Golden Parachute
Tax Solutions LLC
IRC Section 280G Computations & Advisory Services

# Advanced Topics IRC Section 280G

**"Congress 20 years ago inflicted on an otherwise near-perfect Internal Revenue Code section 280G and section 4999, the golden parachute penalty tax provisions"**

Rocap, Donald E., Levin, Jack S. and Ginsburg, Martin D., Revisiting Golden Parachutes. Tax Notes, Vol. 102, No. 2, January 12, 2004. Available at SSRN: http://ssrn.com/abstract=486145

# IRC Section 280G: More Than Just 3X

- Internal Revenue Code Section 280G is both a unique and a complex code section because it often involves multiple disciplines including: accounting, legal, executive compensation, market pricing, as well as business, actuarial and equity compensation valuations.
- Within the various compensation calculations, numerous nuances exists which can materially affect the calculations.

# Agenda

- Some Finer Golden Parachute Points
- Non-Compete Valuations
- Options
- Cutting Through The Confusion

# More Than Meets the Eye: Some Finer Golden Parachute Points

- Accelerating Equity – What's a full month?
- Common 280G Misconceptions
- Pre Versus Post Change of Control Reasonable Compensation: It makes a big difference.
- Discount Rate Planning

## Under IRC Section Reg. 1.280G-1, Q&A 24(c), What is a "Full Month"?

- The value used for the lapse of an obligation to perform services is defined as 1 percent of the amount of the accelerated payment multiplied by the number of **FULL MONTHS** the individual receives accelerated vesting.
  - If stock options original vesting date was June 1, 2013, and now vests on April 1, 2013, how many full months do we have?
  - If stock options original vesting date was May 31, 2013, and now vests on April 1, 2013, how many full months do we have?
  - If stock options original vesting date was June 15, 2013, and now vests on May 2, 2013, how many full months do we have?
  - If stock options original vesting date was May 31, 2013, and now vests on March 31, 2013, how many full months do we have?

# Common Misconceptions within IRC Section 280G

- Executive is terminated and executive's employment agreement states that he will receive a severance payment of 2.99 times average compensation over prior 5 years so we avoid golden parachute issue.
  - Not True. On the contrary, a 2.99 cap on severance almost always creates a golden parachute issue
- Company not addressing change in control in their executive compensation program is a potential big mistake.
  - Lack of planning can result in unintended consequences for all sides, including forfeiting payments.
- Executive agreement states that at the time of the change in control he/she receives a pro-rated bonus payment for the current year, but only if the company has exceeded performance goals. Since the Company has substantially exceeded performance goals this is not a parachute payment.
  - Not True. This is reasonable compensation for services rendered prior to the change in control. Consequently, this is a parachute payment. But for the change in control, the executive would have had to work and achieve performance goals for the entire year to receive any of the bonus.

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# Calculation Issues: Reasonable Compensation for Services Rendered Prior to the CIC

- Reasonable compensation for services rendered **after** the change in control **IS NOT** a parachute payment.
- Reasonable compensation for services rendered **prior** to the change in control **IS** a parachute payment. However, the majority of this amount may be excluded from the excise tax calculation.
- Ascribing a value for reasonable compensation for services rendered prior to the change will not reduce the amount of total parachute payments at all. If an executive has an excess parachute payment the amount determined to be pre change reasonable compensation will only reduce the amount subject to excise tax.
- In the golden parachute calculation for reasonable compensation for services rendered prior to the CIC, a prorated portion of the executive's "base amount" is added back when computing the amount of parachute payment subject to the 20% excise tax (Treas. Reg. §1.280G-1 Q/A 39)
  - Assume base amount = $100K
  - Total parachute payments = $500K (of which $300K is determined to be reasonable comp for pre change services)
  - Excise Tax Calculation $500k (PP) - $100k (1X Base) - ( $300K (RC)-$60K(Q/A 39 Add Back) = $160K * 20% = $32K

# Reasonable Compensation for Post CIC Services

- If an executive is compensated with respect to services rendered after a CIC, such services are **not parachute payments** provided the executive can demonstrate by clear and convincing evidence that such payments represent "reasonable compensation" for such services.
- Under the 280G regulations and related case law, reasonable compensation consists of total compensation and is based in part, on the nature of services to be rendered, the executive's historic compensation for performing such services, and the compensation of individuals performing comparable services in situations in which the compensation is not contingent upon a CIC.
- If an executive enters into such an arrangement, the executive MUST PERFORM SUCH SERVICES, in order to exclude amounts paid for such services.
  - The issue of post-CIC services was litigated in Square D. Company and Subsidiaries v. Commissioner 121 TC 168. ("Square D case")
  - Most common example of such an arrangement is where a company and executive enter into a post CIC consulting arrangement or provide a retention bonus (e.g., Square D Case)

# Reasonable Compensation for Post CIC Services

- Historic Compensation
  - Value ascribed to long-term incentives should be recognized ratably.
  - Square D did not directly opine on the stock option valuation methods but stated that the expert witness for the IRS "used non-standard methods" for valuing stock options as compared the valuation used by the petitioners – we believe this suggest the use of Black-Scholes (or comparable models) is appropriate.
- Market Compensation
  - Square D reinforces the 280G guideline for use of "similarly situated employees" working for "comparable employers" as a means of determining reasonable compensation.
  - Square D standard is slightly different than what is typically used by executive compensation consultants.
  - Only use substantially similar companies for peer analysis.
  - Size of peer group less important in Square D; where no peer data was available, court based reasonable compensation on  historical compensation.
  - Broad based survey data was not accepted in Square D case.
  - $90^{th}$ Percentile acceptable if justified by facts.

# Reasonable Compensation for Post CIC Services Example

**Facts:**

- Assume CEO has an employment agreement that provides him with $3 million severance upon a qualifying termination. His base salary was $750 thousand. Lets assume his job was eliminated and therefore, he can walk away for good reason. His safe harbor threshold is $2 million.
- Two weeks before the transaction NewCo restructures his agreement and provides him with a legitimate one year consulting agreement where he will need to work 25 hours per week to help with the transition. They will pay him $1.75 million. In addition, they will pay him at the close of the transaction $2 million as a settlement for any future severance.

# Reasonable Compensation for Post CIC Services Example

What level of comfort do you have with taking the position that the CEO does not have an excess parachute payment because the $1.75 million is reasonable compensation for services rendered after the CIC?

**Considerations:**

- Would it make a difference in your thought process if the reasonable compensation study demonstrated that total compensation of $1.75 million put the CEO in the 90th percentile of CEO's in that industry?
- What concern would you have if the 1.75 million significantly exceeds historical compensation?
- What concern would you have that the executive is rendering only 25 hours per week of services?

# Valuation Concepts: Reasonable Compensation for Post CIC Services Example

**Considerations Continued:**

- Would it make a difference if the CEO had a gross-up, and his new agreement provided an indemnity if the IRS later reclassifies any of his payments as a parachute payment?
- Should we be concerned that the new agreement was put in place two weeks prior to the deal, paid him $1 million more than his base salary, and reduced his severance payment by this $1 million amount, which corresponds to the amount that he was over the safe harbor threshold?
- Alternatively, are you comfortable with the restructured deal because he was needed in the transition, we are allowed to reduce payment prior to the payments vesting, and the reasonable compensation analysis provides some support for this value?

# Discount Rate Planning – IRC Section Reg. 1.280G-1, Q&A 32

- Generally, present value is determined by using a discount rate that exists on the change in control date.
- Q&A 32 allows the corporation and the disqualified individual to elect to use the applicable federal rate that is in effect on the date that the contract which provides for the payment is entered into, **IF SUCH ELECTION IS MADE IN THE CONTRACT.**
  - Current interest rates are very low so little downside to make this election when drafting new agreements.
  - Maybe think about amending agreements to provide this benefit in the event of a future change in control.

# Ascribing Value to a Non-Compete

- What The Regulations Provide
- The Business Valuation
- Don’t Forget Reasonable Compensation
- The Interview Process
- Structuring Agreements

# Valuing Non-Competition Provisions – The Regs.

- Compensation paid for a restrictive covenant, such as a covenant not to compete **<u>is not a parachute payment</u>** (to the extent the executive can demonstrate that such payments are "reasonable compensation" for future services).
  - Under Treas. Reg. §1.280G-1 Q/A 40, where an executive can demonstrate that payments made after a CIC are reasonable compensation for services rendered after the CIC, such payments are not included. **<u>The regulations specifically provide (Q/A 40(b)), that an example of such services include refraining from performing services (e.g. , a covenant not to compete).</u>**
  - Treas. Reg. §1.280G-1 Q/A 42(b) also provides that the executive must demonstrate by clear and convincing evidence that the agreement substantially constrains the executive's ability to perform services, and there is a reasonable likelihood that the agreement will be enforced.

# Valuing Non-Competition Provisions – Business Valuation

- Where an executive/company ascribes value to a non-compete, the process usually requires both a business and compensation analysis.
  - The business valuation generally involves what the valuation community describes as the "Income-Based Method" analysis
    - Under this methodology, the valuator will construct a Discounted Cash Flow ("DCF") analysis which values the covenant by computing the difference of the projected cash flows assuming a "with" versus "without" competition
    - If there is significant uncertainty in the revenue and expense assumptions in the DCF analysis, it might be helpful to set-up and run a Monte Carlo model using a normal distribution and high standard error assumptions for exogenous variables, thereby establishing a band of reasonable results
  - Although not specified in the 280G regulations, the Income-Based Method is commonly used with respect to valuing covenants for financial reporting as well as other areas of the tax code.

# Valuing Non-Competition Provisions – Business Valuation

- All non-compete analyses should address three key concerns addressed by Revenue Ruling 77-403
  - Whether, in the absence of the covenant, the covenanter would desire to compete with the covenantee;
  - The ability of the covenanter to compete effectively with the covenantee in the activity in question; and
  - The feasibility, in view of the activity and market in question, of effective competition by the covenanter within the time and area specified in the covenant.
- Additionally, the covenanter's economic resources, business expertise in the industry, contacts and relationships with customers, suppliers, and other business contacts, and the buyer's interest in eliminating competition should be considered during the valuation process.

# Valuing Non-Competition Provisions – Reasonable Compensation

- In addition to the business valuation, the valuator must also consider what constitutes "reasonable compensation"
- Applying a business valuation methodology without a compensation analysis will likely not withstand the scrutiny of an IRS audit
- The 280G regulations are vague in describing what constitutes reasonable compensation for purposes of a non-competition arrangement
- Absent specific guidance, a reasonable approach is to follow the IRS guidance for determining reasonable compensation in an active services role
- Under the 280G regulations, reasonable compensation consists of "total compensation" and is based in part, on the nature of services to be rendered, the executive's historic compensation for performing such services, and the compensation of individuals performing comparable services in situations in which the compensation is not contingent upon a CIC (See Treasury Regulations §1.280G-1 Q/A 40).

# Valuing Non-Competition Provisions – Interview Process

- The 280G valuation process generally starts with interviews
- Interview with the individual executive
  - During the interview the valuator will discuss with the executive ways in which the executive could cause hypothetical damage to the company if he/she were to compete. Also discussed will be certain biographical information such as:
    - Age of executive and children
    - Reasons for continuing to work
    - Desire of the executive to compete
    - Feasibility of competing and key leverage points
    - Financial impact of competition
- Interview with financial executive
  - The main purpose of this interview is to help the valuator understand the base case financial projections (the “without competition” analysis)
  - Examples of required information include detailed historical and projected income statements and the company’s weighted average cost of capital
- Follow-up questions – Often the valuator will have follow-up questions with the executive as the report becomes final

# Valuing Non-Competition Provisions Structuring Agreements

- Employment or CIC Agreements that provide severance should include post-termination non-competition restrictions
  - From a 280G valuation perspective, it may be helpful to designate a separate amount of consideration for the non-compete obligation, rather than subsuming that consideration within the severance amount
  - On the other hand, if a specific amount is designated to the covenant in the agreement, that reduces flexibility to assign a greater value to it at the time of a CIC if parachute payments exceed the threshold amount by more than anticipated
- Ideally, non-competition payments should be periodic, rather than lump sum, as it is much easier to demonstrate that the non-competition covenant is likely to be enforced where the agreement provides the company with the ability to stop payment in the event of any breach
- Non-competition agreements must have teeth
  - Restrictive covenants are highly dependent on state law (generally the state in which the executive resides and works)
  - It pays to have counsel well versed in applicable state law draft or at least review the restrictive covenants to make sure they are worded in the manner most likely to be enforceable

# Options

- How do You Value an Option for 280G Purposes?
- Can Vested Options Become Parachute Payments?

# Options: Using the Optimal Valuation Model

- Where equity is accelerated and rolled over into a Newco option, the Regulations do not permit the use of the intrinsic value (e.g. market price minus exercise price)
- Must use a GAAP approved option valuation model or the “safe-harbor “ option valuation found in Revenue Procedure 2003-68
  - Rev. Proc. 2003-68 generally produces a higher value than GAAP approved option valuation models
- Different GAAP approved models may render optimal results: consideration of which model to use, and correlating assumptions, could have an impact on overall value
  - One example of an assumption is remaining life.  Revenue Procedure 98-34 provides a safe harbor methodology.
- The safe harbor method provided in Revenue Procedure 2003-68 and Rev. Proc. 98-34 are considered consistent with generally accepted accounting principles and take into account the factors provided in § 1.280G-1, Q&A 13 (for both public and non-public companies)

# Options: Using Optimal Valuation Model

**Overview of Equity Valuation for CIC Stock Transaction and 280G Compliance (cont.)**

- Revenue Procedure 98-34: Taxpayers may determine the value of Compensatory Stock Options for transfer tax purposes by using a generally recognized option pricing model (for example, the Black-Scholes model or an accepted version of the binomial model) that takes into account as of the valuation date the following factors:
  1. the exercise price of the option;
  2. the expected life of the option;
  3. the current trading price of the underlying stock;
  4. the expected volatility of the underlying stock;
  5. the expected dividends on the underlying stock; and
  6. the risk-free interest rate over the remaining option term

**(Most of these factors are disclosed in the Company's Form 10k)**

- A taxpayer may value a stock option, without regard to whether the option is on publicly or non-publicly traded stock, using any valuation method that (i) is consistent with generally accepted accounting principles (such as FAS 123 or a successor standard) and (ii) takes into account the factors provided in § 1.280G-1, Q&A 13.

# Options: Using Optimal Valuation Model

- Factors deemed reasonable (safe harbor) per Revenue Procedure 98-34:
  - For CIC-related termination, use maximum remaining term unless term is less than 6 months; then use the Computed Expected Life (many companies have a 90-day exercise provision which would enable the use of Computed Expected Life)
    - Computed Expected Life: Ratio of disclosed weighted average life to option term multiplied by option maximum term
  - Use the expected volatility as disclosed in the fiscal year concurrent with the valuation date
  - Use the expected dividend rate as disclosed in the fiscal year concurrent with the valuation date
  - Use the yield to maturity on the valuation date of zero-coupon U.S. Treasury Bonds with a remaining term (as of the valuation date) nearest to the expected life of the option on the valuation date

# Options: Recalculation of Option Value

- If, in addition to vesting, there is, contingent on the change in ownership or control, a substitution of an option on different stock for the option, the valuation is based on the substituted option.
- Pursuant to § 1.280G-1, Q/A-33, for purposes of §§ 280G and 4999, the payor is permitted to re-determine the value of an option, during the 18-month period beginning on the date of the change in ownership or control (the re-determination period), in accordance with this revenue procedure. Recalculation is permitted if, during the re-determination period, either of the following occurs: (1) there is a change in the term of the option due to a termination of employment, or (2) there is a change in the volatility of the stock.
- A recalculation under this revenue procedure must be determined as of the date of payment used in the initial calculation (i.e., the valuation date). Thus, while the term assumption and the volatility assumption are permitted to be re-determined, the spread and the interest rate assumptions continue to be determined as of the valuation date.
- For purposes of re-determining the value of the option, an employer is permitted to use a method other than the method used in making the initial determination, provided that both methods are otherwise permitted under this revenue procedure.
- The base amount does not have to be re-apportioned;

# Options: Can Vested Stock Options Be Subject to IRC Section 280G?

- Assume CEO was granted a stock option at FMV with a $50 exercise price and a ten year term on April 2010. The option was fully vested on April 2012, but not exercised. The option plan states that upon a termination the executive has 30 days to exercise.
- Assume that a CIC occurs on May 2013 whereby the CEO has a qualifying termination. The CEO’s employment agreement states that upon a qualifying termination his/her options receive an exercise period of the lesser of the expiration of the option term or 3 years following the qualifying termination.
- Is the extension of the exercise period which is clearly a result of the CIC a parachute payment under IRC Section 280G?

# Options: Can Vested Stock Options Be Subject to IRC Section 280G?

- IRC Reg. 1.280G-1, Q&A 13 states that the vesting of the option is treated as the "payment in the nature of compensation" for IRC Section 280G purposes. This section supports the side that the extension of the option period for a vested option is not a parachute payment.
- However, can the IRS make the argument that the extension of the option period is really not part of the old option, but really a grant of a new option?
- Now, to go one step further, if we conclude that the extension of the option period is not a parachute payment, would your thought be different if the executive did not have any extension language in his employment agreement, but rather upon the CIC we restructure his agreement to reduce his severance payments by $500,000, and in lieu of this payment we extend the option term by 3 years which has a Black-Scholes value of $500,000.

# Final Thoughts

- Cutting Through the Confusion
- Plan now!
- Questions

# Final Thoughts: Cutting Through the Confusion

- With the growth of influence by shareholder advocacy groups such as ISS – companies and their advisors must accept the responsibility that we live in a world where 280G cannot get swept away by a Gross-up.
- Executive compensation program should balance the interest of all parties:
  – **Executives** should be advised so that they better understand the tax consequences of payments made following a CIC.

# Final Thoughts: Cutting Through the Confusion

**Companies** should be aware that their compensation policies, specifically long-term incentive plans may not be optimal for 280G. Companies which are candidates for a take-over should consider 280G friendly incentives.

**Company Boards** – should seek advice in order to make optimal decisions. With 280G, friendly compensation often runs contradictory to recommendations made by ISS and Executive Compensation Consultants. Its is therefore important to understand and balance such decisions to maximize results.

- Benchmarking is a useful tool but shouldn't be the only tool. Company's must consider their own objectives before worrying about what others are doing.

# Final Thoughts: Be Prepared!

- Advance planning for a potential change in control may save some executives and the company millions of dollars.
- Make sure executive compensation plans (including employment agreement) have considered change in control implications.
- Design a program that balances the interests of the executives, company, board of directors and shareholders.
- Make sure you have considered the golden parachute rules when designing your program.
- **A change in control can happen when a client least expects it – Be prepared now rather than sorry later.**

# Final Thoughts: Be Prepared!

“A pint of sweat will save a gallon of blood.”

General George S. Patton Jr.

# Questions

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