

PHANTOM STOCK PAYMENTS MADE DURING REDEMPTION HELD DEDUCTIBLE

by Robert W. Wood • San Francisco

It is a sad commentary on the state of disclosure that sometimes highly useful bits of information are published by the IRS years after the guidance was issued. In some cases, the release follows prodding by such watchdog organizations as Tax Analysts, based in Arlington, VA. In some cases, litigation is even necessary in order for the supposedly sensitive information (deleted of all names, mind you) to become available to the public and to tax planners alike.

In the case of a 1993 field service advice that was recently released (along with a number of others), we have some guidance now that might be helpful in transactions going forward, even if we did miss a few years between 1998 and 1993, when the field service advice was issued. Such lamentings aside, Field Service Advice 1998-361 (Tax Notes Document 98-25048, Nov. 2, 1998), does provide some interesting guidance.

In the field service advice (FSA), a corporation that made phantom stock payments to its employees during a self-tender redemption offer was not prevented from deducting the payments under Section 162(k). Section 162(k) of the Code, it should be recalled, generally prevents otherwise allowable deductions for any amount paid or incurred by a corporation in connection with the redemption of its stock. The strictures of Section 162(k) were held not to apply

here because these phantom stock payments (and severance payments) were intended as compensation for services rendered, rather than as redemption proceeds.

The FSA involved a publicly-held corporation that offered to redeem its shares to ward off an unsolicited takeover bid. To finance this self-tender, the corporation borrowed money from several banks, paying off the loans by selling half of its subsidiaries. In the restructuring that resulted, the corporation increased severance payments to terminated employees, amended its phantom stock plans to allow employees to receive the value of their phantom shares, and also cashed out employee stock options. A revenue agent challenged the deductibility of these payments, and the matter wound up with internal IRS guidance formatted as a field service advice.

Deductions OK

Fortunately, the IRS concludes in the FSA that the severance payments, phantom stock payments, and even the option cashouts were deductible to the extent that they were compensation for services rendered and not additional redemption proceeds. Although there can be factual issues about what constitutes compensation and what does not, the ruling is still helpful.

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