

Acredula

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

The Role of Golden Parachutes Is Often Misunderstood

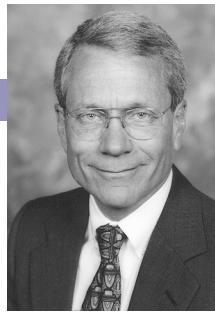
This month's *Acredula* focuses on the tax consequences of golden parachutes.

Due to the notoriety given to misused golden parachutes, the role of golden parachutes as a legitimate component of executive compensation is often misunderstood. A valid use of golden parachutes is to retain an executive, or management team, through a change in control. Their use as a "poison pill" to deter unwanted takeovers, however, too often results in an artificial depression of the market value of the company's capital stock, harming all stockholders.

The difference between valid and abusive golden parachutes is the level of compensation that results. If the level of compensation is sufficient to retain an executive or management team through a change in control, without causing a depression of the market value of the company's capital stock, the golden parachute is legitimate.

Editor's Note

Golden parachutes are important, as no board of directors can manage a company through a merger or acquisition, especially one resulting in a change in control, without retaining the CEO and the core management team. Boards must be diligent in providing executives and management teams with incentives for enduring any change in control. In negotiating parachutes, boards should review the levels of compensation offered by comparable companies. In approving parachutes, boards may want to consult with an independent investment banker to ensure that the compensation offered will not have a material, continuing adverse effect on the market value of the company's capital stock.



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Look Before You Leap: The Tax Consequences of Golden Parachutes

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In the current environment of corporate mergers and acquisitions, it is not uncommon for corporations to enter into employment agreements with key employees. Often referred to as "golden parachute" agreements, these employment agreements usually provide key employees with large severance payments in the event of

termination of employment due to a change in control of the corporation.

Corporations enter into golden parachute agreements with key employees for a variety of reasons, including:

- **Attracting experienced and qualified key employees.** Corporations not offering golden parachute agreements

may have difficulty locating experienced executives to fill vacated positions.

- **Retaining key employees.** Since golden parachute payments provide key employees with financial security and job security in merger and acquisition situations, key employees are more likely to remain employed with a corporation when provided with a golden parachute agreement.



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- **Alleviating the conflict of interest between key employees and shareholders in most merger and acquisition situations.** Conflicts arise because key employees have an interest in remaining employed, while shareholders have a financial interest in the corporation being purchased at a premium. Golden parachute payments provide financial incentives for key employees to act objectively and in the best interest of shareholders in merger and acquisition situations.
- **Protecting against unwanted takeovers.** An acquiring corporation may be hesitant to complete a takeover if it is obligated to make large payments to the acquired corporation's key employees. Corporations enter into golden parachute agreements as a means of increasing the total cost of takeovers, anticipating that the high costs associated with these agreements will deter all but serious takeover inquiries.

Despite their many advantages, golden parachute agreements can be costly to corporations and their key employees if the tax ramifications of such agreements are not taken into account

before they are executed. The Internal Revenue Code (IRC) contains two provisions which are designed to penalize excess golden parachute payments. The first provision restricts the income tax deductibility of excess golden parachute payments, while the second provision imposes a nondeductible 20 percent excise tax on recipients of excess golden parachute payments. The United States Congress enacted these provisions in an effort to discourage payments by corporate employers to key employees as a result of a change in ownership or control of the corporation.

This article summarizes the effect of these two IRC provisions on corporations and key employees who enter into golden parachute agreements.

Overview of Golden Parachute Provisions

The golden parachute provisions of the United States tax laws impose two penalties on golden parachute payments:

1. IRC Section 280G provides that a corporation may not take an income tax deduction for any "excess parachute payment" paid or accrued by a corporation; and
2. IRC Section 4999 imposes an excise tax on any person who receives an "excess parachute payment" equal to 20 percent of the excess parachute payment amount.

Parachute Payments

The IRC provisions apply to "parachute payments." A parachute payment is defined as any payment which is in the nature of compensation and which is paid to or for the benefit of a disqualified individual pursuant to an agreement which violates any federal or state securities laws or regulations.¹ In determining whether a securities law violation exists for purposes of this definition, securities law violations which are technical in nature or are not materially prejudicial to shareholders are not taken into account.²

In order to satisfy this definition of a parachute payment, four components need to be present:

1. Payments must be in the nature of compensation;
2. Payments must be paid to or for the benefit of a disqualified individual;
3. Payments must be contingent on a change in ownership or effective control of the corporation or ownership of a substantial portion of a corporation's assets; and
4. Payments' aggregate present value must equal or exceed an amount equal to three times the individual's base amount.³

Payments in the Nature of Compensation

The first component of a parachute payment is that the payment must be in the "nature of compensation." This phrase is generally defined to include all payments, whether in the form of cash or non-cash, if they arise out of an employment relationship or are associated with the performance of services.⁴ For this purpose, the performance of services includes holding oneself out as available to perform services and also refraining from performing services, such as under a covenant not to compete.⁵ Examples of payments in the nature of compensation include wages, salary, bonuses, severance pay, fringe benefits, pension benefits, and other payments of deferred compensation.⁶ Transfers of property are also considered payments in the nature of compensation.⁷

Payments to Disqualified Individuals

The second component of a parachute payment is that the payment must be paid to or for the benefit of a “disqualified individual.” The parachute provisions define a disqualified individual as any individual who is an employee, independent contractor, or other person defined in the tax law regulations who performs personal services for the corporation, and who is an officer, shareholder, or highly compensated individual of the corporation.⁸

Whether an individual constitutes an “officer” of a corporation is determined on a facts and circumstances basis.⁹ In general, the term officer refers to an administrative executive who is in the regular and continued service of a corporation, and excludes those individuals who are employed for a special or single transaction. An individual who has the title of an officer, but does not have the authority of an officer, will not be considered an officer. On the other hand, an employee who does not have the title of an officer, but who has the authority of an officer, will be considered an officer. Under no circumstances will more than 50 employees (or, if less, the greater of three employees, or ten percent of the employees) of a corporation be considered officers for this purpose.

An individual is considered a “shareholder” if the individual owns stock in the corporation with a fair market value that exceeds the lesser of one million dollars, or one percent of the total fair market value of the outstanding shares of all classes of the corporation’s stock.¹⁰ The constructive ownership rules of the tax provisions apply for purposes of determining the amount of stock owned by an individual.¹¹

The term “highly compensated employee” is defined as an individual who is among the lesser of the highest paid one percent of employees, or the highest paid 250 employees when ranked on the basis of compensation.¹² However, by no means will an individual with annualized compensation less than \$75,000 be treated as a highly compensated employee.¹³

Contingent Payments

The third component of a parachute payment is that the payment must be contingent on one of the following:

- **A change in ownership.** This change is deemed to occur on the date that any one person, or more than one person acting as a group, acquires more than 50 percent of the total fair market value or total voting power of the corporation’s stock.¹⁴ A change in ownership is not deemed to occur if the person or group acquiring the stock already possesses more than 50 percent of the total fair market value or total voting power of the

corporation’s stock. The constructive ownership rules apply for purposes of determining the amount of stock owned by an individual.¹⁵

- **A change in effective control of the corporation.** This change is presumed to occur if, within a 12-month period, any person or group of persons acquires ownership of the corporation’s stock, resulting in possession of 20 percent or more of the total voting power of the corporation’s stock, or a majority of the members of the corporation’s board of directors is replaced by directors whose appointment or election is not endorsed by a majority of the members of the corporation’s board of directors prior to the date of the appointment or election.¹⁶ This presumption may be rebutted by proving that the acquisitions do not change the power to control the management and policies of the corporation from one person to another.
- **A change in ownership of a substantial portion of a corporation’s assets.** This change is deemed to occur on the date that any one person or group of persons acquires (or has acquired during the 12-month period ending on the date of the most recent acquisition by such person or group) assets from the corporation that have a total fair market value greater than or equal to one third of the total fair market value of all of the corporation’s assets immediately prior to the acquisition.¹⁷ A transfer is not treated as a change in the ownership of a corporation’s assets if the assets are transferred to:
 - A shareholder of the corporation in exchange for or with respect to its stock;
 - An entity owned by the corporation;
 - A person or group that owns 50 percent or more of the total value or voting power of all outstanding stock of the corporation; or
 - An entity owned by a person who owns 50 percent or more of the total value or voting power of all outstanding stock of the corporation.¹⁸

A payment is considered contingent on a change in ownership or control if the payment would not have been paid but for the occurrence of an actual change in ownership or control.¹⁹ A payment is not considered contingent if it would have been made whether or not the change occurred.

Additionally, a payment is treated as contingent on a change in ownership or control if:

- **The payment is contingent on an event that is closely associated with a change in ownership or control.** An event is considered closely associated with a change in ownership or control if the event occurs before or after a

change in ownership or control. Examples include the onset of a tender offer with respect to the corporation, a substantial increase in the market price of the corporation's stock on an established securities market, or the voluntary or involuntary termination of a disqualified individual's employment.²⁰

- **A change in ownership or control actually occurs.**
- **The event is materially related to the change in ownership or control.**²¹ An event will be presumed to be materially related to a change in ownership or control if the event occurs within a period beginning one year before and ending one year after the date of change in ownership or control.

A payment that would have been made regardless of whether a change in ownership or control had occurred is treated as contingent on a change in ownership or control if the change accelerates the time at which the payment is made.²² In this situation, only the portion of the payment attributable to the acceleration is considered contingent on a change in ownership or control. That portion is the amount by which the amount of the accelerated payment exceeds the present value of the payment, not taking into account the acceleration. To the extent an accelerated payment does not result in an increase in the present value of the payment, it is not considered contingent on a change in ownership or control.

The parachute payment tax provisions contain a presumption that certain payments are contingent on a change in ownership or control if they are provided pursuant to a contract, or an amendment to a pre-existing contract, that was entered into within one year prior to the change in ownership or control.²³ This presumption can be rebutted if the taxpayer can establish by clear and convincing evidence that the payment is not contingent on a change in ownership or control.

A payment will not be treated as contingent on a change in ownership or control if it is made pursuant to an agreement made after the change in ownership or control.²⁴

Payments Calculated by Base Amount

The fourth and final component of a parachute payment is that the aggregate present value²⁵ of the payment must equal or exceed an amount equal to three times the individual's base amount.²⁶ This is referred to as the parachute payment safe harbor. In other words, assuming the other components of a parachute payment are satisfied, if the aggregate present value of the payments is equal to or greater than three times the individual's base amount, the portion which exceeds that amount is the parachute payment. On the other hand, if the aggregate present value of the payments is less than the amount

equal to three times the individual's base amount, no portion of the payments are parachute payments.

For purposes of this safe harbor calculation, the term "base amount" is defined as the individual's average annual compensation which is includible in the individual's gross income for the taxable years of the base period. The base period generally includes the individual's five taxable years immediately preceding the date of change in control or ownership. In determining an individual's average annual compensation for this calculation, compensation includes the individual's base salary, plus any amount paid by the corporation with respect to which the change in ownership occurs and which is includible in the individual's gross income during the individual's base period.²⁷

The following example illustrates the safe harbor calculation:

Disqualified individual A has an average annual compensation of \$100,000 and receives payments which are contingent on a change in control totaling \$600,000. The payments are parachute payments since they have an aggregate present value at least equal to three times A's base amount of \$100,000 ($3 \times \$100,000 = \$300,000$).

Excess Parachute Payments

Once it is established that a payment constitutes a parachute payment for purposes of the tax provisions, the next step is to determine whether the parachute payment constitutes an excess parachute payment. A payment which constitutes a parachute payment will only be nondeductible under IRC Section 280G or subject to the excise tax of IRC Section 4999 if it constitutes an "excess parachute payment." An excess parachute payment is defined as an amount equal to the excess of any parachute payment over the portion of the base amount allocated to such payment.²⁸ Whether a payment constitutes an excess parachute payment is determined by whether the payment exceeds the individual's base amount, not by whether the payment exceeds three times the individual's base amount.

For purposes of determining whether a parachute payment constitutes an excess parachute payment, the portion of the base amount allocated to any parachute payment is the amount which bears the same ratio to the base amount as the payment's present value bears to the aggregate present value of all such payments.²⁹ In other words, the portion of the base amount allocated to any parachute is determined by multiplying the base amount by a fraction, the numerator of which is the present value of such parachute payment and the denominator of which is the aggregate present value of all such payments.

The amount of a payment determined to be an excess parachute payment may be reduced if the taxpayer can establish by clear and convincing evidence that the payment or portion of the payment is reasonable compensation for personal services actually rendered by the individual before the date of the change in ownership or control.³⁰

The excess parachute payment calculation can be illustrated by the following example:

Disqualified individual B, who has a base amount of \$100,000, is entitled to receive two parachute payments, one for \$200,000 and one for \$400,000. The \$200,000 payment is made at the time of the change in ownership or control, and the \$400,000 payment is made at a future date. The present value of the \$400,000 payment is \$300,000 on the date of the change in ownership or control. Based on the tax provisions, the portion of the base amount allocated to the \$200,000 payment is \$40,000 $((\$200,000/\$500,000) \times \$100,000)$. The portion of the base amount allocated to the \$400,000 payment is \$60,000 $((\$300,000/\$500,000) \times \$100,000)$. Thus, the amount of the excess parachute payment for the \$200,000 payment is \$160,000 $(\$200,000 - \$40,000)$ and the amount of the excess parachute payment for the \$400,000 payment is \$340,000 $(\$400,000 - \$60,000)$.

Exemptions from the Golden Parachute Payment Rules

Of course, not all payments that appear to satisfy the definition of a parachute payment are subject to the golden parachute rules. The tax provisions exclude several types of payments from the definition of a parachute payment. These payments are therefore exempt from the golden parachute rules. The excluded payments include:

- Any payment made to a disqualified individual from a corporation that was a "small business corporation" immediately prior to a change in ownership or control.³¹ A corporation is a small business corporation if it is eligible to make a modified S corporation election under the IRC.³² A corporation is eligible to make this modified election if it is a domestic corporation, does not have more than 75 shareholders, has only shareholders which are individuals, estates or qualifying trusts, and has no more than one class of stock.
- Any payment made to a disqualified individual from a corporation (other than a small business corporation), whose stock was not readily tradable on an established market immediately prior to a change in ownership or

control, if certain shareholder approval requirements are satisfied.³³ For purposes of this exemption, the shareholder approval requirements are considered satisfied with respect to any payment if:

1. The payment was approved by a separate vote of the persons who owned, immediately prior to the change in ownership or control, more than 75 percent of the voting power of all outstanding stock of the corporation; and
 2. Adequate disclosure was made to all persons entitled to vote on all material facts concerning all material payments. (Adequate disclosure is a full and truthful disclosure of the material facts and additional information necessary to make the disclosure not materially misleading at the time it is made. Generally, this involves an analysis of each disqualified individual's compensation, the amount of the parachute payments, the portion of the payment which would be subject to the excise tax, and the effect on the corporation's deduction if shareholder approval is not obtained.)
- Any payment to or from a qualified retirement plan as described in IRC Section 401(a), a qualified annuity plan as described in IRC Section 403(b), a simplified employee pension plan (SEP) as described in IRC Section 408(k), or a simplified retirement account (SIMPLE) as described in IRC Section 408(p).³⁴
 - Any payment which the taxpayer establishes by clear and convincing evidence to be reasonable compensation for personal services that will be rendered by the disqualified individual on or after the date of the change in ownership or control.³⁵ This exception does not apply to securities violation parachute payments.

Designing Strategies for Parachute Payments

As the summary of the parachute payment tax provisions illustrates, the parachute payment rules are quite complex. Because of the penalties which may be imposed on excess parachute payments, corporations and key employees often design their golden parachute agreements to minimize the impact of these penalties. Corporations and key employees utilize several approaches in minimizing the impact of the tax provisions, including:

- **Limiting the amount of the parachute payment through a provision in the parachute agreement.** The provision will usually provide that if any payment constitutes an excess parachute payment, it will not be made. A modification of this approach is to limit the

amount of the parachute payment only if the key employee's after-tax benefit is greater by applying the limitation than if the limitation is not applied.

- **Increasing the amount of the parachute payments to provide the key employees with a tax "gross up."** The tax "gross up" is an additional payment which is used to pay the excise tax on the excess parachute payment so that the key employee's tax position is the same as it would have been if the golden parachute rules had not been applied.
- **Structuring benefit arrangements so that they fit within one of the exceptions to parachute payments summarized above.** Additionally, corporations and key employees may attempt to increase a key employee's base amount so that a parachute payment may be larger before it exceeds the safe harbor formula.
- **Deciding not to design their golden parachute agreements to minimize the impact of the parachute payment tax provisions.** Instead, they may decide to accept the tax consequences imposed on excess parachute payments as a cost of conducting business.

Conclusion

The United States tax laws contain two provisions designed to penalize payments to key employees in the event of a corporate takeover. If these payments constitute excess parachute payments, the corporation will be disallowed an income tax deduction for the payment and an excise tax will be imposed upon the recipient of the payment. Due to the nature of these penalties, it is important to review the tax ramifications of golden parachute payments in order to ensure that the corporation and key employee land safely.

¹ IRC §280G(b)(2)(B) and Prop. Reg. §1.280G-1, Q-2.

² Prop. Reg. §1.280G-1, Q-37.

³ IRC §280G(b)(2)(A) and Prop. Reg. §1.280G-1, Q-2.

⁴ Prop. Reg. §1.280G-1, Q-11.

⁵ Prop. Reg. §1.280G-1, Q-11.

⁶ Prop. Reg. §1.280G-1, Q-11.

⁷ Prop. Reg. §1.280G-1, Q-11.

⁸ IRC §280G(c) and Prop. Reg. §1.280G-1, Q-15.

⁹ Prop. Reg. §1.280G-1, Q-18.

¹⁰ Prop. Reg. §1.280G-1, Q-17.

¹¹ See IRC §318(a).

¹² IRC §280G(c).

¹³ Prop. Reg. §1.280G-1, Q-19.

¹⁴ Prop. Reg. §1.280G-1, Q-27.

¹⁵ See IRC §318(a).

¹⁶ Prop. Reg. §1.280G-1, Q-28.

¹⁷ Prop. Reg. §1.280G-1, Q-29.

¹⁸ Prop. Reg. §1.280G-1, Q-29.

¹⁹ Prop. Reg. §1.280G-1, Q-22.

²⁰ Prop. Reg. §1.280G-1, Q-22.

²¹ Prop. Reg. §1.280G-1, Q-22.

²² Prop. Reg. §1.280G-1, Q-22(c).

²³ Prop. Reg. §1.280G-1, Q-25.

²⁴ Prop. Reg. §1.280G-1, Q-23.

²⁵ Present value is determined as of the date of the change in control or ownership by using a discount rate equal to 120% of the applicable federal rate (AFR), compounded semiannually. Prop. Reg. §1.280G-1, Q-31 & Q-32.

²⁶ IRC §280G(b)(3) and Prop. Reg. §1.280G-1, Q-30-34.

²⁷ Prop. Reg. §1.280G-1, Q-21.

²⁸ IRC §280G(b)(1) and Prop. Reg. §1.280G-1, Q-38.

²⁹ Prop. Reg. §1.280G-1, Q-38.

³⁰ Prop. Reg. §1.280G-1, Q-39.

³¹ IRC §280G(b)(5)(A)(i).

³² IRC §280G(b)(5) provides that a corporation is a small business corporation if it satisfies the definition contained in IRC §1361(b), without regard to paragraph (1)(C).

³³ IRC §280G(b)(5)(A)(ii). For purposes of this exemption, stock does not include preferred stock as defined in IRC §1504(a)(4) if the payment does not adversely affect the redemption and liquidation rights of any shareholder owning such stock; the term "established securities market" means an established securities market as defined in Treas. Reg. §1.897-1(m); and stock shall be treated as readily tradable if it is regularly quoted by brokers or dealers making a market in such stock.

³⁴ IRC §280G(b)(6).

³⁵ Prop. Reg. §1.280G-1, Q-39-40.^{Conclusion}

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