes on any person who receives an excess parachute payment a tax equal to 20 percent of the amount of the payment.

Section 1.280G-1 of the Proposed Income Tax Regulations, Q&As 27, 28 and 29, published in the Federal Register on May 5, 1989, (54 Fed. Reg. 19,390), provides guidance concerning when a corporation will be considered to have undergone a change in ownership or effective control, or a change in the ownership of a substantial portion of its assets.

Q&A 27(a) provides that a change in the ownership or control of a corporation occurs on the date that any one person, or more than one person acting as a group,

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acquires ownership of stock of the corporation that, together with stock held by such person or group, possesses more than 50 percent of the total fair market value or total voting power of the stock of such corporation. Q&A 27(b) provides that 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 an entity that enters into a merger, consolidation, purchase or acquisition of stock, or similar business transaction with the corporation.

Q&A 28(a) provides, in part, that a change of 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, 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 the 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.

The presumption of Q&A 28(a)(1) and (2) may be rebutted by establishing that the acquisition or acquisitions of the corporation's stock, or the 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). Q&A 28(b) contains the same language as Q&A 27(b) concerning when persons will be considered to be "acting as a group."

The information submitted indicates that, immediately following the Purchase, the Buyer did not acquire more than 50 percent of the value of the outstanding Company stock. Since Company's shareholders retained sufficient stock value and voting power following this transaction, Company did not experience a change of ownership under Q&A 27.

Due to the Purchase described above, however, Buyer received a greater than 20 percent voting interest in Company. Accordingly, it is presumed that Buyer experienced a change in effective control under Q&A 28(a)(1). (The presumption of Q&A 28(a)(2) concerning a replacement of a majority of the board of directors did not occur.) Company has rebutted this presumption by establishing that the acquisition of its stock by Buyer did not transfer the power to control its management and policies. Factors establishing that control was not transferred include that there is substantial stock ownership remaining with its founders and current management; Buyer's interest will fall to below 20% over a relatively short period of time due to dilution that will occur when options are exercised by Company's employees; none of Buyer's shareholders or management hold management positions with Company; Buyer's acquisition is consistent with that of an institutional investor; and Company, in fact, competes in the marketplace with other businesses owned or invested in by Buyer.

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Accordingly, based strictly on the information submitted and Company's representations, we rule as follows:

- 1) The Purchase did not cause a change in the ownership or effective control of Company, nor did it cause a change in the ownership of a substantial portion of Company's assets within the meaning of section 280G of the Code.
- 2) The provisions of section 4999 of the Code do not apply to any payments that are received by employees or former employees of Company that are contingent upon the Purchase.

Except as specifically ruled on above, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent. The Taxpayer should attach a copy of this ruling to any income tax return to which it is relevant.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent that the regulations are inconsistent with any conclusion in the ruling. However, when the criteria in section 12.05 of Rev. Proc. 2000-1, 2000-1 I.R.B. 4, 47 are satisfied, a ruling is not revoked or modified retroactively, except in rare or unusual circumstances.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to the taxpayer and the other authorized representative.

Sincerely yours,
ROBERT B. MISNER, Assistant Chief,
Executive Compensation Branch
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)

Enclosure:

Copy for 6110 purposes