

## **Summary of Tax Consequences of Golden Parachute Payments Upon a Change in Control: Internal Revenue Code Section 280G**

The tax implications of Section 280G merit careful consideration with respect to all change in control and executive severance arrangements.

Section 280G of the Code generally provides that, if certain payments in the nature of compensation paid to a "disqualified individual" exceed three times the individual's "base amount" (generally an average of the individual's W-2 compensation for the five years preceding the year in which the change in control occurs) ("parachute payments"), then all amounts paid in excess of one times the base amount (the "excess parachute payment") are nondeductible to the employer. Section 4999 of the Code imposes a 20 percent excise tax on the recipient of any "excess parachute payment."

This memorandum briefly describes Sections 280G and proposed regulations there under and explains the circumstances under which the deductibility of compensation will be denied and excise taxes under Section 4999 will be imposed. The IRS previously proposed regulations under Section 280G in 1989. These were never finalized. The new proposed regulations are effective for transactions occurring on or after January 1, 2004. For transactions occurring between now and January 1, 2004, taxpayers may rely on either the 1989 proposed regulations or the new proposed regulations.

To ascertain whether an excess parachute payment exists and therefore whether the unfavorable tax treatment under Code Sections 280G and 4999 applies, it is essential to determine (i) whether the recipient is a "disqualified individual," (ii) whether the payments equal or exceed three times the disqualified individual's "base amount," and (iii) whether the payments made were contingent upon the occurrence of a change in control, and as such constitute "parachute payments."

### **Definitions and Application of Section 280G**

#### **A. Disqualified Individual**

Section 280G only applies to payments made to a "disqualified individual," which is defined to include an employee or independent contractor who is either an officer, shareholder, or highly compensated individual at any time during the determination period.

#### **B. Base Amount**

A disqualified individual's "base amount" is the average of the individual's total taxable compensation (i.e., W-2 compensation) paid by the corporation for the five years preceding the year in which the change in control occurs.

In the event an individual has not been employed by the corporation for a period of five years prior to the change in control, his or her base amount is calculated based only on

the years during which he or she has been employed. Generally, for partial years (e.g., the initial year of employment where the individual commenced employment during the year), the compensation paid in respect of the portion of the year during which the individual was employed is annualized, and the annualized amount is included in the calculation of the base amount. (All members of an affiliated group of corporations are generally treated as a single corporation under Section 280G.)

Because compensation for this purpose takes into account, among other things, the taxable income attributable to stock option exercises and the extent to which the individual has elected to defer compensation, the base amounts of individuals do not necessarily correlate to their relative positions or compensation levels at the time of the change in control.

### C. Parachute Payments

#### 1. General

A parachute payment is any payment in the nature of compensation made to a disqualified individual that is contingent on a change in control of a corporation if the aggregate present value of all such payments made to the disqualified individual equals or exceeds an amount equal to three times his or her base amount. Generally, a payment is to be treated as one which would not, in fact, have been made in the absence of a change in control, and therefore is to be treated as "contingent" on such change, unless it is substantially certain that, at the time of the change, the payment would have been made whether or not the change occurred. In addition, a payment that would in fact have been made had no change in control occurred may nevertheless be treated as contingent on a change in control if the change accelerates the time at which the payment is made.

Payments constituting parachute payments include, but are not limited to, (i) cash severance payments payable upon a termination of employment following a change in control, (ii) continued welfare benefits for a period of time following a termination of employment after a change in control, (iii) increased benefits that are payable solely by reason of the change in control (e.g., enhanced pension benefits), and (iv) some or all of the value of stock options, restricted stock, or other forms of stock-based compensation the vesting or payment of which is accelerated upon a change in control.

There is a presumption that a payment made pursuant to any agreement entered into, or amended in a significant respect, within one year prior to a change in ownership or control is contingent upon the change unless the presumption is overcome by clear and convincing evidence.

Payments to a disqualified individual pursuant to an agreement that violates any generally enforced federal or state securities laws or regulations are also parachute payments.

## 2. In the Nature of Compensation

Payments are generally payments in the nature of compensation if they arise out of an employment relationship or are associated with the performance of services. For this purpose, the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement). Such payments include (but are not limited to) wages and salary, bonuses, severance pay, fringe benefits, and pension benefits and other deferred compensation.

## 3. Change in Control

Payments will constitute parachute payments if they are considered contingent on (i) a change in ownership, (ii) a change in effective control, or (iii) a change in the ownership of a substantial portion of the corporation's assets.

a. *Change in Ownership.* A change in ownership occurs when any person or group acquires more than 50% of the total fair market value or voting power of the stock of the corporation.

b. *Change in Effective Control.* A change in the effective control of a corporation is presumed to occur when either (i) any person or group acquires, within a 12-month period, 20% or more of the voting power of the stock of the corporation or (ii) a majority of the corporation's board of directors is replaced during any 12-month period by individuals not endorsed by a majority of the then current members of the board. This presumption may be rebutted by establishing that the acquisition of stock or the replacement of directors did not transfer the power to control the management and policies of the corporation from any one person (or group) to another person (or group).

c. *Change in Ownership of Substantial Portion of the Corporation's Assets.* A change in ownership of a substantial portion of a corporation's assets occurs when any person or group acquires, within a 12-month period, assets having a fair market value of at least one-third of the fair market value of the corporation's assets. This would include the sale of a subsidiary representing one-third or more of the fair market value of the assets of a corporation.

## 4. Calculation

The 1989 proposed regulations and the new proposed regulations include special calculations for determining the extent to which payments are considered contingent on a change in control. For instance, in respect of a payment that is substantially certain to be

made, such as by vesting before the change in ownership or control occurred, and the change merely accelerates the time of payment, the payment will be characterized as contingent on such change, but only to the extent by which the accelerated payment exceeds the present value of the payment absent acceleration.

A payment is also considered contingent on a change in control if the change accelerates the time at which the payment becomes vested, as in the case of the accelerated vesting of stock options. However, if such a payment is substantially certain to be made in the future without regard to the change in control if the disqualified individual continues to perform services for a specified period of time, the portion of the payment that is considered contingent on the change in control is equal to the lesser of (i) the amount of the accelerated payment and (ii) the sum of (a) the excess of the accelerated payment over the present value of the payment which would have been made in the absence of acceleration plus (b) an amount to reflect the lapse of the obligation to continue to perform services (equal to 1% of the value of the payment for each full month for which the service requirement has lapsed). This calculation frequently serves to lower the amount of parachute payments.

If the normal vesting of such options or other payments is based upon other than the performance of services by the executive, such as achievement of specified performance goals, then the entire payment that becomes vested upon a change in control will be deemed to be contingent on the change in control.

In the case of stock options, for purposes of Section 280G, the payment occurs when an option vests and the value of the payment is the value of the vested option. The new proposed regulations provide that the value of a vested option may be determined by any method prescribed by the Commissioner of the Internal Revenue Service in published guidance. Such guidance has been issued in Rev. Proc. 2002-13, which provides for several methods of determining the value of an option including a safe harbor approach modeled after the Black-Scholes valuation method. The new proposed regulations also provides guidance for determining the value of the obligation to pay health care benefits.

## 5. Exempt Parachute Payments

Notwithstanding the foregoing, the following four types of payments are exempt from the definition of "parachute payment" and therefore are not subject to the unfavorable tax treatment under Sections 280G and 4999 of the Code:

- a. payments with respect to a small business corporation;
- b. payments with respect to a corporation where (i) immediately prior to the change in control, the corporation does not have stock which is readily tradable on an established securities market, and (ii) the payment was approved by a vote of the persons who owned, immediately before the change in control, more than 75% of the voting power of all outstanding stock in the corporation, but only if there was adequate disclosure to the

company's stockholders of all material facts concerning the payments which (but for this exemption) would be parachute payments with respect to the disqualified individual;

c. payments to or from qualified plans; and

d. payments of reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in control, established by clear and convincing evidence.

### **Approaches to Addressing 280G**

A material consideration with respect to golden parachute agreements pertains to the treatment in the agreement of the excise tax provisions under Code Sections 4999 and 280G. There are essentially three alternative approaches that could be used to address Code Section 280G and one of them should be adopted-Section 280G should not be ignored.

The first is a provision that would require the company to make a gross-up payment with respect to severance payments and/or any other payments made to the executive. The effect of the gross-up payment is to offset the impact of the excise tax imposed on payments made to the executive. Thus, the corporation would provide the individual with payments such that the individual would receive on an after-tax basis an amount equal to the amount he or she would have received in the absence of the imposition of excise taxes. There is a trend toward more widespread use of gross-up provisions, particularly for the most senior executives. However, some companies require that, in order for a gross-up to apply, the covered executive would have to realize a meaningful benefit by virtue of its application (e.g., the total parachute payments must exceed three times the safe harbor by at least \$25,000 or a specified percentage). This last approach is intended to balance the cost of a gross-up to the company with the benefit to the covered executive and would result in the payment of a gross-up only where payment of the excise tax by the covered executive would be materially inconsistent with his or her expectations under the severance agreement.

Another provision which could be used is referred to as the "alternative cap" or "modified cap." The alternative cap provides that the payments and benefits payable to an executive would be reduced to the extent necessary so that no excise taxes would be imposed if to do so would result in the executive retaining a larger amount, on an after-tax basis, taking into account the excise and income taxes imposed on the payments and benefits.

The third approach is commonly referred to as a "cap." Under this provision, all parachute payments payable to the executive would be reduced so that no excise tax would be imposed on any of the payments and benefits and thus the total amount of payments would never exceed three times his or her "base amount" under this provision.