Grossing up Golden Parachute Payments

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As M&A Tax Report readers are aware, golden parachute payments come up frequently in corporate transactions. As we've noted in these pages in the past, formula clauses and tax gross-ups are pretty common. For prior coverage, *see* Robert Wood and Christopher Karachale, *When Golden Parachutes Rip*, M&A Tax Rep., Mar. 2010, at 4; and Wood, *Golden Parachute Guidance*, M&A Tax Rep., Aug. 2009, at 5.

It's easy to see why this practice developed. Golden parachute payments of the excess variety hurt everybody, both the paying company and the executive. The executive gets slapped with a 20-percent nondeductible excise tax on the excess portion of the golden parachute payment. The company loses its deduction on the excess portion as well.

As a result, many companies include tax gross-up provisions, so an executive who is hit with the nondeductible 20-percent excise tax is made whole by an additional amount of money. In essence, this is the flipside of a savings clause. A savings clause would serve to restrict payments that are contingent on a change in control to amounts that will *not* trigger the bad excess parachute payment treatment.

Of course, if the executive has negotiated for a whopping payment that *will* trigger the golden parachute rules, shouldn't he receive it? There may be no right answer to this question. Maybe tax gross-ups are a good thing, so the affected executives don't focus myopically on their own problems and don't grumble at a key time that they were cheated out of a change in control payment for which they had bargained. Maybe tax gross-ups are a bad thing, making shareholders angry and potentially affecting shareholder votes.

New Wave?

However you come down on this issue, it's an interesting problem, one recently highlighted in TAX NOTES. [*See* Andrew Liazos and Daniel Senecoff, *Golden Parachute Rules in Corporate Transactions,* TAX NOTES, May 17, 2010, at 801.]. The authors make a case that tax gross-ups are mostly a good thing, and maybe even necessary. But they also suggest a couple of other strategies that they say might work. They include the following:

1. **Noncompete.** The authors point out that payments considered reasonable compensation for services rendered *after* a change in control are ignored in running the excess parachute payment tab. Notably, a payment for a covenant not to compete is to be treated as the equivalent of providing services after a change in control. [*See* Reg. §1.280G-1, Q&A-42(b), (d), Example 3.] That means a payment to comply with a covenant not to compete can fall wholly outside the daunting excess parachute payment formula. True, the authors urge caution, and describe the nuances. But it is a clever and exciting possibility.
2. **Calculation maneuvers.** I'm not sure how to characterize this part of their theory, but it involves playing with the numbers that go into the formula. The base amount used to determine (after a multiplier of 3) what goes in the "excess" category can be manipulated. Indeed, it can be increased by exercising options, electing not to defer amounts under a nonqualified deferred compensation plan, and paying bonuses during the five-year period ending before the year of the change in control.

These are fundamental points. The base amount isn't a static number. The flip side is also not static. The value of payments can also be reduced, for example, by cashing out options on a change in control. That could limit the value to the cash-out amount (as opposed to a higher value associated with an unexercised option that could be exercised after a change in control).

What else? The authors point out that reasonable compensation for services to be rendered *after* a change in control includes payments received by an executive as *bona fide* damages for breach of contract because of an involuntary termination without cause. [Reg. §1.280G-1, Q&A-42(c)).] You get the idea.

Conclusion

Most of us are used to seeing limiting language that says an otherwise contractually required payment won't be made if it will trigger the bad consequences of an excess parachute payment. Most of us are also familiar with the gross-up notion that goes the other direction. But Liazos and Senecoff have suggested interesting and important thoughts about some more sophisticated approaches. If they are right that many companies are now decrying tax gross-ups in this context, their article becomes all that much more required reading.