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Legend

X =

Y =

Dear

This is in response to your request for certain rulings on behalf of X concerning the application of section 162(m) of the Internal Revenue Code and the regulations thereunder to certain compensation plans of X and Y.

X intends to spin off its subsidiary, Y, in a two-step transaction. First X, has sold some, but less than 20 percent, of the stock of Y to the public in an IPO and has listed Y's stock on one of the stock exchanges. As a result, Y became a publicly traded corporation. Second, the distribution of the remaining stock of Y to X's shareholders as a dividend or in exchange for shares of X stock may take place at some future date to be decided upon by the Board of Directors of X.

One day prior to the IPO, Y's stock option and executive compensation plans (the Plans) were approved by X, its parent. Because the respective administration committees for the Plans have retained the right to change the performance targets, X and Y understand that the Plans (like any other shareholder-approved plans authorizing amendments of performance targets) will have to be resubmitted to shareholders for approval at least once every five years.

Three of the Plans will be administered by Y's Compensation Committee (which will include as members certain officers and directors of X). The fourth Plan will be administered by the Y Strategy Board (whose members currently are Y management employees). It is not contemplated that any performance awards will be made under the fourth plan to any of the top executives of Y.

Section 162(a)(1) of the Code provides that there will be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 162(m)(1) of the Code provides that in the case of any publicly held corporation, no deduction shall be allowed under this chapter for applicable employee remuneration with respect to any covered employee to the extent that the amount of such remuneration for the taxable year with respect to such employee exceeds $1,000,000.

Section 1.162-27(c)(1)(ii) of the Income Tax Regulations provides that a "publicly held corporation" includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)). For purposes of this section, however, an affiliated group of corporations does not include any subsidiary that is itself a publicly held corporation. Such a publicly held subsidiary, and its subsidiaries (if any), are separately subject to this section.

According to section 1.162-27(e)(4)(viii) of the regulations, for purposes of the shareholder approval requirements, the shareholders of the publicly held member of the affiliated group are treated as the shareholders of all members of the affiliated group.

Section 1.162-27(c)(2)(i) of the regulations defines a "covered employee" as any individual who on the last day of the taxable year, is (A) the chief executive officer of the corporation or is an individual acting in such capacity, or (B) among the four highest compensated officers (other than the chief executive officer).

Section 1.162-27(c)(2)(ii) of the regulations provides that whether an individual is the chief executive officer described in section 1.162-27(c)(2)(1)(A) or an officer described in section 1.162-27(c)(2)(i)(B) is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

Section 1.162-27(e)(2) of the regulations provides that qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. A performance goal is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually established the goal. However, in no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed.

Section 1.162-27(e)(3)(i)(D) of the regulations defines an outside director, in

relevant part, as one who does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as director. For this purpose, remuneration includes any payment in exchange for goods or services.

According to section 1.162-27(e)(3)(ii)(C) of the regulations, if remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity by which the director is employed or self-employed other than as a director, the remuneration is considered directly or indirectly received by the director.

Section 1.162-27(e)(3)(iii)(A) of the regulations provides that for purposes of sections 1.162-27(e)(3)(ii)(B) and (C), remuneration that was paid by the publicly held corporation in its preceding taxable year to an entity is de minimis if payments to the entity did not exceed 5 percent of the gross revenue of the entity for its taxable year ending with or within the preceding taxable year of the publicly held corporation.

According to section 1.162-27(f)(1) of the regulations, in the case of a corporation that was not a publicly held corporation and then becomes a publicly held corporation, the deduction limit of section 1.162-27(b) does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held. In accordance with section 1.162-27(c)(1)(ii), a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on section 1.162-27(f)(1). Also see section 1.162-27(e)(4)(viii).

Section 1.162-27(f)(4)(i) of the regulations provides that if a subsidiary that is a member of the affiliated group described in section 1.162-27(c)(1)(ii) becomes a separate publicly held corporation (whether by spinoff or otherwise), any remuneration paid to covered employees of the new publicly held corporation will satisfy the

exception for performance-based compensation described in section 1.162-27(e) if the conditions in either section 1.162-27(f)(4)(ii) or (iii) are satisfied.

Section 1.162-27(f)(4)(ii) of the regulations provides that remuneration satisfies the requirements of section 1.162-27(f)(4)(ii) if the remuneration satisfies the requirements for performance-based compensation as set forth in sections 1.162-27(e)(2), (3), and (4) by application of sections 1.162-27(e)(3)(viii) and (e)(4)(viii) before the corporation becomes a separate publicly held corporation, and the certification required by section 1.162-27(e)(5) is made by the compensation committee of the new publicly held corporation. Section 1.162-27(f)(4)(ii) does not apply here because the shareholders of X did not vote to approve the Plans before Y became publicly held.

Section 1.162-27(f)(4)(iii) of the regulations provides that remuneration satisfies the requirements of section 1.162-27(f)(4)(iii) if the remuneration satisfies all of the

requirements of sections 1.162-27(e)(2), (3), and (5). The outside directors (within the meaning of section 1.162-27(e)(3)(viii)) of the corporation before it becomes a separate publicly held corporation, or the outside directors of the new publicly held corporation, may establish and administer the performance goals for the covered employees of the new publicly held corporation for purposes of satisfying the requirements of sections 1.162-27(e)(2) and (3). The certification required by section 1.162-27(e)(5) must be made by the compensation committee of the new publicly held corporation. However, a taxpayer may rely on section 1.162-27(f)(4)(iii) to satisfy the requirements of section 1.162-27(e) only for compensation paid, or stock options, stock appreciation rights, or restricted property granted, prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation.

Accordingly, we rule that:

1. Because, according to section 1.162-27(e)(4)(iii) of the regulations, the shareholders of X are treated as the shareholders of all members of the affiliated group, the approval of the Plans by X on the day before the IPO did not serve as satisfactory shareholder approval of the Plans.

2. Compensation paid or options granted under the Plans approved only by X's board will be considered performance-based only for the compensation or grants paid or awarded prior to the first regularly scheduled meeting occurring more than 12 months after Y became a separate public corporation. Section 1.162-27(f)(4)(iii) of the regulations.

3. Y may obtain satisfactory shareholder approval of the Plans (and of any additional performance plans that are established by Y after the IPO), at any shareholder meeting up to and including the first regularly scheduled meeting occurring more than 12 months after the IPO. In the case of any shareholder votes obtained after the IPO and before the spinoff of the remaining shares of Y stock held by X to X's shareholders, the shares of Y stock held by X can be voted by an officer of X on behalf of X.

4. After Y's shareholders have approved Y's performance-based plans, such plans need not be resubmitted to shareholders until the latest to occur of:

a. the expiration of such plan;

b. the material modification of such plan; or

c. if (and only if) Y's compensation committee has authority to change the targets under the plan's performance goals, the first shareholder meeting that occurs in the fifth year following the year in which the plan was approved by Y's shareholders.

5. The deduction limit of section 162(m) of the Code will not apply to any remuneration paid to Y employees pursuant to any of the performance-based plans maintained by X prior to the IPO, provided that the conditions of section 162(m) were satisfied when those awards were made and the awards are not materially amended after their grant.

6. Employees and officers of X may serve as "outside directors" on the Y Compensation Committee, so long as the remuneration paid by Y to X does not exceed more than five percent of X's gross revenues.

7. The performance period and related service period established by the Y Compensation Committee for performance awards under the Plans may be as short as a single calendar quarter, or the period between the IPO and the spinoff, so long as the performance goals are established prior to or during the first 25 percent of the period of service to which the performance goal relates.

8. The compensation paid and deducted by Y after the IPO to any of its covered employees (other than performance-based compensation) is deductible to the extent it does not exceed $1,000,000 per taxable year. In applying the $1,000,000 limit, the compensation paid to executives by X, Y, or any other entity within the X affiliated group that was deductible prior to the IPO is disregarded.

9. A new "taxable year" for purposes of applying the $1,000,000 deduction limit on non-performance-based compensation will begin for Y on the date that Y is spun off from the X controlled group.

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,

ROBERT MISNER
Assistant Chief, Branch 4
Office of the Associate
Chief Counsel
(Employee Benefits and
Exempt Organizations)

Enclosure:
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