Severance Payments and Other Golden and Quasi-Golden Parachutes

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In this day of relatively hot merger and acquisition activity, many companies have instituted change in control compensation arrangements for executives that are triggered on an acquisition. While typically not engendering the greatest sympathy from either the public or from a company's shareholders, such arrangements can serve legitimate business needs. From a tax perspective, of course, there are several sets of rules that must be observed.

Section 280G of the Code makes payments of so-

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called "excess parachute payments" nondeductible to the paying corporation. Furthermore, Section 4999(a) imposes a nondeductible 20% excise tax on the excess parachute payments. Between nondeductibility for the payment itself, and a 20% excise tax (that itself is *also* nondeductible) on the payments, the cost of paying such amounts can obviously be quite steep.

To review the basics, this rather harsh regime applies only to "excess" parachute payments. Section 280G defines a parachute payment as any compensatory payment to or for the benefit of a disqualified person (officer, shareholder, key employee or highly compensated person performing personal services for the corporation) under the following circumstances:

- The payment is contingent on a change in the ownership or effective control of the corporation or a substantial portion of its assets, and the aggregate present value of the compensatory payments equals or exceeds three times the base amount; or
- The payment is made pursuant to an agreement that violates any generally enforced securities laws or regulations.

Usually, determining whether something is a parachute payment is relatively easy. Note, however, that a parachute payment generally does not include payments to or from qualified pension and profit-sharing plans, annuity plans and simplified employee pensions. I.R.C. §280G(b)(6).

A parachute payment is considered "excess" if: (1) it is made to a "disqualified individual," generally an easy requirement to meet; (2) the payment is contingent on a change in the control or ownership of the corporation; and (3) the present value of the payment is at least three times the individual's "base amount." This base amount is essentially annualized compensation for the individual for a five-year period ending before the date of the change in control.

It is certainly not a wholly satisfactory solution, but one way of curbing the likelihood that excess parachute payments will be made is to include a savings clause in any compensation contracts and/or enabling resolutions. Such a clause essentially says that, notwithstanding any other arrangement or commitment, the company will have no liability to pay an excess parachute payment that would incur the wrath of the nondeductible excise tax.

Rulings on Parachute Payments

Quite apart from relying on such savings clauses (which effectively require a determination by the company or its counsel or accountants before checks are cut), there seem to be a significant number of companies that request a ruling on the matter. A recent example is Letter Ruling 9608020.

There, the IRS considered an arrangement calling for severance payments made to executives of an acquired company, as well as amounts paid for vested stock and stock options. The change of control agreements called for the executives of the acquired corporation to receive severance payments, cash for their restricted stock and stock options, payments for post-change services, payments of employee benefits, and payments under benefit plans.

The Service ruled that the payments for the vested stock and the stock options were not nondeductible payments in the nature of compensation under Section 280G(b)(2). However, the Service effectively bifurcated the payments, ruling that a portion of the payments for unvested stock (that received accelerated vesting contingent on the change of control) did constitute parachute payments. In effect, the Service looked at the difference between vested stock and stock options that would be payable *in any event*, and those that received preferential treatment (not an uncommon occurrence) by reason of the change in control.

It may seem an overly common-sensical conclusion, but it should be comforting to know that in this ruling the Service also noted that the base pay and benefits paid to executives for actual services rendered after the change of control will not be considered parachute payments—to the extent they constitute "reasonable compensation." The obvious meaning from the latter phrase is that some level of scrutiny could be applied as to the reasonableness of payments made for services that are ostensibly rendered to the company post change of control.

What constitutes "reasonable compensation" has

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always been a somewhat amorphous standard, tied to factual determinations. While a cynical attitude might suggest that virtually no compensation these days is unreasonable, there is a fair amount of learning in the case law concerning the factors that produce extraordinary pay rates. Education, special skills, special results, inadequate past compensation, etc., can all be used effectively to defeat an unreasonable compensation assertion by the IRS. The fact that there is an out for avoiding parachute payment status altogether by virtue of characterizing a payment as reasonable compensation is at least some solace.

Supplemental Retirement?

Another element of Letter Ruing 9608020 concerns the supplemental retirement plan (SERP) payment. The ruling concludes that those executives that were under age 52 on the date of the change of control will be treated as receiving a payment contingent on the change of control to the extent that the SERP has been enhanced by crediting the executive with time of employment. The ruling refers to Prop. Reg. §1.280G-1, Q&A 24(c)(1)(ii) and 24(c)(2). Those portions of the proposed regulations deal with the value of the lapse of the obligation to perform services to earn that enhanced value of the SERP. Executives over age 52 on the date of the change of control, on the other hand, are considered as receiving nondeductible payments contingent on the change of control to the extent of the enhanced value of the SERP payment. (See Prop. Reg. §1.280G-1, Q&A 24(c).)

This situation presumes, of course, that it will be easy to determine what constitutes an agreement that is contingent on a change in control. In some cases, there can be timing issues even if the payment is explicitly not contingent on a change in control. Interestingly, Section 280G itself (which defines excess parachute payments) states that an agreement that is entered into within one year *before* a change in control, or a substantial amendment to an existing agreement made within one year of the change, will be presumed to be contingent on a change in control unless the contrary is established by clear and convincing evidence. I.R.C. §280G(b)(2)(C).

In any case, there probably will be increased energy focused on the golden parachute payment rules given the current volume of acquisition activity and the layoffs and employee relations issues that these acquisitions often engender. ■