

The Golden Parachute Excise Tax Penalties





“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>



Consequences of IRC Section 280G and 4999IRC

- IRC Section 280G Disallows a Deduction for **“excess parachute payments”** paid to a **“disqualified individual”** that is **“contingent”** on a **“change in ownership or control”** of a **corporation**
- IRC Section 4999 Imposes an Excise Tax of 20% on **“Disqualified Individuals”** who receive **“excess parachute payments**



When does 280G Apply?

- When a “Disqualified Individual” (an employee or independent contractor who is subject to the golden parachute rules) receives payments or benefits on account of a Change in Control which equals or exceeds three times his/her average taxable compensation (“base amount”) for the 5 years preceding the year of the CIC (e.g. the “threshold”)
- Where the DI exceeds his/her threshold, the DI will be subject to excise tax on the amount of CIC payments and/or benefits which exceed one times his/her base amount



Golden Parachute Elements

- Corporation
- Change in Control
- Disqualified Individual
- Parachute Payments
- Excess Parachute Payments
- Base Amount
 - Average Compensation for the 5 Years Prior to the CIC
- Safe Harbor Threshold Amount
 - 3 times “base amount” less \$1



Corporation

- Requires a “corporation”.
 - Does not apply to Partnerships, S-Corps and LLCs taxed as partnerships
 - Applies to both public and private corporations



Change in Ownership or Control (“CIC”)

- What’s a Change in Ownership or Control?
 - Person or group acquires more than 50% of the total fair market value or total voting power of the stock of the Corporation
 - During a 12-month period, the sale of a substantial portion (1/3 or more) of the fair market value of the Corporation’s assets
 - Person or group acquires more than 20% of the voting power of the stock of the corporation in a 12 month period (*effective control*)
 - Majority of board members replaced (*effective control*)



Disqualified Individuals (“DI”)

- **Disqualified Individuals (“DI”)**
 - **Shareholders** – must hold at least 1% of the fair market value of outstanding shares of the corporation
 - Vested stock options count
 - **Officers** - up to 10% of the total employee population (minimum of 3; maximum of 50 officers)
 - **Highly Compensated Individuals** – highest paid 1% of the employee population (up to 250) with annualized compensation in excess of \$115,000



What is a Parachute Payment?

- Generally, a parachute payment is a payment that would not have been made in the absence of a CIC
- Common parachute payments include:
 - Severance
 - Deal bonuses
 - Health & welfare benefits received during severance period
 - Unvested payments (such as options, restricted shares, long term incentive plans, or other retirement plans) which receives accelerated vesting on the CIC
 - Additional pension credits
 - Pro-rated annual bonuses



Calculating the Excess Parachute

- **“Excess Parachute Payment”** occurs if the present value of all CIC payments made or to be made to the particular individual equals or exceeds **three times the individual's "base amount”**
 - **Base Amount** = average 5 years taxable compensation
 - **Safe Harbor** = 3 times base amount less \$1
 - **Excess Parachute Payment** = the amount which the actual value (as opposed to present value) of the parachute payment exceeds 1 times the base amount



How to Value Equity that Vests Upon a CIC?

- **Performance-Based Vesting** - In general, if an unvested payment vests as a result of a CIC, and normal vesting was based on performance criteria, the entire payment will be a parachute payment.



How to Value Equity that Vests Upon a CIC?

- **Time-Based Vesting** - In general, if unvested property vests as a result of a CIC, and normal vesting was solely time-based, the parachute amount of the payment is calculated as follows:
 - The present value of receiving such payment early; plus
 - The “lapse of obligation factor” which equals 1% multiplied by the number of full months of acceleration (for which the DI is no longer required to render services to receive such payment)
 - For example, if a DI receives a payment 6 months early, the lapse of obligation factor is 6% of the total payment



Private Corporation – Shareholder Approval Exception

- If the stock of the corporation is not publicly-traded:
 - Shareholders may be allowed to vote on the payments
 - Vote must pass by **more than** 75% of shareholders entitled to vote



Private Corporation – Shareholder Approval Exception

- The vote must take place among shareholders of record **determined no earlier than 6 months** before the CIC
- **Adequate disclosure** about all material facts about the payments to all shareholders entitled to vote
- Disqualified Individuals who would receive payments **are not permitted to vote** on the matter
- Vote must **determine the right of the DIs to receive or retain the payments** (i.e., the DIs must agree to waive the payments if the requisite vote is not attained)



Private Corporation – Shareholder Approval Exception

- The vote can be on part of the payments
- Can be separate votes for each DI, or a single vote on all payments to all DI's
- The CIC cannot be contingent on the outcome of the vote
- Entity shareholders – pass through voting



International Aspects of 280G

- **Foreign Parent with U.S. Operations**
 - Could lose U.S. deduction on parachute payments
 - Transfers to U.S., include foreign source income
- **Foreign Buyer of Foreign Target with No U.S. Operations**
 - No loss of U.S. deduction, but DIs could be U.S. taxpayers
- **U.S. Citizens and Permanent Residents subject to U.S. tax on worldwide income**
 - Expatriates and Local Hires who are U.S. taxpayers may be DIs



Politics & Current Events

- Institutional investors and proxy advisors are generally opposed to excise tax gross-ups and CIC payments greater than 3 times salary plus bonus
- Companies generally believe these arrangements are necessary to prevent top executives leaving when a CIC occurs
- The gross-up for golden parachute excise taxes is disappearing fast



Politics & Current Events

- Dodd-Frank Act “Say on Golden Parachute Payments” provision requires shareholder nonbinding vote on parachute payments to named executive officers (“NEOs”)
 - Latest reports indicate close to 90 companies disclosed SOGP arrangements in their merger-related proxies – all received majority support but less support than for overall merger transaction
 - ISS issued “Against” recommendations for 12% of these arrangements—all passed



ISS Perspective on Golden Parachutes

- “Poor pay practices” resulting in “Against” vote recommendation from ISS:
 - Excessive payments (greater than 3 times salary and bonus)
 - See WCA Waste Corporation/Macquarie Infrastructure Partners II
 - New or materially amended arrangements providing for CIC excise tax gross-ups (including modified or conditional gross-ups)
 - See Citadel/Cumulus, SAVVIS/CenturyLink
 - New or materially amended arrangements providing single-trigger or “modified single-trigger” CIC payments
 - See Warner Music Group/Airplanes Music
 - ISS favors “double-trigger” arrangements, triggered by termination “without cause” or “for good reason” after CIC
 - Single trigger equity vesting prior to deal completion



Institutional Perspectives

- **Fidelity:** Wants shareholder approval of (and generally will vote against) arrangements that provide: (i) excise tax gross-ups, (ii) CIC single-trigger for cash incentives, or (iii) lump sum payment of cash and equity acceleration that may total more than 3x salary and bonus for termination in connection with a CIC
- **Vanguard:** Wants shareholder approval of (i) CIC severance providing more than 3x salary and bonus or (ii) any guaranteed non-CIC-related severance
- **CalPERS:** Severance arrangements exceeding market standards (2.99X salary and target bonus) ratified by shareholders; will not approve tax gross-ups on severance. Unvested equity should not accelerate; should convert into the equity of the newly formed company.



Planning Ahead

***“A PINT OF SWEAT WILL SAVE A
GALLON OF BLOOD”***

- GENERAL GEORGE S. PATTON JR.



Common 280G Planning Strategies

- 280G impact is reduced or eliminated by
 - Cutting back payments to safe-harbor,
 - Increasing the executive's base amount,
 - Careful classifications of payment as “reasonable compensation” for services rendered before or after a CIC, or
 - Careful valuation of a payment made in connection with a CIC.



Planning Strategies: Cutting Back to Safe Harbor

Planning Decision:

Cut back only if executive is made better?

Cut back so that Company benefits from full deduction?



Planning Strategies: Increasing the Base Amount

- In years prior to CIC:
 - Exercise stock options
 - Accelerate payments that are exempt from 409A



Planning Strategies: Reasonable Compensation

- Post CIC Consulting Arrangements
- Where an executive can demonstrate that payments made after a CIC are reasonable compensation for services rendered after the CIC, such payments are not parachute payments.
 - Executive **MUST ACTUALLY PERFORM SERVICES**
 - Valuation must be reasonable
 - Look at historic compensation and market compensation
- The issue of post-CIC services was litigated in *Square D. Company and Subsidiaries v. Commissioner* 121 TC 168(2003)



Planning Strategies: What is Reasonable Compensation?

- Strongly recommend your advisor understands analysis in Square D court decision
 - Methodology accepted in Square D is similar but not the same as methodology used by compensation consultants
- Historic Compensation
 - Value ascribed long-term incentives should be recognized ratably.
 - Square D did not opine on stock option valuations
- Market Compensation
 - Only use substantially similar companies for peer analysis
 - Size of peer group less important
 - Survey data discouraged
 - 90th Percentile acceptable if justified by facts.



Planning Strategies: Valuing Non-Competition Provisions

- Post CIC Services include *refraining* from performing services (e.g. , a covenant not to compete)
 - “Reasonable compensation for personal services includes reasonable compensation for holding oneself out as available to perform services and refraining from performing services”
 - 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



Planning Strategies: Non-Competition Business Valuation

- To ascribe value to a non-compete, the process involves both a business and compensation valuation analysis:
- Business Valuation:
 - To value a non-compete, the most commonly used methodology among valuation experts is the Income Method”
 - The valuator will construct a Discounted Cash Flow (“DCF”) analysis which values the covenant by taking the difference of the cash flow assuming a “with” versus “without” competition



Planning Strategies: Non-Competition Business Valuation

- The business valuation report should address Revenue Ruling 77-403, specifically:
 - 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.



Planning Strategies: Non-Competition Interview Process

- The 280G valuation process generally starts with interviews with the covenantor and a financial executive:
 - Discuss biographical information, as well as ways in which he/she could cause hypothetical damage to the company by competing
 - Understand the company’s financial position and base case forecasts (the “without competition” analysis)
 - Follow-up questions – Often the valuator will have follow-up questions with the executives as the report is finalized



Planning Strategies: Non-Competition Interview Process

- Executives may be hesitant to provide specific sensitive information
 - The valuator should work with the executive to ensure he/she is comfortable with the report before rendering as final or sharing it with the acquiring company
 - Where an executive may have received an offer of employment, we encourage the executive to retain such correspondence in his or her tax file



Planning Strategies: Non-Competition Reasonable Compensation

- Reasonable Compensation for a non-compete
 - Regulations **do not provide** clear guidance on what constitutes reasonable compensation
- What value to ascribe to a non-compete?
 - Can the taxpayer ignore the reasonable compensation study?
 - Typical non-compete business valuation reports do not consider reasonable compensation
 - Can the taxpayer follow the same methodology for compensation provided in the Treasury Regulations for active compensation?
 - Should the taxpayer discount the value of what is reasonable compensation based on the executive NOT performing services?
 - If the business valuation is less than compensation valuation should the taxpayer take the lesser of the two?



Planning Strategies: Non-Competition Structuring Agreements

- Non-competition agreements must have teeth
 - It is more convincing if non-competition payments are periodic; and thus could be clawed back in the event of a breach
 - Restrictive covenants are highly dependent on state law, thus it is advisable to have counsel review restrictive covenants to ensure they are enforceable
 - Consider designating a separate amount of consideration for non-compete obligation.
 - Such a structure could replace “Severance” and thus be more inline with a pay for performance model.
 - On the other hand, if a specific amount is designated to the covenant in the agreement, that reduces flexibility to assign a greater value at the time of a CIC.



Planning Strategies: Reasonable Compensation for Prior Services

- Payments qualifying as reasonable compensation for services rendered prior to a CIC are parachute payments.
 - However, those payments may not be subject to excise tax, and may be deductible to the Corporation
- In general, evidence in determining reasonable compensation for pre-CIC is similar to post-CIC services
- When deducting reasonable compensation for prior services from total parachute payments, 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
- Examples "pre-CIC payments": retention bonus, current year bonus payment, performance-vested equity



Planning Strategies: Using Optimal Valuation Model for CIC Stock Transaction

- Must use a GAAP approved option valuation model or the “safe-harbor” option valuation found in Revenue Procedure 2003-68 (usually computes relatively high values)
- Different 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)



Planning Strategies: Using Optimal Valuation Model for CIC Stock Transaction

- Revenue Procedure 98-34: Must use 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:
 - the exercise price of the option;
 - the expected life of the option;
 - the current trading price of the underlying stock;
 - the expected volatility of the underlying stock;
 - the expected dividends on the underlying stock; and
 - the risk-free interest rate over the remaining option term
- Use maximum remaining term unless term following termination is less than 6 months; then use the Computed Expected Life (ratio of disclosed average weighted life and option term x maximum remaining term)



Planning Strategies: Using Optimal Valuation Model-Example

- Expected Life (sub-optimal exercise): Company-specific exercise data will often reveal price multiples of the exercise price at which option exercises often occur. Using this information in a binomial valuation model could reduce the value of the option relative to the standard expect term approach and lead to lower CIC costs.
 - This technique is most applicable if a) the offer price is substantially over the recent market price, and b) the market price is already at a premium to the exercise price;
 -and the time to exercise (maximum term) is less than 6 months



Planning Strategies: Using Optimal Valuation Model-Example

- Assumptions for substituted stock option:
 - 90 days to exercise upon termination (qualify for Computed Expected Term)
 - Weighted average expected life (10-K): 5 years
 - Option term: 10 year
 - Rollover term: 7 years
 - Computed Expected Term: 3.5 years [7 x (5/10)]
 - CIC price: \$70 Exercise Price: \$30
 - Volatility: 40% Interest Rate: 0.5%
- Black Scholes Value: \$42.513
- Now assume a suboptimal exercise factor of 2
 - Black Scholes value: \$40.000
 - Value reduced by \$2.513 per option (6% reduction)



Planning Strategies: Recalculation of Option Value

- Pursuant to § 1.280G-1, Q/A-33 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)
- Recalculation is permitted if, during the re-determination period, (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.
 - Must be determined as of the date of payment used in the initial calculation (i.e., the valuation date)
 - Can use different approved valuation method
 - The base amount does not have to be re-apportioned



Concluding Thoughts

- Avoid 280G surprises by starting a dialogue with Human Resources, your Company Board (Compensation Committee), and your outside compensation/tax advisors.
- Plan ahead
 - Review agreements to determine 280G exposure, and plan accordingly
 - Check to see what your peer companies are doing or have done with respect to golden parachute arrangements and tax gross-ups. You don't have to be the leader, but at least avoid being the laggard.



“I’M PROUD TO PAY TAXES IN THE UNITED STATES, THE ONLY THING IS – I COULD BE JUST AS PROUD FOR HALF THE MONEY”

- ARTHUR GODFREY



Contact Information

Laurence Wagman

Golden Parachute Tax Solutions

51 JFK Parkway, First Floor West

Short Hills, NJ 07078

(973) 847-5980

Ari Benjamin

Golden Parachute Tax Solutions

1501 Broadway, 12th Floor

New York, NY 10036

(646) 571-2156