

Payments to Cancel Stock Options and SARs on Takeover are Deductible

by Robert W. Wood • San Francisco

Despite what may seem to be the prevailing norm that expenses incurred in connection with takeover transactions must be capitalized rather than deducted (see “*INDOPCO* Rears Its Ugly Head, Preventing Deductions, Says Full Tax Court,” in this issue), there is at least a ray of light applying in the compensation venue. In a recent Technical Advice Memorandum, No. 9540003, the IRS considered a target company (“Target”) that deducted amounts paid to employees in cancellation of employee stock options and stock appreciation rights, all occurring in the context of a takeover of Target.

Target had two management incentive plans, providing statutory and nonstatutory stock options and stock appreciation rights in Target’s stock. Both stock option plans required the consent of the optionholder before any changes in the rights and obligations under outstanding unexercised options could be made. Similarly, the SAR plan said specifically that in the event of a takeover, the

holder of the SAR would receive the cash value of the shares subject to an option.

Target entered into an acquisition agreement with another company which required Target to cancel its stock option plans and make settlement payments to the holders of the SARs and options.

Consequently, Target made a settlement payment equal to the difference between the exercise price of the options and the price the acquiring company was paying for the stock. The SAR holders received cash equal to the federal income tax imposed on the settlement payments. The plan participants were paid when the options were cancelled. Target cancelled the outstanding options and SARs as required, and the acquisition was completed.

The settlement payments for the cancellation of the options and SARs were treated as compensation to the participants and reported on Forms W-2. Target deducted the full amount paid. The IRS disagreed, labelling the premium portion of the stock option settlement payment, plus the full amount of the SAR cancellation payment, as takeover costs that had to be capitalized under Section 263. In technical advice, however, the Service ruled that all of the stock options and the SAR settlement payments had originated from the compensatory obligations described in the company’s plans, not as a result of the takeover itself. Consequently, the Tech Advice Memo concludes that all of the obligations paid to plan participants were deductible as ordinary and necessary business expenses. ■

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