

FAQ: Golden parachute payments under Section 280G

Companies that are planning for a merger or acquisition have various issues to consider as they prepare for the transaction, one of the issues being golden parachutes.

Golden parachute payments are payments of compensation made to an individual when his or her company experiences a change in control. Congress added Section 280G to the Internal Revenue Code to discourage companies from paying golden parachutes. This was in response to critics who believed that golden parachutes, among other things, encouraged company management to proceed with a merger or acquisition that may not be in the best interest of shareholders so management could receive these large compensation payouts.

The golden parachute payment rules under Section 280G are complex and difficult to navigate without a proper understanding of how the rules work. The answers to these frequently asked questions will help you better understand the rules.

1 What is a parachute payment?

Parachute payments arise when a corporation experiences a change in control. A parachute payment is a payment in the nature of compensation made to a "disqualified individual" triggered by a change in control. This includes all payments or benefits that would not have been made if no change in control had occurred.

What is the difference between parachute payments and excess parachute payments?

A parachute payment includes all payments in the nature of compensation made to a disqualified individual because of a change in control. Parachute payments result in excess parachute payments if the total parachute payments exceed a threshold amount.

The threshold amount is three times the disqualified individual's "base amount" (the average annual compensation of the individual over the past five years, as described in more detail below). If the total parachute payments exceed three times the base amount, then excess parachute payments exist. However, the "three times base amount" calculation is simply a threshold test. If the parachute payments exceed three times the base amount, then the total excess parachute payments equal the total parachute payments less one times the base amount.

Contact information

Jeff Martin

Manager, Washington National Tax Office T 202.521.1526 E Jeffrey.Martin@gt.com

www.GrantThornton.com/cbc

3 What tax penalties are associated with parachute payments?

Parachute payments themselves do not result in adverse tax consequences. However, excess parachute payments do result in penalties. The disqualified individual must pay a 20 percent excise tax on all excess parachute payments that he or she receives. This is in addition to the ordinary income taxes the disqualified individual must pay related to the excess parachute payments. Also, the corporation may not take a tax deduction for the excess parachute payments.

- 4 Can the corporation "gross up" the disqualified individual for the excise tax? Yes. The corporation may make additional payments to the disqualified individual to gross up the disqualified individual for the excise tax that applies to the excess parachute payments. The corporation may do this to make the disqualified individual whole and pass the excise tax burden to the corporation. The corporation should be aware that the gross-up payments will also be considered excess parachute payments. Thus, the gross-up payments will be subject to the 20 percent excise tax and will not be deductible by the corporation.
- 5 **Besides penalties, why should a corporation care about parachute payments?** There are many reasons why a corporation should be concerned. The corporation must report the excess parachute payments separately on the Form W-2 or Form 1099 provided to the disqualified individual and the IRS. In addition, the corporation is responsible for withholding the 20 percent excise tax from the payments made to the disqualified individual and depositing the excise tax with the IRS.

The disqualified individual's employment or service contract may require the corporation to gross up the disqualified individual for the 20 percent excise tax if payments result in excess parachute payments, so the corporation must be able to calculate the excise tax accurately. In addition, the employment or service contract may include a "haircut" provision that limits the amount of parachute payments so no payments result in an excess parachute payment. The corporation must be able to identify and calculate all parachute payments that will be made to the disqualified individual so the haircut provision can be applied accurately.

The entity acquiring the corporation in the change in control may require the corporation to represent that no payments will result in excess parachute payments. If excess parachute payments will be made, then the acquiring corporation may require an adjustment to the purchase price of the corporation.

Public corporations must pay special attention to parachute payments because of the reporting requirements associated with their annual proxy statements. A public corporation must report separately all parachute payments that may be made if a change in control occurs. In addition, all parachute payments actually made upon a change in control must be reported on the proxy statement.

6 What is a change in control?

A change in control includes any of three events: (1) a change in ownership of the corporation's stock, (2) a change in ownership of a substantial portion of the corporation's assets, or (3) a change in effective control of the corporation.

7 Can a change in control occur if a parent corporation sells all the stock of a subsidiary?

Yes. A change in control will occur with respect to the subsidiary if the subsidiary is a corporation. Also, a change in control may occur with respect to the parent corporation if the stock of the subsidiary is a substantial portion of the parent corporation's assets.

8 Who are disqualified individuals?

Disqualified individuals include shareholders who own more than one percent of the fair market value of the corporation's stock, officers of the corporation and highly compensated individuals. A disqualified individual can be an employee, an independent contractor or a director.

9 When is a payment contingent on a change in control?

A payment is contingent on a change in control if the payment would not have been made had no change in control occurred or if the payment is made as a result of an event that is closely associated with the change in control and the event is materially related to the change in control. For example, voluntary or involuntary separation from service is an event closely associated with a change in control. If the separation from service is materially related to the change in control, payments made to the disqualified individual upon separation from services will be parachute payments.

Are any payments presumed to be contingent on a change in control?

Yes. Payments are presumed to be contingent upon a change in control if the payment is made pursuant to an agreement entered into within one year before the change in control or an amendment to an agreement made within one year before the change in control. This presumption can be rebutted by showing clear and convincing evidence that the agreement was entered into, or the amendment was made, without regard to the change in control.

How are stock options treated for purposes of the parachute payment rules?

In general, vested stock options are treated as outstanding stock for purposes of the parachute payment rules. Thus, vested stock options are treated as outstanding stock when determining who is a shareholder for purposes of identifying disqualified individuals. Stock options that become vested because of the change in control will be treated as outstanding stock for purposes of identifying disqualified individuals. Vested stock options are also treated as outstanding when determining if a change in ownership of the corporation has occurred. On the other hand, stock options that are not vested are not treated as outstanding stock. Vested stock options are not treated

as a parachute payment, while stock options that become vested because of the change in control are treated as a parachute payment.

10 What are some examples of parachute payments?

Parachute payments include all payments in the nature of compensation that are contingent on a change in control. This is a very broad definition and could include forms of compensation that you may not identify initially. Some examples of parachute payments include the following:

- Bonuses paid because of the consummation of the change in control
- Retention bonuses paid after the change in control
- Accelerated vesting of stock options, restricted stock or other forms of equitybased compensation
- Fringe benefits
- Severance payments
- Accelerated vesting of nonqualified deferred compensation
- Life insurance
- Post-change-in-control consulting arrangements

11 How can we reduce or eliminate the portion of a payment that is treated as a parachute payment or excess parachute payments?

The portion of a payment that is treated as a parachute payment can be reduced or eliminated by demonstrating with clear and convincing evidence that the payment is reasonable compensation for personal services provided after the change in control. For example, a severance agreement may provide that the disqualified individual may not compete with the corporation for a certain period of time after employment is terminated. The corporation may be able to demonstrate that all or a portion of the severance payment is reasonable compensation for the disqualified individual not to provide services to a competitor. If this can be demonstrated, the parachute payment for the severance can be reduced by the amount that is reasonable compensation for not competing with the corporation.

Excess parachute payments can be reduced by demonstrating with clear and convincing evidence that a portion of the excess parachute payment is reasonable compensation for services performed before the change in control. For example, when compared to similar executives at peer companies, the disqualified individual may have been underpaid in years prior to the change in control. The corporation may be able to demonstrate that all or a portion of a change-in-control bonus or other parachute payment is a "catch-up" payment to the disqualified individual for being underpaid in previous years.

In order to reduce parachute payments or excess parachute payments for reasonable compensation, the corporation must show clear and convincing evidence that the

compensation is reasonable. This may require a compensation study to determine what is reasonable.

12 What is the base amount and how is it calculated?

The base amount is used to calculate the three-times and one-times thresholds discussed above. A disqualified individual's base amount is equal to the disqualified individual's average annualized wages over the five years preceding the year in which the change in control occurs. Thus, the disqualified individual's wages for the year of the change in control do not count towards the base amount. A disqualified individual's wages include the amount reported on the disqualified individual's Form W-2 or Form 1099. Special rules apply for disqualified individuals who did not provide services to the corporation for the entire five years prior to the change in control, for disqualified individuals hired midyear and for disqualified individuals who were hired during the year of the change in control.

13 **Do the parachute payment rules apply to both private and public corporations?** Yes. Both private and public corporation that experience a change in control are subject to the parachute payment rules under Section 280G.

14 **Do the parachute payment rules apply to entities other than corporations?** In general, no. Entities such as partnerships and tax-exempt organizations are not subject to the parachute payment rules. However, some other entities that are not corporations are treated as corporations for purposes of the parachute payment rules, including publicly traded partnerships and real estate investment trusts.

15 Are all corporations subject to the parachute payment rules?

No. A corporation that qualifies as a "small business corporation" is not subject to the parachute payment rules. In order to qualify as a small business corporation for purposes of the parachute payment rules, the corporation may not have more than 100 shareholders, may not have as a shareholder a person other than an individual (with certain exceptions) and may not have more than one class of stock. Certain other requirements must be met in order to qualify as a small business corporation. Generally, these are the requirements a corporation must meet in order to make an election to be treated as an S corporation. However, a corporation is not required to have made an S election in order to qualify as a small business corporation for purposes of the parachute payment rules.

16 When should I begin considering parachute payments?

You can start preparing for parachute payments as early as when the corporation enters into an employment or service contract with an individual who will or may be considered a disqualified individual. Certain provisions can be included in the plan to limit exposure to the parachute payment rules.

You should not wait until immediately before or after a change in control to address parachute payments. Certain planning opportunities may be available if the planning takes place in the year prior to when the change in control occurs. If you find yourself in a situation where the change in control is imminent or has already occurred, you should act quickly to involve a tax consultant to help identify parachute payments and determine whether the adverse tax consequences associated with excess parachute payments apply.

Are there any opportunities to plan for parachute payments?

Yes. There are various planning opportunities than can be implemented to reduce the likelihood that excess parachute payments will exist upon a change in control. There are strategies for increasing a disqualified individual's base amount, thereby reducing the likelihood that the total parachute payments will exceed the three-times base amount threshold. Under a special rule, if private companies are able to obtain shareholder approval of payments that will be made to a disqualified individual upon a change in control, the approved amounts are not treated as parachute payments. Additional strategies exist to plan for parachute payments.

17 Who should I contact to learn more about the golden parachute rules? Please contact Jeffrey A. Martin in our Washington National Tax Office at 202.521.1526 or leffrey.Martin@gt.com.

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