THE M&A TAX REPORT

The Monthly Review of Taxes, Trends & Techniques

Volume 1, Number 11 June 1993

TAX INSTITUTE

Editor-in-Chief

Robert W. Wood
San Francisco

Managing Editor

Lesli S. Laffie, LL.M.

Advisory Board

Gilbert D. Bloom
KPMG Peat Marwick
Washington

Louis S. Freeman
Sonnenschein, Nath & Rosenthal
Chicago

Elliot G. Freier
Irell & Manella
Los Angeles

Lawrence B. Gibbs
Johnson & Gibbs
Washington

Steven K. Matthias
Deloitte & Touche
San Francisco

Matthew A. Rosen
Skadden, Arps, Slate, Meagher & Flom
New York

Irving Salem
Latham & Watkins
New York

Joseph L. Schiffhouer
Jones, Day, Reavis & Pogue
Pittsburgh

Mark J. Silverman
Steptoe & Johnson
Washington

Robert Willens
Lehman Brothers
New York

Additional Compensation Held Excess Parachute Payments in *Balch*

by Robert W. Wood • San Francisco, CA

Golden parachute payments are starting to trigger significant litigation. Recently, we reported on the Tax Court's decision in *Powell*, 100 TC No.

Continued on Page 3

ALSO IN THIS ISSUE:

- **New! Current Problems and Possibilities** 4
- Prudential, Allergan, and Tokos Medical Adopt Poison Pill Plans 6
- IRS Permits Intangible's Depreciation 8
- Readers Write: ESOPs Redux 8

6 (1993). There, the court found the Code's parachute payment provisions inapplicable, admittedly hinging on the provisions' 1984 effective date. (See "Tax Court Rejects Sweep of Golden Parachute Provisions in *Powell*," 1 *M&A Tax Rep't* 9 (April 1993), p. 6.) Now, the Tax Court has decided another case on the provisions, with not as favorable a result.

In *Balch*, 100 TC No. 21 (1993), the court determined that compensation constituted an excess parachute payment under Sections 280G and 4099. Section 4999(a) imposes a 20% excise tax (nondeductible) on "excess parachute payments," as defined in Section 280G.

Just the Facts

Balch was an officer of Jewel Companies. After

Continued on Page 5

Jewel agreed to merge with American Stores, it executed severance pay agreements with Balch and other officers to induce them to remain in Jewel's employ until a change in control occurred. Each agreement provided that if the executive's employment was terminated as a result of such a change, the executive would receive an amount equal to three times the sum of annual salary and target bonus in effect on the date of change in control or the date of termination, whichever was greater.

Less than a month after these severance pay agreements were executed, Jewel realized that the agreements were subject to the golden parachute provisions. Consequently, Jewel and the executives amended the agreements to reduce the severance payments to an amount that would *not* be deemed an excess parachute payment under the Code. After American acquired Jewel, American paid the executives additional compensation and bonuses based on the difference between each executive's severance pay under the original agreement and the severance pay due under the amended severance agreements.

Balch received $317,500 in severance in 1984. Thereafter, he maintained a role as trustee for several of Jewel's benefit plans. For these services, American paid him $60,000 a year in 1985 and 1986.

Not Reasonable Compensation

The Service determined that a substantial portion of the additional compensation and bonuses paid to Balch and the other executives was an excess parachute payment. The Service based its conclusion on the premise that Balch's services in 1985 and 1986

Continued on Page 6

ADDITIONAL COMPENSATION Continued From Page 5
had only been worth $15,000 in each year. It contended that it was appropriate to determine the amount of reasonable compensation for Balch's services by multiplying his daily rate of compensation prior to the termination of his full-time employment by the number of days worked thereafter.

Agreeing with this analysis, the Tax Court determined that all of the elements of an excess parachute payment were present. The additional compensation was contingent on a change in control under Section 280G(b)(2)(A)(i). Although there was an oral agreement that American would use its best efforts to employ Balch and the other executives to compensate them for the reduction in their severance pay under the amendment to the agreement, the court found that the payment of the additional compensation was contingent on American's success in using its best efforts to employ the executives. According to the Tax Court, this additional "best efforts" contingency did not change the fact that all of the payments to the executives were contingent on a change in control of Jewel.

Finally, the court held that Balch did not carry his burden of proving that the $60,000 received in the later two years was truly reasonable compensation for the services rendered. Balch served as administrative trustee for two of Jewel's benefit plans, and continued to serve informally as secretary to the Jewel Company Investment Trust. The court also held that the Service's use of daily rates of compensation was appropriate.

Dangerous Precedent

For companies trying to avoid the excess parachute provisions, *Balch* may represent dangerous authority. After all, it approves a comparison of pre-change daily compensation rates in evaluating the reasonableness of compensation paid after the change in control. Even assuming that a daily rate is not an inappropriate measure for full-time service, the fewer the services that are performed, the more problematic to taxpayers the reference to daily rates may become. For example, if the executive is merely remaining available to consult, but doing very little actual consulting, it may be difficult to determine the appropriate index against which to apply a daily rate.

Furthermore, *Balch* demonstrates that a savings clause in a golden parachute agreement (specifying that in no event will payments exceed three times the Section 280G base amount, or invoking some other formula to insure that the excess parachute payment definition is not triggered) will not be effective if *outside* the golden parachute agreement, unreasonable compensation is paid that is deemed paid under the golden parachute agreement.

Balch suggests that considerably more sophistication will be required of taxpayers attempting to exceed the formula limit set forth in Section 280G without triggering the wrath of Section 4999. ■

MISSED AN ISSUE?

Current subscribers to **The M&A Tax Report** can get copies of issues preceding the commencement of their subscription by sending the **month and year** of the issue desired, along with a **$10** check per issue ordered to:

TAX INSTITUTE
P.O. Box 192026
San Francisco, CA 94119