

Golden Parachute Guidance

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Golden parachute payments, one must admit, have a storied past. Golden parachute payments first came to prominence back in 1984 with the enactment of Code Sec. 280G, and the corollary excise tax enacted by Code Sec. 4999. Proposed Regulations were first released in 1989, and then re-proposed in 2002. They were finalized in 2003.

The golden parachute label, along with the reciprocal golden handcuffs, features prominently in many business deals. Notably, these rules apply to private as well as public companies.

Chief Counsel Advice 200923031 (Feb. 2, 2009) gives new guidance on the implications of these rules in the context of a reorganization.

Just the Basics

A parachute payment isn't entirely proscribed, but isn't favored either. It incurs two extra tax burdens if it is of a certain size, being deemed "excess." A parachute payment is a payment in the nature of compensation to (or for the benefit of) a disqualified individual that is contingent on a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the corporation's assets. If the payment has a present value of at least three times the disqualified individual's base amount (generally the person's average annual compensation for the five years before the change), the payment becomes an *excess* payment.

That makes the payment nondeductible to the extent it exceeds that base amount. [See Code Sec. 280G(b)(1).] The bad consequences come with a double whammy: not only is the payment nondeductible to the payer, but it also incurs an excise tax. The excise tax is assessed on the recipient of the excess parachute payment. The excise tax is 20 percent of the excess parachute payment, and it too is expressly made nondeductible.

"Disqualified individuals" are defined in a way one would expect. Generally, they include any employee, independent contractor or other person specified in regulations who performs personal services for a corporation, and who is an officer, shareholder or highly compensated individual. [See Code Sec. 280G(c) and Reg. §1.280G-1, Q&A-15 through Q&A-20.] "Highly compensated" is defined to mean anyone who is a member of the highest paid one percent of employees or, if less, the highest paid 250 employees. [See Code Sec. 280G(c).]

Most of the niceties of golden parachute practice involve not merely cash payments but other types of consideration. In fact, cash is relatively straightforward. Other consideration is often confusing. The law is clear that payments may come in a variety of forms, and the restricted property rules of Code Sec. 83 are very much in the mix. For example, the vesting of options is treated as a payment in the nature of compensation. [See Reg. §1.280G-1, Q&A-13.]

Over the years, a considerable amount of attention has also been paid to triggering events. In general, a payment will be treated as contingent on an ownership or control change if it *in fact* would

not have been made had no change occurred. This is so even if the payment is expressly conditioned upon another nonacquisition event. [See Reg. §1.280G-1, Q&A-22(a).]

New Guidance

You may think you have mastered these rules, and that you can spot a parachute payment when you see one. Nevertheless, CCA 200923031 suggests that there are subtleties here or, more pejoratively, traps for the unwary. Essentially, this Chief Counsel Advice examines consideration in an acquisition. More particularly, it examines the extent to which the cancellation of nonlapse restrictions under Code Sec. 83, and/or the acceleration of vesting of unvested stock rights, constitute parachute payments.

In the ruling, a company maintained a stock rights plan for designated executives. The stock rights were options to purchase Class A Common at book value, and the right to purchase Class B Common at par value. Notably, the issuing corporation has rights and obligations under the plan to repurchase at book value the Class A Common (this is referred to as a "book value restriction") and to repurchase the Class B Common at par value.

A transaction is planned in which the corporation will be acquired by an unrelated third-party buyer. We are told that in this transaction, the book value restriction provided in the plan will be cancelled. As a result, the corporation's shareholders will be entitled to receive fair market value for their Class A Common on the closing of the transaction. Moreover, certain unvested stock rights will become fully vested, and the stock rights and certain Class A Common will be cashed out.

The IRS concludes that the removal of the book value restriction with respect to the Class A Common is a non-compensatory cancellation of a nonlapse restriction under Code Sec. 83. Of course, that is good. It means that this cancellation will not require an amount to be included in the income of the executives.

Furthermore, the IRS concludes that no portion of the consideration of the transaction payable with respect to the vested Class A Common is a parachute payment. The amount of the parachute payment attributable to the

acceleration of the vesting of the unvested stock rights, however, is determined by applying the regulations to the value of the stock rights at the time of vesting (taking into account the transaction consideration, not limited by the book value restriction).

What seems key about this ruling comes in the company's representations to the IRS. The company represented that the cancellation of the book value restriction will affect all Class A Common and stock rights to acquire Class A Common. Moreover, the company represented that the cancellation is occurring pursuant a negotiated arm's-length transaction.

The company was even able to represent to the IRS that the executives who participate will not take a salary adjustment in connection with the cancellation. Finally, the company represented that it would not treat the cancellation of the book value restriction as a compensatory event.

Saving Grace

Savings clauses are pretty common in various types of agreements. A golden parachute

payment savings clause would typically operate as a stop-gap, to say that no matter what all of the other provisions in a compensation agreement may state, no "excess parachute payment" will be made. Some savings clauses may require an executive to repay any amount of compensation that ends up being viewed as an excess parachute payment.

Note, however, that such "unring-the-bell" provisions are less common with golden parachute payments than they are with regular old compensation that is later adjudged to be unreasonable. (An example of the latter type of savings clause is featured in *Menards, Inc.*, No. 08-2125 (7th Cir. 2009) [see Robert W. Wood, *Funny Money: Deducting Reasonable Compensation*, M&A TAX REP., Apr. 2009, at 5], where the Seventh Circuit rejected the IRS's arguments based on the savings clause). Far better than savings clauses, particularly of the repayment variety, is to avoid the problem from the start. CCA 200923031 suggests ways to do that in the case of some acquisitions.