The Golden Parachute Excise Tax—Not Just a Public Company Issue

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When a company engages in merger and acquisition ("M&A") discussions, the management team responsible for putting together the transaction finds out quickly that such an endeavor is time consuming and extremely complicated. Valuation analysis, financing, merger integration, legal, taxation and other regulatory concerns all enter into the M&A maze. To get through this maze, an army of lawyers, accountants, and investment bankers become a valuable resource assisting the company with the transaction. Unfortunately, because of the enormous amount of regulations and tax rules surrounding M&A transactions, compliance is a challenge. One example where compliance is a challenge is accounting for the golden parachute excise tax, specifically where a transaction involves the acquisition of a private company.

BASIC GOLDEN PARACHUTE EXCISE TAX RULES

In general, the golden parachute excise tax is discussed in Internal Revenue Code ("IRC") Sections 280G and 4999. A golden parachute excise tax is triggered where the present value of change-in-control payments and benefits received or to be received by a disqualified individual are equal to or greater than three times the disqualified individual's base amount. A disqualified individual is an executive who is subject to IRC Section 280G.[1] A disqualified individual's "base amount" is the executives' average taxable company compensation for the five years preceding the year of the change-in-control.[2] The amount which is $1 less than three times the disqualified individual's "base amount" is often referred to as the golden parachute or 280G threshold amount. The golden parachute threshold amount is the maximum amount of parachute payments that an executive may receive and not be

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subject to a golden parachute excise tax. When a disqualified individual receives change-in-control benefit(s) which exceed his/her golden parachute threshold amount, the disqualified individual will incur a 20% excise tax on the portion of total parachute payments which exceed one-times the individual's base amount. It is important to emphasize that although the safe harbor allows the executive disqualified individual to receive change-in-control payments of up to three times his/her base amount, such individual can be as little as $1 over the golden parachute threshold amount, and be subject to a significant excise tax because the excise tax only exempts one times the executives base amount. Finally, the portion of the total parachute payment that is subject to the excise tax becomes a non-deductible payment for corporate income tax purposes. The basics of the 280G rules are best illustrated by the following example:

> Executive A (a disqualified individual) receives change-in-control benefits equal to $2 million dollars, has a "base amount" of $500,000, and works for a company with a marginal corporate income tax rate of 40%. In this example, the benefits Executive A receives exceeds three times his average base compensation (e.g. $2 million is greater than [$500,000 * 3]—$1), resulting in the executive having a golden parachute excise tax liability of $300,000 (e.g. [$1,500,000 * 20%]). Moreover, the Company will lose a $1,500,000 deduction which is equal to $600,000 on an after tax basis (e.g. $1,500,000 * 40%). Thus, the combined IRC Section 280G and IRC 4999 related costs are $900,000, $300,000 for the excise tax (executive's responsibility), and $600,000 attributed to the economic cost of losing the corporate deduction (corporate cost).

The above example demonstrates the magnitude of an IRC Section 280G golden parachute issue. In this example, the executive is over the golden parachute threshold amount by $500,000 (pre-tax), and the total after tax cost as a result of this issue is $900,000.

Although the golden parachute problem can be very expensive for both the executive and their respective companies, in the case of private companies, all golden parachute excise tax costs may be eliminated if an IRC Section 280G compliant shareholder approval is obtained. The following provides a brief explanation as to which companies are exempt from 280G, and what requirements are necessary for a company to obtain a 280G compliant shareholder vote.

Which Non-Public Companies are "Exempt" from IRC Sections 280G and 4999?

Generally, Treasury Regulations 1.280G-1 Q/A 6 provides that any payment to a disqualified individual is exempt from IRC Sections 280G and 4999 if they fall under any of the following:

- A corporation which would qualify as a small business corporation (e.g. "S-Corporation") as defined by IRC Code Section 1361(b).[3]
- Partnerships or Limited Liability Company ("LLC") provided that such entities do not elect to be taxed as corporations.[4]
- A corporation which is "tax exempt" (e.g. 501(c)(3)).
- Non-public corporations other than a small business corporation (S-Corporation), if immediately before the change-in-control, no stock in such corporation was readily tradable on an established securities market or otherwise; **and the shareholder approval requirements provided by IRC Section 280G are met.**

What Percentage of Shareholder Support is Necessary to Exempt a Payment from Being Subject to the Golden Parachute Excise Tax?

Where a non-publicly traded corporation is being acquired, such corporation can exempt change-in-control payments from the golden parachute rules, if such payments are approved by shareholders representing 75% of the voting power of the corporation immediately before the change-in-control. Although this may sound straightforward, there are a number of intricate rules which must be followed, as it relates to disclosure and the shareholder vote. If any of the requirements of 280G are not carefully adhered to, the vote would be invalid and the executives and company would be subject to 280G and 4999 related costs. In order to comply with 280G there must be adequate disclosure, and all of the voting requirements must be properly met.

Disclosure Requirements

- Before the vote, there must be adequate disclosure to ALL persons entitled to vote. Adequate disclosure consists of disclosure of "all material facts concerning all material payments which would be parachute payments with respect to a disqualified individual."[5] Examples of "material facts" are: the event triggering the payment or payments, the total amount of the payments that would be parachute payments if the shareholder approval requirements are not met, and a brief description of all payments being made (e.g., accelerated vesting of options, bonus, or salary). From a practical standpoint, it is always better to disclose too much rather than too little.[6]
- The disclosure must determine the right of the disqualified individual to receive such payment(s). In other words, if the vote fails, the executive must not be entitled to receive such payment(s). Where an executive is entitled to a payment under a prior agreement, he or she must forfeit the right to such payment(s) or benefit(s) if he or she does not receive the vote of at least 75% of the shareholders which would enable him or her to receive the payment or benefit. In normal practice, where legal counsel drafts the necessary shareholder approval documents, they will also include a parachute payment waiver agreement to ensure the disqualified individual has waived his/her right to payments subject to the shareholder approval vote.

Voting Requirements

- The regulations provide that a shareholder approval vote can be on less than the full amount of payments. Shareholder approval can be a single vote on all payments to any one disqualified individual, or on all payments to more than one disqualified individual. However, the total payment(s) <u>submitted</u> for shareholder approval must be separately approved by shareholders.[7]
- The shareholder vote must occur within six months of the change-in-control. In determining the shareholders entitled to vote, the regulations specifically state that the vote can be based on the shareholders of record as of any day within the six month period immediately prior to and ending on date of the change in ownership or control.[8]
- A disqualified individual who receives parachute payments **is prohibited** from voting on his/her or anyone else's parachute payments. In order to compute whether the 75% voting threshold has been reached, the disqualified individual's voting shares are disregarded.[9]
- Where an approval of the

change in ownership or control is contingent, or otherwise conditioned on the approval of any payment to a disqualified individual that would be a parachute payment absent such vote, such vote will not be valid for the 280G exemption.

SHOULD ALL CHANGE-IN-CONTROL BENEFITS/ PAYMENTS BE SUBJECT TO THE SHAREHOLDER VOTE?

No! The only amounts which should be subject to a vote are the amounts which put the disqualified individual over his/her "Golden Parachute Threshold Amount." Moreover, because any amounts subject to a vote are at risk if the vote fails, in general, it would be better for a disqualified individual to subject only an amount (with perhaps some cushion) which would otherwise subject the executive to a golden parachute excise tax.

To illustrate this point further, we refer to the above example where Executive A receives change-in-control benefits of $2 million and has a "base amount" of $500,000. In the example, Executive A's Golden Parachute Safe Harbor amount is $1,499,999 ([$500,000 *3] -$1). Consequently, in order to keep this executive from being subject to the IRC Section 280G excise tax the executive must have at least $500,001 of his/her change-in-control payments/benefits made contingent upon receiving a shareholder vote. Accordingly, the executive would receive all change-in-control payments excise tax free if such payments are approved by more than 75% of the company's shareholders. It is important to emphasize, that if the required 75% is not attained the executive cannot be entitled to the $500,001 payment.

Although in this example $500,001 is the minimum that needs to be placed at risk in a vote, it is always advisable to provide an additional cushion by subjecting more than the minimum to the vote because sometimes situations change after the vote. For instance, if the vote happens on the June 1, 2011, and the change-in-control occurs on July 1, 2011, the required applicable federal rates used in some of the golden parachute calculations will be different, thus affecting the parachute calculations. A second instance might be that the cost of future benefits might be different than anticipated (i.e. if the executive was provided with the cash value of health benefits for three years following the change-in-control, the estimated costs could increase in the plan years following the change-in-control). A third example would be a minor payment or benefit which might have been inadvertently omitted when calculating the initial change-in-control benefit. Regardless of the situation, by providing an extra cushion, the executive and company have added protection, specifically in cases where all of the facts may not be known on the change-in-control date.

COMMON CONCERNS AND BEST PRACTICES

Although the 280G rules regarding the private company exception provide a method to eliminate golden parachute issues, there are several consequences unrelated to tax which often become concerns.

Privacy Surrounding Compensation Decisions

Although shareholder approval provides a way in which companies can avoid Golden Parachute excise tax related costs, there are often considerations outside of the 280G context which are of concern to companies. As discussed above, full disclosure requires that the company disclose "all material facts concerning all material payments with respect to a disqualified individual." This provision of the rules is usually of concern to both the company and the executive. One such example involves the communication of payments among employees. The disclosure rules require disclosure to ALL shareholders who are not eligible to receive parachute payments (absent the shareholder vote). Thus, a lower level employee or executive, who is also a shareholder of record, would be privy to compensation details management would rather not disclose. Consequently, the Company's leadership must decide whether or not they will disclose this confidential information to all shareholders, knowing if they do not disclose the necessary information there could be significant parachute costs to both the executives and company. A second example involves disclosure to outside shareholders (a shareholder that is not employed by the company). It is not uncommon for management to be concerned that an outside shareholder might raise objections with respect to change-in-control payments. As uncomfortable as the above situations may be, when a company considers the shareholder approval option, it must understand that it will have to disclose such facts to ALL shareholders without exception. Simply stated, a company CANNOT cherry pick its way up to 75%.

New Compensation Arrangements Buyer Entered into Prior to the Change-in-Control

Another issue which often comes up involves whether payments or benefits occurring from agreements entered into by an executive immediately prior to the change-in-control involving post change-in-control services are reasonable compensation for services rendered following a change-in-control, or whether they are change-in-control payments. In general, payments that are reasonable compensation for services rendered following a change-in-control are not parachute payments. However, because such arrangements are entered into within one year prior to the change-in-control, in order to establish "reasonable compensation" the executive must prove by clear and convincing evidence that such payments or benefits are reasonable compensation for services rendered following the change-in-control. The Regulations indicate that in order to provide clear and convincing evidence the individual's annual compensation for such services cannot be "significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments" Furthermore the Regulations specifically provide that following example of reasonable compensation for services to be rendered on or after the date of the change-in-control:

> If the individual's duties and responsibilities are substantially the same after the change in ownership or control, the individual's annual compensation for such services is not significantly greater than such individual's annual compensation prior to the change in ownership or control, apart from normal increases attributable to increased responsibilities or cost of living adjustments. If the scope of the individual's duties and responsibilities are not substantially the same, the annual compensation after the change is not significantly greater than the annual compensation customarily paid by the employer or by comparable employers to persons performing comparable services.[10]

Where this becomes an issue, especially with private companies, is where the buyer wants to retain and reward key executives with long-term incentive compensation (usually in the form of equity), provided the transaction becomes financially successful. Under these arrangements, it is common to see the maximum compensation which could be earned by an executive to be significantly higher than what the executive and respective market peers currently earn. This creates a situation where the executive and the private company are faced with either contemplating arguing that such arrangement is reasonable compensation for services to be rendered after a change-in-control, or more simply, putting the potential payments up to a 280G shareholder vote. Generally, it is recommended that such payments are included in the 280G shareholder vote, and that the maximum amount which can be earned under the plan be disclosed. Although such amounts are very large, if a proper shareholder vote is attained, the executives and company do not have to be concerned that they will ever need to demonstrate to the IRS that the amount of such payments are reasonable compensation for services rendered after the change-in-control. Furthermore, the company will not have to consider or incur the time/cost of conducting a study to demonstrate that such payments are reasonable compensation for services rendered after a change-in-control.

Lastly, if both options are not acceptable, a third option is to not enter into any post change-in-control compensation arrangements until after the transaction closes. The regulations explicitly state that arrangements entered into after a change-in-control are not parachute payments.[11]

CONCLUSION

The Golden Parachute Excise Tax is obscure, expensive and generally avoidable for private companies. Therefore, where a private company is being acquired, it is extremely important that all golden parachute excise tax issues are vetted prior to the close of a transaction. Failure to examine the golden parachute rules as part of the M&A process, could result in increased and unnecessary deal related costs, not to mention very angry executives. Fortunately, where private companies are concerned, there is an easy remedy that can provide the maximum benefits to all parties involved.

NOTES:

[1]For more information regarding who is a disqualified individual see Treasury Regulations 1.280G-1 Q/A 15-20.

[2]In general, where an executive works less than five years, the average is taken over the number of years preceding the year of the change-in-control in which the executive has rendered services. Detailed on how to precisely calculate an executive's "base amount" can be found in Treasury Regulations 1.280G-1 Q/A 34-36.

[3]One exception is that under IRC Section 280G the S-corporation restriction that a nonresident alien cannot own stock in the corporation does not apply.

[4]Treasury Regulations 1.280G-1 Q/A 2(a)(3) provide that 280G is triggered by a change-in-control of a corporation. Treasury Regulations 1.280G-1 Q/A 45 defines a corporation to include a publicly traded partnership treated as a corporation under section 7704(a).

[5]Treasury Regulations Section 1.280G-1 Q/A 7(a)(2).

[6]Treasury Regulations Section 1.280G-1 Q/A 7(c).

[7]Treasury Regulations Section 1.280G-1 Q/A 7(b)(1).

[8]Treasury Regulations Section 1.280G-1 Q/A 7(b)(2).

[9]Where a disqualified individual receiving parachute payments owns voting shares, the total voting shares outstanding is reduced by his respective shares. For example, if Private Company X has 125,000 outstanding shares, and disqualified individual receiving parachute payments owns 25,000 shares, in order for there to be a successful 280G shareholder vote, remaining voting shareholders holding more than 75,000 shares must approve such parachute payments.

[10]Treasury Regulations Section 1.280G-1 Q/A 42(a)(2).

[11]Treasury Regulations Section 1.280G-1 Q/A 23.

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Golden Parachute Tax Solutions is the first single focused IRC Section 280G boutique accounting firm in the United States. We are an industry leader who only employs top experts in the field. In addition we are an accounting firm which does not provide audit services, and therefore, we are never restricted from performing valuation services which are often required in preparing golden parachute computations.

Regardless of the size of an engagement, our expertise and independence makes us the firm best suited to deliver the exceptional service our clients deserve.

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