

## Committee Reports

# COMREP ¶ 280G1.02 Golden parachute contracts. ('84 TRA, , PL 98-369, 7/18/84)

*Conference Report*

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### **General rules.**

Under the Act, no deduction is allowed for "excess parachute payments." Furthermore, if any such payment is made by the acquiring company, or a shareholder of the acquired or the acquiring company, Congress did not intend that it be treated as part of the acquiring company's purchase price for the acquired company, or as increasing the shareholder's basis in his stock in the acquired or acquiring company.

Finally, a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment.

### **Parachute payment.**

A "parachute payment" is any payment (1) in the nature of compensation (including payments to be made under a covenant not to compete or similar arrangement), (2) to (or for the benefit of) a "disqualified individual", (3) if such payment is contingent on a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of its assets—but only if the aggregate present value of all such payments made or to be made to the disqualified individual equals or exceeds 3 times the disqualified individual's "base amount."

The disqualified individual's "base amount" is the average annual income in the nature of compensation (including, for example, ordinary income with respect to stock options) with respect to the acquired corporation includible in the disqualified individual's gross income over the 5 taxable years of such individual preceding the individual's taxable year in which the change in ownership or control occurs. (If the individual did not perform services for the corporation throughout that 5-taxable-year period, the relevant period is that portion of the 5-taxable- year period in which he did perform services for the corporation, with compensation for any portion of a taxable year being annualized before an average is determined. Thus, if an individual was employed by the corporation for 2 years and 4 months preceding his taxable year in which the change in ownership or control occurs and his compensation income from the corporation was \$30,000 for the 4-month period, \$120,000 for the first of such 2 full years, and \$150,000 for the second, his base amount would be \$120,000 (the sum of  $(\$30,000 \times 3) + \$120,000 + \$150,000$ , divided by 3).) The Secretary is to prescribe regulations determining the base amount in any case in which the disqualified individual did not perform services for the corporation prior to his taxable year in which the change in ownership or control occurs.

A "disqualified individual" means any individual who is an employee, independent contractor, or other person specified in regulations who performs personal services for the corporation and who is an officer, shareholder, or highly-compensated individual of such corporation. (It is contemplated that regulations will provide an exception for shareholders of the acquired corporation holding *de minimis* amounts of its stock who are

not officers or highly-compensated individuals of the corporation.) Personal service corporations and similar entities generally are treated as individuals for this purpose. Thus, for example, if an officer of a corporation performs services for that corporation through a personal service corporation, parachute payments to the personal service corporation are to be treated as made to a disqualified individual.

To be a parachute payment, a payment must be contingent on a change in ownership or control. In general, a payment is to be treated as contingent on a change in ownership or control if such payment would not in fact have been made had no change in ownership or control occurred. A payment generally is to be treated as one which would not have in fact been made unless it is substantially certain, at the time of the change, that the payment would have been made whether or not the change occurred. A payment may be a parachute payment even if the target corporation neither paid it nor had any obligation to pay it but it is paid by the acquiring company (for example, under an employment contract, consulting agreement, covenant not to compete, or similar arrangement) or any other person interested in the change. A payment may also be a parachute payment if it is contingent on an event closely associated with a change in ownership or control (for example, the onset of a tender offer). Furthermore, a payment is also to be treated as contingent on a change in ownership or control if the change determines the time such payment is in fact to be made. Finally, a payment may be a parachute payment even if the employment or similar relationship of the disqualified individual is not terminated (voluntarily or involuntarily) as a result of the change in ownership or control.

The following examples illustrate the "contingent on a change in ownership or control" concept.

*Example (1).*

Assume that a contract provides that payments are to be made to a disqualified individual if a change in control of the corporate employer occurs. Assume that, more than 1 year after the contract is entered into, control does change and that payments are made under the contract. The payments are contingent on a change in ownership or control, even if the individual continues in the employ of the target corporation (or the acquiring company).

*Example (2).*

Assume that a contract is entered into providing for payments to a disqualified individual contingent upon his employment being terminated at any time over the succeeding 3 years. Eighteen months later, a change of control occurs, and shortly thereafter, the individual's employment terminates. Under this example, a factual determination must be made as to why employment was terminated. If termination occurred because of the change, payments under the contract are to be treated as contingent on the change in control.

*Example (3).*

Assume that a disqualified individual is a common law employee of a corporation. A change in control of the corporation occurs, and, pursuant to a formal or informal understanding reached before the change occurs, the individual enters into an employment agreement, consulting agreement, agreement not to compete, or similar arrangement with the acquiring company for a term of 3 years. An amount equal to the value, generally determined as of the date the contract becomes operative, of payments

to be made under such an agreement is to be treated as contingent on the change in control.

*Example (4).*

Assume that a contract between a disqualified individual and the corporate employer provides for the acceleration of vesting or payment of deferred incentive compensation, for the acceleration of the time for the exercise of stock options, or for payments in cancellation of stock options, contingent on a change in control of the corporation and that a change in ownership or control occurs. Payments resulting from such a contract are to be treated as contingent on the change in control.

**Parachute payment presumption.**

Under the Act, payments under a contract entered into within 1 year before a change in ownership or control are to be presumed contingent on such a change unless the contrary is established by clear and convincing evidence. Whether the presumption can be rebutted will depend on the circumstances surrounding the execution of the contract, including what the contract provides and whether it was entered into at a time when a takeover attempt had commenced or the corporation otherwise viewed itself as a likely takeover candidate. For example, suppose a corporation and a disqualified individual who was a common-law employee enter into a contract calling for a lump-sum severance payment to the individual upon termination, for whatever reason (including death, retirement, or termination for cause), of his employment. The contract was entered into after the corporation had been advised by its investment banker that it was a prime takeover candidate. Nine months later, the corporation is taken over. Subsequently, the individual's employment is terminated. Payments under the contract are treated as contingent on a change in control even though the payments would legally have been required even had no change occurred, unless the 1-year presumption is rebutted by clear and convincing evidence.

If a contract which does not provide for any payments contingent on a change in ownership or control and which is entered into more than 1 year before the change is amended less than 1 year before the change, the presumption is to be applied only to payments pursuant to the amendment.

**Property transfers.**

Under the Act, transfers of property are to be treated as payments for purposes of applying the provisions. Any such property generally is taken into account in an amount equal to its value at the date of transfer, and all such property is to be valued. For this purpose, the terms "transfer" and "property" are to be interpreted broadly. Thus, for example, the grant of stock options to a disqualified individual with respect to an acquired corporation by an acquiring corporation as a part of the acquisition transaction are transfers of property.

**Change in ownership or control.**

Whether a particular transaction involves a change in the ownership or effective control of a corporation or in the ownership of a substantial portion of its assets is to be determined under all the facts and circumstances, giving due regard to the purposes of the provisions.

### **Excess parachute payments.**

“Excess parachute payments” are any parachute payments in excess of the base amount which are not reasonable compensation for personal services actually rendered (or to be rendered) by the disqualified individual. Under the Act, it is presumed that no parachute payment is reasonable compensation for personal services. Such presumption is rebuttable by clear and convincing evidence.

To the extent the taxpayer establishes that the payment involved is reasonable compensation for personal services, the amount involved is first applied against the base amount. However, the Congress intended that personal services adequately compensated for by payments that are not parachute payments not be taken into account in determining whether parachute payments are payments of reasonable compensation.

To illustrate these rules, assume that the disqualified individual's base amount is \$100,000. Assume further that a payment totalling \$400,000, which is contingent on a change in control, is made to the disqualified individual on the date of the change. Under the Act, parachute payments total \$400,000, and the provisions apply because \$400,000 exceeds \$300,000 (3 times the base amount). Excess parachute payments are as much as \$300,000 (\$400,000 less \$100,000, the base amount). Assume that the taxpayer by clear and convincing evidence establishes that reasonable compensation for services compensated for by the parachute payment totals \$150,000. Under the Act, excess parachute payments equal \$250,000 (\$300,000 less (\$150,000 less \$100,000)).

If, in the above example, payments contingent on the change in ownership or control totalled \$290,000, the provisions of the Act would not apply. In that case, those payments would not equal or exceed \$300,000 (3 times the base amount). This result would follow even if the taxpayer was unable to establish that any of the \$290,000 was reasonable compensation for personal services actually rendered. The tax consequences of the payment of the \$290,000 would be determined under prior law.

### **Reasonable compensation.**

The Congress believed that in most large, publicly- held corporations, top executives are not under-compensated. Accordingly, the Congress contemplated that only in rare cases, if any, will any portion of a parachute payment be treated as reasonable compensation in response to an argument that a disqualified individual with respect to such a corporation was under-compensated for periods prior to the change in ownership or control.

On the other hand, payments of compensation previously earned are generally to be treated as reasonable compensation under the provisions, assuming they qualify as reasonable compensation under section 162. For example, payments under the following agreements would generally be treated as reasonable compensation under the provisions if such payments would have been made in the future in any event, even though the timing of such payments is in fact triggered by a change in ownership or control: (1) payments in cancellation of a normal stock option, or normal stock appreciation right, granted more than 1 year before the change; (2) the right to exercise, after termination of employment, stock options or stock appreciation rights issued as part of a normal compensation package granted more than 1 year before the change; (3) compensation deferred pursuant to a plan of the employer, such as a staggered bonus plan, or at the election of the executive; and (4) payments under a retirement plan that supplements a tax-qualified plan to the extent designed to compensate a newly-hired highly-compensated individual for the loss of retirement benefits attributable to services actually performed for a prior employer.

As indicated above, an amount equal to the value of payments to be made under an employment contract, consulting agreement, covenant not to compete, or similar arrangement for a stated term entered into between the acquiring company and a disqualified individual with respect to the target corporation may constitute parachute payments. To the extent payments under such an agreement are, at the time such agreement is entered into, determined to be reasonable for the consideration (including consideration in the form of not competing) to be provided by the individual under the agreement, such payments are to be treated under the provisions as reasonable compensation for personal services actually rendered. In the case of an employment contract, whether payments under it would be deemed reasonable would depend on all the facts and circumstances, including the individual's historic compensation, the duties to be performed under the contract, and the compensation of individuals of comparable skills outside of an acquisition context.

### **Violation of securities laws or regulations.**

Under the Act, the term parachute payment also includes any payment under a contract that (1) provides for payments of a type which the Congress intended to discourage by enacting the new rules, and (2) that violates any applicable securities laws or regulations. However, the rules relating the reasonable compensation are not applicable in determining how much of any such parachute payment is excessive.

For this purpose, the Congress intended that applicable securities laws or regulations include State as well as Federal laws or regulations. However, the Congress intended this rule to apply only if the violation is a serious one. It was not intended to apply if the violation is merely technical in character or is not materially prejudicial to shareholders or potential shareholders.

### **Excise tax.**

As is indicated above, a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment. In general, the Congress intended that, except as regulations may provide to the contrary, this tax be imposed for the taxable year of the recipient in which the payment is properly includible in the recipient's gross income under general Code principles, without regard to special rules deferring the taxable year of inclusion.

### **Withholding.**

The Act provides that an amount equal to the excise tax is to be withheld under section 3402 upon payment of excess parachute payments constituting wages. The Act also provides rules as to when excess parachute payments are taken into account under the FICA tax provisions.

### **Application.**

In determining whether payments contingent on a change in ownership or control equal or exceed 3 times the base amount, the value of amounts to be paid on a future date certain is to be determined on a present value basis in accordance with the principles of section 1274(b)(2), as added by the Act. Under that section, a discount rate equal to 120 percent of the applicable Federal rate, compounded semiannually, is to be used. Except as regulations may provide to the contrary, present values are to be determined as of the date the contract under which the payments are to be made becomes operative.

Where the amount of the payments contingent on a change in ownership or control depends on some uncertain future event, the likelihood that that event will occur is to be taken into account in determining value. For example, assume that a disqualified individual is entitled to payments contingent on a change having a present value equal to 4 times the base amount, less any compensation the disqualified individual earns from unrelated employers in the succeeding 3 years. If, under all the facts and circumstances, it can be determined, at the time the contract becomes operative, that the present value of such compensation is twice the base amount, then the payments are not parachute payments. If, on the other hand, it cannot be determined, at that time, that the individual will earn any such compensation, the payments are parachute payments.

The provisions are to be applied to that part of each parachute payment which is in excess of the portion of the base amount allocated to such payment. Under the Act, the portion of the base amount allocated to any payment is that portion of the base amount determined by multiplying the base amount by a fraction the numerator of which is the present value of such payment, and the denominator of which is the aggregate present value of all such payments. Any reasonable compensation in excess of the base amount is to be allocated to the first parachute payments made.

### **Other rules.**

The Act contains broad regulatory authority, authorizing the Treasury to prescribe such regulations as may be necessary to carry out the purposes of the provisions. These are to include, without limitation, regulations applying the provisions in the case of related corporations and personal service corporations and similar entities. They are also to detail the effect of the rules regarding the disallowance of a deduction (1) where a deduction was taken in a year prior to the change, as under section 404, (2) where incentive stock options are involved, and (3) in other cases.

No inference was intended as to the deductibility under prior law of amounts paid or incurred under so-called golden parachute agreements. Nor was any inference intended as to the deductibility of any payments contingent on a change in ownership or control which do not have a present value in excess of 3 times the applicable base amount.

### **Effective Date.**

The provisions are effective for payments made under contracts entered into or renewed after June 14, 1984. For this purpose, the grant, after June 14, 1984, of a stock option or similar arrangement under a plan approved prior to that date is not to be treated as a pre-June 14, 1984, contract. A contract cancellable unconditionally at will by either party to it, the disqualified individual or the company, is to be treated as a new contract entered into on the date any such cancellation, if made, would be effective. Thus, for example, if an employer can, at will, cancel a golden parachute contract entered into before June 15, 1984, by giving 3-months notice, the contract is to be treated as a new contract on September 15, 1984, whether or not it is in fact cancelled. The Congress did not intend that a parachute contract be treated as cancellable at will for this purpose if it could be cancelled only by terminating the employment relationship or similar relationship of the individual involved as well. In such a case, cancellation would produce a significant change in the relationship of the parties to each other in addition to merely terminating a parachute arrangement.

The provisions are also effective for all payments made under a contract entered into before June 15, 1984, if, after June 14, 1984, the contract is amended or supplemented in significant relevant respect. Under this rule, the provisions will apply to payments

made under pre-June 15, 1984, contracts which are amended or supplemented in significant relevant respect after June 14, 1984, even though, had no such amendment or supplement occurred, payments under the pre-June 15, 1984, contract would have been grandfathered.

A contract is to be treated as amended or supplemented in significant relevant respect only if those provisions of it in the nature of parachute provisions are amended or supplemented in a manner that provides significant additional benefits to the executive. Thus, for example, a contract generally is to be treated as amended or supplemented if it is amended or supplemented to add or modify, to the executive's benefit, a change in ownership or control trigger, to increase amounts payable (or, where payment is to be made under a formula, to modify, to the executive's advantage, the formula) in the event of such a trigger, or to accelerate the payment of amounts otherwise payable at a later date in the event of such a trigger. However, a stock option which is currently exercisable whether or not a change in ownership or control occurs is not to be treated as amended in significant material respect merely by reason of an amendment permitting the disqualified individual to surrender it for cash or other property. Since the disqualified individual could have exercised the option and then sold the stock received upon the exercise, the individual is not materially benefitted by the amendment.

Nor is a contract to be treated as amended or supplemented in significant relevant respect merely by reason of normal adjustments in the terms of the employment relationship or similar relationship. For example, if a pre-June 15, 1984, contract calls for a payment in the event of a change in ownership or control equal to 4 times a disqualified individual's annual compensation, a normal increase in his annual compensation is not to be treated as an amendment or supplement to the contract. Similarly, if a corporation, consistent with its historical practices, after June 14, 1984, grants non-vested stock options to a large group of disqualified individuals or other employees, only 1 or a few of whom have grandfathered contracts, and the vesting of all such options is accelerated in the event of a change in ownership or control, the grant generally is not to be treated as a significant amendment or supplement to those contracts (although the provisions are applicable to the options). Whether any adjustment in the terms of the relationship will be considered normal for this purpose depends on all the facts and circumstances. These would include (1) the length of time between the adjustment and the change in ownership or control, (2) the extent to which the corporation, at the time of the adjustment, viewed itself as a likely takeover candidate, (3) a comparison of the adjustment with historical practices of the corporation, (4) the extent of overlap between the group receiving the benefits of the adjustment and those members of that group who are the beneficiaries of pre-June 15, 1984, parachute contracts, and (5) the size of the adjustment, both in absolute terms and in comparison with the benefits provided to other members of the group.

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