What Color Is Your (Big) Golden Parachute?

By Robert W. Wood • Wood LLP • San Francisco

Golden parachutes are not just opening, they are positively billowing grandiosely out into the wind. And when it comes to color and quality, they are more of the platinum variety. Some recently announced acquisitions involve golden parachutes puffing up to unprecedented levels. Let's consider these paydays:

- Eugene Isenberg, former Nabors Industries Ltd. CEO, who is said to be netting a cool $100 million in cash for stepping down as CEO even though he'll still be wearing the Chairman's hat
- Sanjay Jha of Motorola Mobility Holdings, soon to be acquired by Google, who is exiting with $65.7 million
- Michel Orsinger of Synthes Inc., which will be acquired by Johnson & Johnson, yielding a parachute payment of $51.9 million
- George Lindemann of Southern Union Company, scheduled to be acquired by Energy Transfer Equity, ready to receive parachute payments worth $53.8 million
- Marshall Larsen of Goodrich Corporation, set to be acquired by United Technologies, in the process of pulling the ripcord on $34.9 million

Perhaps it is unfair to lump Mr. Isenberg's outsized payday in with the rest. After all, his deal is not part of an acquisition. Besides, he is not even *leaving* his company. He is stepping down as CEO, but keeping his job as Chairman.

Even without Mr. Isenberg, though, all of the other packages are more impressive than these not-so-golden and nonmerger exit checks:

- Leo Apotheker: $13 million from Hewlett-Packard
- Carol Bartz: $10 million from Yahoo

Merger deals are different, of course. The parachute context involves payments expressly conditioned on a change in control. The move to poke holes in parachutes started in 1984 with the tax provisions reviewed below. Yet these tax provisions didn't stop the practice entirely.

Tax Gross-ups

Not surprisingly, executives love tax gross-ups. That makes sense, given that they could be facing extra taxes. The more generally applicable the gross-up, the better. Congress tried to curb excessive golden parachutes by enacting extra taxes in 1984, including a dual-pronged excise tax and the additional sanction of nondeductibility.

Tax gross-ups seemed to be one answer, and many companies responded by reimbursing the departing executives with a tax gross-up on the payout. Arguably, that made the situation even more controversial. Adding to the controversy and the magnitude of the issue is the fact that much of the consideration in these circumstances does not come in cash. Much of the typical payday comes in the accelerated vesting of options or the release of restrictions on otherwise restricted stock. That can be a double-edged sword.

Moreover, from a nontax perspective, it is not clear how the Dodd-Frank provision is impacting such payments. It now requires some golden parachute arrangements to be subject to shareholder approval. So far, reports suggest no exit package has been voted down.

Yet particularly in the current climate, one wonders whether that situation will continue. Indeed, exit package figures are getting unprecedented levels of attention.

Packing the Parachute

Golden parachute payments are those for which the company is allowed no deduction because of Internal Revenue Code Section ("Code Sec.") 280G. Not only that, but the recipient incurs a whopping 20-percent excise tax under Code Sec. 4999, in addition to normal payroll withholding and income tax. The combination of these two provisions is surely meant to be draconian.

Yet the provisions are now well-worn. They have become something to take into account and try to obviate. For one, the Code Sec. 280G rules are replete with definitions.

Basically, a parachute payment is defined 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) where either of the following applies:

- 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 (the base amount is generally the five-year average of the employee's W-2 compensation).
- The payment is made pursuant to an agreement that violates any generally enforced securities laws or regulations.

In determining whether a payment constitutes a parachute payment, restricted stock and stock options can really jam up the works. This is especially true with restricted stock which has been the subject of a Code Sec. 83(b) election.

Regulations covering golden parachute payments became effective January 1, 2004. There have been many nuances and many worries. Of course, one of the most fundamental concerns is whether one has had the requisite change of control triggering the application of these rules.

In assessing the measurement of a change in control, Rev. Rul. 2005-39, IRB 2005-27, 1, highlights a fundamental inconsistency. In effect, one disregards Code Sec. 83(b) elections in determining when golden parachute payments are deemed received. On the other hand, one is to respect those very same Code Sec. 83(b) elections in determining what stock is outstanding when measuring a golden parachute change of control.

Celestial Pay

In Rev. Rul. 2005-39, Sun Corp. and Moon Corp. both had readily tradable stock and merged on February 20, 2005, to form Twilight Corp. Other than somewhat different positions regarding restricted employee stock, this was a merger of equals. The vested shareholders of Sun and Moon each received 50 percent of the stock of Twilight.

However, Sun and Moon both had employee stock plans for which none of the stock had been vested as of the merger date. Even so, as not infrequently occurs, all employees had made Code Sec. 83(b) elections. The stock held by the Sun employees had a market value of \$3X, and the stock held by the Moon employees had a market value of \$2X.

Interestingly, if the unvested employee stock was *not* treated as outstanding under these facts, there would be no change in ownership under Code Sec. 280G. Axiomatically, there would therefore be no triggering of the golden parachute rules. After all, the shareholders of Sun and Moon each owned exactly 50 percent of the stock of Twilight.

However, what if the holders of the unvested employee stock were treated as Sun and Moon shareholders, respectively? They could be so treated, one could argue, because of the Code Sec. 83(b) elections. In that event, the Sun shareholders would by definition have acquired more than 50 percent of Twilight and hence of Moon.

Thus, as to Moon, there would be a change of ownership under Code Sec. 280G. This may start to sound like Code Sec. 382 analysis. Keep in mind, of course, that an ownership change occurs under Code Sec. 280G on the date that any one person (or more than one person acting as a group) acquires ownership of stock of a corporation that, together with stock already held by that person or group, possesses more than 50 percent of the total fair market value or total voting power of the stock of the corporation. Code Sec. 318 rules apply in determining ownership by attribution.

Code Sec. 83(b) Election

Code Sec. 83(a) postpones income recognition events on transfers of property subject to restrictions. The corollary is that an employer who transfers the property receives no deduction until the time it can be included in the income of the employee. Code Sec. 83(b), on the other hand, allows the taxpayer who is receiving this stock or other restricted property to elect to include it in income on transfer.

If the taxpayer makes the Code Sec. 83(b) election, the income is measured by the excess, if any, of the fair market value of what is received (measured regardless of restrictions or risks of forfeiture) over the purchase price. Particularly when this excess is close to zero, the election can be a good tax play for the employee.

A zero excess (where the price paid for the restricted stock equals fair market value) will mean that despite the election, the employee has no income tax consequence on the transfer. Making the Code Sec. 83(b) election can be smart where the executive is paying market value.

The result is a nice potential upside, a conversion, if you will, so that the restricted property and any appreciation morphs from ordinary income to capital gain property.

Interaction of Code Secs. 280G and 83(b)

Interestingly, Code Sec. 280G makes no reference to Code Sec. 83(b). Code Sec. 83 long predates Code Sec. 280G, so one might think that the latter provision would invoke some explicit interaction. Code Sec. 280G allows the Treasury Secretary the authority to prescribe regulations, and that they did.

The Code Sec. 280G regulations take the position that an election made by a disqualified individual under Code Sec. 83(b) will be disregarded for purposes of Code Sec. 280G in determining the amount and timing of the receipt of payments in the nature of compensation. [*See* Reg. §1.280G-1, Q&A-12(b).] This seems to take Code Sec. 280G a step further, covering situations in which the transferor is not entitled to a deduction in any event.

After all, Code Sec. 280G is meant to deny deductions for excess parachute payments. That purpose does not seem to be served here. Rev. Rul. 2005-39 does conclude that stock that was subject to the Code Sec. 83(b) election must be considered as outstanding stock in measuring the change in control.

Rev. Rul. 2005-39 seeks to resolve this apparent contradiction by stating that an expansive rule needs to be implemented to determine whether a change in ownership or control has occurred, citing Reg. §1.280G-1, Q&A-27(c) for this purpose. The ruling says that an employee should be considered the owner of unvested shares of restricted stock for which an election has been made under Code Sec. 83(b).

Why? Because the regulations under Code Sec. 83(b) treat stock transferred to an employee in connection with the performance of services as *substantially vested* when the employee makes that election. After all, the employee is also considered the *owner* of the stock.

On the other hand, restricted stock with respect to which an election under Code Sec. 83(b) has not been made is *not* considered outstanding for purposes of determining whether a change in ownership or control has occurred.

Audit Techniques

Practitioners might agree with the IRS's position in Rev. Rul. 2005-39. On the other hand, they might find it inconsistent with the regulations. Yet it is not hard to understand why the IRS would like such a rule.

Moreover, when the IRS later released an MSSP on golden parachute audit techniques, the central issues were clear. [*See* Tax Analysts Doc. No. 2005-7773, 2005 TNT 77-25, released Apr. 13, 2005.] This manual includes reporting requirements for golden parachute payments and gives nine steps for Revenue Agents to follow in conducting a parachute examination:

1. Determine whether there has been a change in ownership or control.

2. Establish who are disqualified individuals.
3. Determine each disqualified individual's base amount and multiply it by three to establish the safe harbor amount.
4. Determine what payments in the nature of compensation were made to each disqualified individual that were contingent on the change in ownership or control.
5. Determine whether any of the payments that were contingent on the change of ownership or control because of acceleration can have the contingent portion reduced under the regulations.
6. Reduce each parachute payment by whatever portion the taxpayer establishes with "clear and convincing evidence" is reasonable compensation for services to be rendered on or after the change of ownership or control.
7. Determine the present value of the contingent payments, as reduced by Steps 5 and 6, to determine whether the aggregate present value of all the payments equals or exceeds the safe harbor amount (Step 3).
8. If the present value of the contingent payment exceeds the safe harbor amount (Step 7), determine whether the taxpayer has shown with clear and convincing evidence that a portion of the payment is reasonable compensation for services rendered before the change in ownership or control.
9. Calculate the excess parachute payment by subtracting from each parachute payment the greater of the allocable base amount or the reasonable compensation of Step 8.

Parachute Endings

The golden parachute rules are hardly new. In an era in which tax rules seem to change quite frequently, they have been around for decades, since 1984. Yet they can still be somewhat of a "gotcha" for some practitioners who are not used to encountering them.

That can be unnerving and quite expensive. If you do have a golden parachute payment problem, the consequences of ignoring the issue can be pretty serious. It can include disallowing the deduction for the payment under Code Sec. 280G and incurring the 20-percent excise tax under Code Sec. 4999. People will be unhappy.

Golden parachute payments and the mechanical aspects of their computation seem like ripe subjects for examination. The IRS must think so too. The presence of the MSSP guidelines means that golden parachute payments may be even more likely to be examined. Don't fail to consider them.

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