

Dealing With the Non-Tax Aspects of Golden Parachute Payments

by Robert W. Wood • San Francisco

Readers of *The M&A Tax Report* are likely aware of the once controversial enactment of Section 280G of the Code, making payments of so-called “excess parachute payments” nondeductible to the paying corporation. This slap on the wrists from a tax perspective was (and still is) coupled with the nondeductible 20% excise tax on excess parachute payments imposed by Section 4999(a). Between nondeductibility for the payment itself, and a 20% excise tax (that itself is also nondeductible), the cost

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of paying such amounts is admittedly steep.

This harsh regime applies only to “excess” parachute payments. 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) 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.

Determining whether a payment constitutes a parachute payment is typically rather easy. Significantly, however, a parachute payment normally does not include payments to or from qualified pension and profit-sharing plans, annuity plans and simplified employee pensions. (See I.R.C. §280G(b)(6).)

Since it is only “excess” parachute payments that are sanctioned, the definition of excess is important. A parachute payment is “excess” if: (1) it is made to a “disqualified individual;” (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.

Savings Clause In Action

One feature of such agreement that is now relatively common is some type of savings clause. A savings clause in a contract might say 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. Apart from the tax mechanics of such a provision, it obviously can have significant substantive effects—particularly on the payee whose benefits will be cut off. Such was the situation in the recent Seventh Circuit case of *Anthony W. Cvelbar v. CBI Illinois, Inc.*, No. 96-1669 (7th Cir., Feb. 14, 1997).

Mr. Cvelbar was the executive vice president of a bank that was acquired by CBI. In that connection, he received a severance agreement, a monthly stipend and medical benefits. This package was offered to Cvelbar and four other top executives, ostensibly to encourage loyalty and continued dedication by management. The severance package was provided in March of 1990, but was not triggered until termination.

Two years later, in 1992, the bank merged with CBI Illinois, and CBI assumed the target’s duties under its severance agreement with Cvelbar. Later in 1992, CBI terminated Cvelbar. CBI made payments to him for a period of two years. Then, CBI terminated the payments on the basis of its counsel’s determination that some of the payments were contingent on a change in ownership or control as provided in Section 280G of the Code.

Not So Fast...

Cvelbar sued CBI in state court claiming continued benefits. He argued that not only did state contract law provide him with same, but also that he was entitled to them under ERISA. CBI removed the action to federal court, and the district court granted CBI partial summary judgment. The court found that CBI had discretion under the termination agreement

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to resolve the matter and that the decision by counsel was not arbitrary or capricious.

Consequently, the matter wound up in the Seventh Circuit. There, Cvelbar argued that the termination agreement did not constitute an ERISA plan, and that even if it did, CBI's decision was based on an arbitrary or capricious interpretation of the savings clause in the agreement. Interestingly, the labor department filed an *amicus curiae* brief arguing that Cvelbar's agreement was an ERISA plan.

The Seventh Circuit agreed with the labor department (and CBI) that this was indeed an ERISA plan, simply because it was an ongoing administrative scheme with reasonably ascertainable terms. Furthermore, the court concluded that it was irrelevant whether an arrangement pertains to only one person. In this case, the Seventh Circuit found Cvelbar's termination package to be an ERISA plan because it had reasonably definite terms and involved CBI in ongoing responsibility that was far more than merely writing checks. The court found that a reasonable person could ascertain the benefits and beneficiaries of this termination package. Unfortunately for Cvelbar, the Seventh Circuit also found (as had the district court below) that the savings clause dealing with excess parachute payments was not ambiguous, and that CBI's counsel's interpretation of the provision was not arbitrary or capricious. The court referred to the proposed regulations under Section 280G (Prop. Reg. §1.280G-1, Q&A-22(b)), which indicated that CBI's counsel had a reasonable basis for concluding that these payments were contingent on a change of ownership or control.

Make Doubly Sure

In some respects, *Cvelbar v. CBI Illinois, Inc.* is unremarkable. Basically, it's just a contract dispute. On the other hand, to those of us who may think primarily about deductibility and the like, it serves as a useful (or painful, depending on one's perspective) reminder that a savings clause can have real and significant consequences.

Interestingly, this case also suggests that savings clauses might be included in something less than

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absolute fashion, only disallowing that portion of a payment that would be considered excess, and not terminating the whole arrangement. After all, that would be a far more traditional use of a savings clause in the context of various tax provisions. For example, it used to be a relatively common feature of compensation contracts to state that if and when an amount of compensation payable to an executive was determined to be unreasonable and therefore nondeductible, that compensation only (only the unreasonable portion) would not be paid. In some cases, contracts even stated that such an unreasonable sum would have to be paid back from the executive to the corporation.

In the context of golden parachute agreements, where the tax sanction is more serious than mere nondeductibility (there is the excise tax to consider, too), a savings clause that merely caps the compensation at one dollar below the excess parachute payment level would seem to be more sensible and more defensible (not to mention more palatable!) than wiping out the arrangement altogether. ■