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EXCESSIVE COMPENSATION?

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Okay, so it is hard to tell these days what compensation is deductible under Section 162 and what might be viewed as excessive. All of us are now used to the rules of Section 162(m) which, when they were enacted, might have seemed draconian. The real question is whether compensation counts as performance-based, thus meeting the test of Section 162(m)(4).

A recent letter ruling, Letter Ruling 200016024, is useful confirmation that compensation attributable to the exercise of stock options is performance-

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based. Of course, the important qualifier is that the stock options in this ruling were granted to a key employee at the time the business was formed. The Service notes in the ruling that:

- the amount of compensation depended solely on the increase in stock value after the option was granted;
- the number of shares was specifically stated; and
- the shareholder approval and adequate disclosure requirements were met.

In determining what constitutes excessive compensation, the facts won't always be this easy.

To begin with, there are now concerns about the timing of compensation. Since last year's Tax Court decision in *Norwest Corp., et al. v. Commissioner*, 112 T.C. No. 9 (1999), there has been concern about which salaries could be treated as deductible and which were related to an acquisition. The Tax Court in *Norwest* considered a target corporation that was a state bank. The Tax Court required Norwest to capitalize employee salaries as well as legal, investment banker and accounting fees, all of which related to due diligence review and the investigation of a potential merger. The IRS required this capitalization (and the Tax Court agreed) notwithstanding the fact that these fees and expenses were incurred *prior* to the acquisition of the target.

The holding in *Norwest* extends the application of the *INDOPCO* doctrine to reach fees and expenses incurred before an acquisition. The $64,000 question in the case (actually it was a much bigger dollar figure than this!) was whether these costs were sufficiently related to an event that produced a significant long-term benefit. The Tax Court admitted that the costs were not direct costs of facilitating the event that produced the long-term benefit (the merger). Nonetheless, the Tax Court held that the costs were essential to achieving that benefit. This fine-tuning of words extends the reach of *INDOPCO* even further. (For additional discussion, see Muntean, "Tax Court Bloats *INDOPCO* in *Norwest Corp. v. Commissioner*," Vol. 7, No. 10, *M&A Tax Report*, May 19, 1999, p. 1.)

Golden Parachute Problems, Too

Of course, the golden parachute rules are a separate set of restrictions on compensation deductibility. Not only is deductibility restricted, but there is an excise tax, too. Section 280G of the Code makes payments of "excess parachute payments" nondeductible to the paying corporation. This nondeductible slap on the corporate wrist is coupled with a nondeductible 20% excise tax on the excess parachute payments (imposed by Section 4999(a)). Between nondeductibility for the payment itself, and a 20% excise tax that is also nondeductible, the cost of paying excess parachute payments is severe.

One trick is to avoid the "excess" moniker. A parachute payment is subject to the harsh regime only if it is "excess." A parachute payment is

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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 easy. Significantly, though, 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 only excess parachute payments are sanctioned, the definition of "excess" is crucial. 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 five-year period ending before the date of the change in control.

What About Restructuring?

Does a change in control occur in a corporate restructuring? Fortunately, the answer seems to be no. In Letter Ruling 9847011, a parent's sale of its subsidiary stock was held not to be a change in ownership or control of the parent, nor was it even considered an event closely associated with a change in ownership or control. The parent and its wholly-owned subsidiary, were members of an affiliated group. The subsidiary accounted for less than 20% of the parent's value. This subsidiary was sold to an independent purchaser, thus triggering termination payments to the subsidiary's executives. In the same year that the subsidiary was sold, another purchaser acquired all of the parent's stock.

The question in the ruling was whether the payments made on termination to the executives of the subsidiary were made because of a change in ownership or control. The Service ruled that they were not. Even though the payments made to the executives of the subsidiary were contingent on the sale of the subsidiary, they were not held to be parachute payments under Section 280G.

Savings Clause

Despite such a favorable determination, it is becoming increasingly common to see some type of savings clause in any significant executive compensation package. A savings clause in a contract might say that, notwithstanding any other arrangement or commitment, a company will have no liability to pay an excess parachute payment that would incur the wrath of the nondeductible excise tax. Although such clauses can dramatically limit the size of the payment made to a departing executive, they can act as an effective reign on the corporation's liability both for large payments and for liability for the golden parachute payment tax.

Section 162(m) Limits

Another example of planning around excess compensation problems is Letter Ruling 200019010. There, the IRS ruled that corporate officers who resign before the last day of the tax year, with no intent to resume their duties, will not be covered employees under Section 162(m). Thus, compensation paid to those individuals for that year will not be subject to the Section 162(m) deduction limitation. Just think of the possibilities this suggests.

In the letter ruling, the corporation was a publicly-held calendar year taxpayer. Several of the officers had resigned (or intended to resign) as officers, not intending to resume their duties. The question in the ruling was whether, solely for the year of their resignation, their compensation would not count under the limits of Section 162(m). Interestingly, the ruling notes that it did not matter to this conclusion that the officers were listed as the CEO or the four highest compensated officers during the year.

Barbie's Toys

Consider the recent report that Jill Barad, former CEO of Mattel, received an exit package valued at close to $50 million. After Barad's three-year term at Mattel's helm, and her resignation in the face of mounting losses, it staggers the imagination that the proxy statement shows $50 million in exit pay (valued in current dollars). See Bannon, "Mattel Proxy Says Jill Barad Received Severance Package of About $50 Million," *Wall Street Journal*, May 1, 2000, p. B9.