Golden Parachutes Again in the News

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M&A Tax Report readers know that we often cover golden parachute developments. Well, there are a couple of new ones. The Wall Street Journal recently noted that less than a year after Congress moved to crack down on executive compensation abuses, a number of companies are promising to pick up the tax burden befalling executives whose pay plans don't fit squarely within the new rules of Code Sec. 409A. [*See* Plitch, *Executives Find Relief on Pay Deals*, Wall St. J., June 20, 2005, at C3.] Although the latest trend seems to involve tax hits that executives take on deferred compensation packages, the situation is being analogized to that which occurs with golden parachute payments triggered on a merger or other change in control.

Indeed, when Congress tried in the 1980s to curb excessive golden parachutes by taxing these packages with a dual-pronged excise tax and nondeductibility, many companies responded by reimbursing the departing executives with a tax gross-up on the payout. In the recent run at tax gross-ups, the target is the new rules imposed by the American Jobs Creation Act of 2004 on deferred compensation plans. This is a decidedly different corporate governance climate. As such, it seems doubtful that tax gross-ups will become as common with deferred compensation packages as they now are with golden parachute payments.

Turning to the recent tax development, the IRS released Rev. Rul. 2005-39, which deals with restricted stock and the Code Sec. 83(b) election as applied to the golden parachute rules. [*See* Rev. Rul. 2005-39, IRB 2005-27, 1, Tax Analysts Doc. No. 2005-13073, 2005 TNT 116-9.]

Background of Golden Parachutes

As a refresher, recall that golden parachute payments are those for which the company is allowed no deduction because of Code Sec. 280G, and on which the recipient incurs a whopping 20-percent excise tax under Code Sec. 4999. The Code Sec. 280 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 apply:

- 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 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.

Rev. Rul. 2005-39 highlights the inconsistency between disregarding Code Sec. 83(b) elections in determining when golden parachute payments are deemed received, and respecting those 83(b) elections in determining what stock is outstanding when measuring a golden parachute change of control.

In Rev. Rul. 2005-39, Sun Corp. and Moon Corp. both have 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, but for which 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, and thus no triggering of the golden parachute rules. After all, the shareholders of Sun group and Moon group each own exactly 50 percent of the stock of Twilight. However, if the holders of the unvested employee stock are treated as Sun and Moon shareholders, respectively, because of the Code Sec. 83(b) elections, 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.

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 postpones income recognition events on transfers of property subject to restrictions. The corollary is that the employer who transfers the property receives no deduction until the time that it can be included in the income of the employee. Code Sec. 83(b) 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 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 play. 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, resulting in the upside on the restricted property being converted from ordinary income to capital gain.

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 there would be some explicit interaction. Code Sec. 280G allows the Treasury the authority to prescribe regulations. 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, and that purpose doesn't seem 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 resolves this apparent contradiction by stating that an expansive rule needs to be implemented to determine whether a change in ownership or control has occurred. The ruling cites 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), because the regulations under Code Sec. 83(b) treat stock transferred to an employee in connection with a 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.

MSSP Audit Techniques

Whether one agrees with the IRS's position in Rev. Rul. 2005-39 or finds it inconsistent with the regulations, there seems little doubt that the IRS will apply this rule. Interestingly, it was only a few months back that the IRS released an MSSP on golden parachute audit techniques. [*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 a whopping nine steps for the Revenue Agent 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 that were made to each disqualified individual 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.

Conclusion

Although the golden parachute payment rules have been around since 1984, many practitioners do not frequently encounter them. I believe one of the reasons for this is the savings clause that so often gets inserted into corporate deals. On the other hand, if you do have a golden parachute payment problem, the consequences can be pretty serious, including the disallowance of the deduction for the payment and the 20-percent excise tax under Code Sec. 4999. In this post–Sarbanes Oxley world, the scrutiny facing companies and their executives in such an event will be that much more serious.

I suppose the presence of the MSSP guidelines means that golden parachute payments may be more likely to be examined in the future. The conclusion in Rev. Rul. 2005-39 makes it more likely that taxpayers will unwittingly stumble into the golden parachute regime.

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