Memorandum

Re A Primer on the U. S. Federal Income Tax "Golden Parachute" Rules and Strategies Commonly Used to Avoid Them

The Internal Revenue Code of 1986, as amended ("IRC") imposes two severe tax penalties on "excess parachute payments." IRC § 280G denies the payor's deduction for an "excess parachute payment," while IRC § 4999 imposes a 20% excise tax on the recipient of an "excess parachute payment."

The basic elements of an "excess parachute payment"

A "parachute payment[1]" is, generally, any amount in "the nature of compensation" paid to (or for the benefit of) a "disqualified individual[2]" if:

- The payment is contingent on a change in control[3] of a corporation; and
- The total of all the "parachute payments" to the "disqualified individual" equals or exceeds an amount equal to three times the "disqualified individual's" average gross taxable compensation from the corporation for the five (fewer than five if the "disqualified individual" has not worked for the corporation for at least five years) calendar year period preceding the calendar year in which the change in control occurs.[4]

1 Note that while the term "golden parachute" was in general business usage when IRC §§ 280G and 4999 were enacted in 1984, the terms "parachute payment" and "excess parachute payment" as used in IRC §§ 280G and 4999 are ultimately artificial constructs of U. S. tax law. They have no definite U. S. legal meanings apart from their use in IRC §§ 280G and 4999.

2 Generally, a "disqualified individual" is an individual who is an officer, a one percent or more shareholder, or among the highest-paid 1% (limited to 250 individuals for corporations with 25,000 or more employees) of the corporation's employees.

3 Generally, the transactions that qualify as changes in control for purposes of the IRC §§ 280G and 4999 tax penalties are transactions that are considered "changes in control" in common business usage. Nevertheless, what constitutes a change in control for purposes of IRC §§ 280G and 4999 is precisely defined in IRC § 280G and its regulations. Thus, the facts of any actual transaction should be checked carefully against the change in control definition in IRC § 280G, since a given transaction may fall outside the definition's ambit. However, since the focus of this memorandum is on how the golden parachute tax penalties apply if there is a change in control, and the contractual strategies commonly used by companies to address the business problems posed by those penalties, there will be no further discussion in this memorandum regarding what does or does not constitute a change in control under IRC § 280G.

4 The period of five or fewer calendar years over which the disqualified individual's annual gross taxable compensation is averaged is called the disqualified individual's "base period." Partial years in the "base period" are annualized, but nonrecurring compensation (e.g., a "signing bonus") in a partial year is not annualized.

If the total of the payments received by a "disqualified individual" that are contingent on the change in control (the "parachute payments") exceeds three times the disqualified individual's "base amount," then the excess of the total amount of the "parachute payments" over one times the disqualified individual's "base amount" is treated as an "excess parachute payment" subject to IRC §§ 280G and 4999.

IRC §§ 280G and 4999 "Cliff"

The calculations to determine whether the golden parachute tax penalties apply have what can be described as a "cliff" effect: As long as the total payments to the "disqualified individual" that are contingent on the change in control are less than three times the disqualified individual's base amount, the penalties do not apply. But if the three times the base amount threshold is touched, theoretically even by one dollar, then the "disqualified individual" falls over the "cliff," and all payments to the "disqualified individual" in excess of one times his or her base amount are subject to the penalty.

Example 1: Assume that an executive who is a "disqualified individual" has earned an average of $200,000 per year in W-2 reportable gross income from a corporation during the preceding five years. Thus, $200,000 is the executive's "base amount." Also assume that the executive has a change-in-control agreement under which the corporation will pay him or her $1 million if a change in control occurs. A change in control does occur and the $1 million is paid to the executive and is the only amount paid to the executive that is "contingent" on the occurrence of the change in control. Since $1 million exceeds three times the executive's base amount (i.e., it exceeds $600,000), the $1 million payment constitutes a "parachute payment." Of the $1 million parachute payment, $800,000 (the amount by which the $1 million payment exceeds one times the executive's $200,000 base amount) constitutes an "excess parachute payment." As an "excess parachute payment," the $800,000 is not deductible by the paying corporation under IRC § 280G and an excise tax of $160,000 (20% of $800,000) is imposed on the executive.

Example 2: Assume the same facts as in Example 1, except that the executive's agreement provides for a change-in-control payment of $599,999, not $1,000,000. Because the $599,999 payment is less than three times the executive's $200,000 "base amount," the golden parachute tax penalties of IRC §§ 280G and 4999 do not apply.

Example 3: Assume the same facts as in Example 2, except that the executive's change-in-control agreement provides for a payment of $600,000, not $599,999. Because the $600,000 payment equals or exceeds three times the executive's $200,000 "base amount" (it just equals it), the golden parachute tax penalties apply to the "excess parachute payment" of $400,000 (the excess of the $600,000 parachute payment over one times the executive's $200,000 base amount).

Payments treated as "contingent" on change in control

In order to be a "parachute payment," a payment must be "contingent" on the occurrence of a change in control of a corporation. Although there are extensive regulations regarding when a payment will be treated as being "contingent" on a change in control, including special presumptions for payments made within one year before or after a change in control, the test is ultimately one of facts and circumstances, and generally a "but for" standard applies. Thus, for example, if a corporation agrees to pay a disqualified individual a severance payment upon involuntary termination for any reason, and later the disqualified individual receives the payment because he or she is involuntarily terminated following a change in control, the payment will generally be deemed to be "contingent" on the change in control, at least if it occurs within the first year following the change in control.

It is important to understand that not just cash severance and change in control bonus payments, but virtually all economic compensation that is "contingent" on a change in control, can produce "parachute payments." For example, if the right to exercise stock options is accelerated in connection with a change in control, then the economic value of that acceleration is estimated and the resulting amount will generally be treated as a parachute payment. Even benefits that may be nontaxable, such as free or subsidized health plan coverage following a termination of employment in connection with a change in control, will generally be subject to the "golden parachute" tax penalties. However, early distributions from nonqualified deferred compensation plans such as supplemental executive retirement plans (SERP's) and nonqualified defined contribution savings plans are not subject to the "golden parachute" tax penalties if they were already fully vested before the change in control and would have earned interest or other earnings credits or actuarial increases if they had not been paid early on account of the change in control.[5]

The parachute portion of any amount that would, or would likely, have been paid even if a change in control had not occurred, but whose payment or vesting, or both, is or are accelerated on account of the change in control, is determined using arbitrary, but relatively simple, formulas. Generally, if only the timing, and not the vesting, of a payment is accelerated, then the portion of the payment that is treated as a "parachute payment" is equivalent to an interest charge, and, at least where the acceleration is over only a relatively short period of time, it will be relatively small. Where both the timing and the vesting of the payment are accelerated, then the portion of the payment that is treated as a parachute payment will include both interest and a pseudo-actuarial component to account for favorable resolution of the vesting uncertainty that was present before the change in control. This pseudo-actuarial component is equal to 1% of the gross payment amount for each full month by which the payment's vesting is accelerated.[6]

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[5] Benefits under qualified retirement plans under Section 401(a) of the Code are not subject to the "golden parachute" tax penalties, even where vesting in such benefits is accelerated in connection with the change in control.

[6] Note that the foregoing discussion assumes that the payment in question was subject to simple "time" vesting. If the payment vested only on either attainment of a performance goal or the occurrence of a change in control, then the entire amount of the payment would generally be treated as a parachute payment.

Provisions often included in agreements between corporations and executives to deal with "golden parachute" tax penalties

The U. S. federal income tax penalties on "excess parachute payments" (the paying corporation's loss of its deduction under IRC § 280G and the imposition on the executive of a 20% excise tax under IRC § 4999) are often, depending on the circumstances, both substantial and disproportionately large relative to the incremental amount of compensation causing the penalties to apply.[7] Because of this, change in control severance agreements or similar arrangements will often include provisions designed to limit the executive's and/or the employing corporation's exposure to the golden parachute tax penalties. Three basic types of provisions are in common use: "2.99 caps", "best net" provisions, and "excise tax gross-ups."

A "2.99 cap" automatically limits total "parachute payments" received by the executive to an amount that does not exceed 2.99 times his or her base amount. Such an arrangement will always benefit the corporation, and may or may not benefit the executive, depending on the amount cut off by the 2.99 cap. For example, if the executive's base amount is $1 million, and the total of the parachute payments that would otherwise be paid to him or her is $3.1 million, then the executive will be better off with a 2.99 cap than without it, because the $110,000 ($3.1 million minus $2.99 million) given up by the executive is less than the $420,000 in IRC § 4999 excise tax (20% of $2.1 million, which is the excess of $3.1 million over $1 million) that would otherwise be imposed on the executive. At the same time, the corporation saves $845,000 (35% of $2 million, plus the unpaid $110,000).

A "best[8] net" provision resembles a 2.99 cap, but in this case the executive's payment is reduced only if the excess of the total amount of the parachute payments that would otherwise be paid to him or her over 2.99 times his or her base amount is sufficiently small that cutting back the total amount to 2.99 times his or her base amount would result in the executive's receiving a greater total payment. For example, in the example in the preceding paragraph, where the executive would pay $420,000 in excise tax to receive an additional $110,000, the 2.99 cutback would apply, and therefore the executive would forego the additional $110,000 (i.e., he or she would receive $2.99 million, not $3.1 million). The company would save $845,000. On the other hand, if the total of the parachute payments otherwise owed to the executive in the example was $4 million, then the cap would not apply, because the executive would receive an additional $1,010,000 ($4 million minus $2.99 million), while having to pay additional tax of $600,000 (20% of $3,000,000).[9]

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[7] For example, in Example 2 above, neither the corporation nor the executive suffered any tax penalties when the corporation paid the executive $599,999. But when in Example 3 the corporation increased the payment to the executive by just $1, a $400,000 "excess parachute payment" resulted, causing the corporation to lose a $400,000 deduction, and the executive to be required to pay $80,000 (20% of $400,000) in excise tax. At a combined penalty tax rate of 55% (35% for the corporation and 20% for the executive), the total tax cost of the additional $1 payment in Example 3 was $220,000.

[8] Since the provision compares only two amounts, "better net" would probably be a more appropriate term, but we typically see such provisions referred to in agreements as "best net."

[9] Note, however, that in this example the executive actually gains almost nothing by not having his total parachute payments limited to $2.99 times his or her base amount, since the additional $1,010,000 that he or she nominally would receive would be subject to ordinary federal income tax of $404,000. So, after both ordinary federal income tax and the IRC § 4999 excise tax, the executive would be better off by only $6,000 ($1,010,000 minus [20% x $3,000,000] = $410,000; $410,000 minus $404,000 = $6,000). The

Finally, an "excise tax gross-up" holds the executive harmless from the effect of the IRC § 4999 excise tax, regardless of the cost to the company. The company agrees to reimburse the executive for (a) any excise tax owed by him or her under IRC § 4999 on the amount of any excess parachute payment and (b) both the IRC § 4999 excise tax and ordinary income tax on the "gross-up" payment itself.[10] Of course, both the original excess parachute payment amount and the entire gross-up payment will be nondeductible to the company under Section 280G of the Code, so excise tax gross-ups can be very expensive for corporations agreeing to pay them.[11]

Other tax planning strategies

Parachute payments can sometimes be reduced through strategies that do not require an actual reduction in the amount to be received by the executive. For example, any portion of what would otherwise be a "parachute payment" that can be treated as reasonable compensation for a covenant not to compete provided by the executive to the paying corporation should escape characterization as a "parachute payment." Additionally, if the likelihood of a change in control is known sufficiently in advance, the executive, with or without assistance from the company, may be able to boost his or her "base amount" by accelerating significant amounts of gross taxable compensation into the last year of his or her "base period" (e.g., by exercising already vested stock options). However, the ability to achieve a favorable outcome in a "golden parachute" situation after a change in control has occurred is relatively limited, so corporations with severance or other arrangements that implicate the "golden parachute" tax penalties should carefully consider employing one of the contractual mechanisms described above to limit the economic cost of potential parachute payments.

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company, however, in this example would lose $1,050,000 (35% of $3,000,000) worth of deductions under IRC § 280G. Note also that this assumes a relatively simple "best net" provision under which the cap does not apply as long as the executive nets more (even only slightly more) on an after-tax basis than without the cap. More complex "best net" provisions that would weigh the relative costs and benefits to the corporation and the executive are possible and may be advisable, but are seldom, if ever, encountered.

[10] Viewed one way, this results in a circular calculation. Any payment under the exercise tax gross-up is itself contingent on a change in control, and is therefore a "parachute payment." So the excise tax on the excess parachute payment is calculated, then the income and excise tax on the reimbursement, producing additional reimbursement. Then the income and excise tax on the additional reimbursement is calculated, producing yet more reimbursement, etc. However, the bottom line can easily be estimated. For example, assume that an executive's marginal ordinary federal income tax rate is 35%, and that he or she will receive a $1 million excess parachute payment. The IRC § 4999 excise tax on this amount would be 20% of $1,000,000, or $200,000. Thus, to be "grossed up," the executive would need to receive an additional $200,000 after the imposition and payment of both IRC § 4999 excise tax and ordinary federal income tax. The executive's combined tax rate on the gross-up payment will be 55% (his or her 35% marginal ordinary federal income tax rate, plus the IRC § 4999 tax rate of 20%). Thus, in this example the executive needs to receive a gross-up payment of $444,444 ($200,000/45%), since, after taxes at 55%, the $444,444 payment will leave him or her with just the amount necessary to pay the $200,000 excise tax.

[11] In the example in footnote 10, the cost to the company of paying the executive the $1,000,000 excess parachute payment is $794,444 (35% x the intended $1 million excess parachute payment, plus the $444,444 gross-up payment, which is also nondeductible under IRC § 280G).

Application of "Golden Parachute" tax penalties to nonpublic companies, partnerships, and tax-exempt organizations.

The "golden parachute" tax penalties of IRC §§ 280G and 4999 do not apply to payments made on account of a change in control of a partnership, an LLC taxable as a partnership, an "S" corporation, or, generally, a tax-exempt organization; they also do not apply to payments in connection with a change in control of a "C" corporation that meets the requirements to elect "S" corporation tax status, but that has not made the election.[12]

In the case of a "C" corporation[13] that would not qualify to make an "S" election,[14] but that is not publicly traded,[15] the "golden parachute" tax penalties of IRC §§ 280G and 4999 are avoided on payments that are approved by a vote of more than 75% of the corporation's voting power. To qualify for this exception:

- The shareholder vote must specify the approved payment in detail (e.g., identifying the payee and the amount of the payment), and the approval must be by more than 75% of the voting power of the persons who are shareholders at the time of the change in control; these combined requirements typically mean that a special shareholder vote must be held immediately before or after the change in control.

- The vote must be an up or down vote on whether the payment will be made, which typically requires that the payment's prospective recipient agree to give up his or her right to the payment if it does not receive the required approval.[16]

"What if" planning is crucial

We strongly advise companies and executives who think that their compensation arrangements may raise significant "golden parachute" tax issues under the U.S. federal income tax provisions to test their agreements under various business assumptions (e.g., stock price) to quantify the importance of the issue.

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[12] Generally, to qualify to make an "S" election, a corporation must have no more than 100 shareholders, all of whom must be individuals, estates, or certain permitted trusts or tax-exempt organizations; the corporation also must have only one class of stock. The additional requirement that to be eligible to elect "S" status a corporation must not have any nonresident alien shareholders is disregarded for purposes of determining whether a corporation is exempt from the IRC §§ 280G and 409A "golden parachute" tax penalties.

[13] Including an LLC taxable as a "C" corporation.

[14] See footnote 12.

[15] And that is neither a member of an affiliated group that includes a publicly-traded corporation nor a corporation whose stock comprises one-third or more of the value of a publicly traded corporation.

[16] The prospective recipient's agreement to forego a parachute payment that is not approved by the required vote of shareholders will typically be structured so as to place at risk only the portion of the payment that exceeds the "three times the base amount" 280G threshold.