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More Parachute Payment Rulings

by Robert W. Wood • San Francisco

The sting of parachute payment characterization can be severe. Section 4999(a) imposes a nondeductible 20% excess tax on "excess parachute payments." Under Section 280G an excess parachute payment is a payment in the nature of compensation to a "disqualified individual" if the payment is contingent on a change in the ownership or control of the corporation, and the present value of the payment is at least three times the

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management and a commitment date has occurred.

1. An exit plan includes a change to distributed computer processing from mainframe computer processing that requires the purchase of new personal computers. The cost of purchasing the new personal computers is not an exit cost because the cost will benefit activities that will be continued. The cost fails to satisfy the condition that it neither be associated with nor benefit activities that will be continued.

2. An exit plan includes plant consolidations that are expected to lead to higher costs related to customer service problems. As a result, customer deductions (sales allowances) on sales *after* the commitment date are expected to be higher as a percentage of sales than historical amounts. The increase in customer service costs is not an exit cost because the cost is directly associated with generating revenues after the exit plan commitment date. The cost fails to meet the condition that it neither be associated with nor incurred to generate revenues after the exit plan's commitment date.

3. An exit plan includes a plant closure. The enterprise will operate the plant for one year from the commitment date to complete outstanding customer orders. Unfavorable overhead variances that will result from the fixed nature of certain manufacturing costs and the smaller number of units in production are not exit costs. The costs are neither contractual obligations nor incremental to other costs incurred by the enterprise in the conduct of its activities prior to the exit plan commitment date.

What the Future Holds

It will be some time, of course, before the outcome of EITF 94-3 is clear. And some changes are likely. For example, although we have not had definitive confirmation, it appears that a decision may have been reached to fold discontinued operations accounting (*see* APB 30) into the broad restructuring category. We had speculated that, in the face of restrictions relative to restructuring accounting, corporations would attempt to qualify for "disc op" accounting—where loss accruals are more prevalent—applicable to the disposal of a "segment" of an entity. This opportunity may now be unavailable.

Fortunately, though, the FASB has decided to delay the effective date of its statement regarding impairment of long-lived assets, including goodwill. Thus, goodwill write-downs will likely continue under the more permissive guidelines of present law throughout 1995. ■

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individual's "base amount." Disqualified individuals include most personal service providers that are officers, shareholders or highly compensated persons. The base amount is essentially annualized compensation for a five-year period ending before the date of change of control.

Given audit risks, in appropriate circumstances it may be wise to seek an advance ruling. For example, in Letter Ruling 9442010, the Service considered a restructuring that took place in three transactions. First, a holding company purchased newly issued shares of a subsidiary's stock and debentures. Then, the holders of the holding company's convertible debentures were given 79% of the shares of the subsidiary's stock and debentures in exchange for their convertible debentures in the parent. Finally, the holding company was merged into a subsidiary of the subsidiary (a second-tier subsidiary), with existing stockholders of the holding company receiving 21% of the post-restructuring voting power of the subsidiary, plus warrants.

This restructuring required regulatory approval, upon which it was conditioned. Furthermore, 90% of the holding company's debenture holders had to approve, plus a majority of the shareholders of the holding company. The holding company obtained these various approvals by negotiation with an unofficial committee of debenture holders that was disbanded after the restructuring. However, this committee was permitted to nominate new directors to fill new seats on the board of the subsidiary.

Is There a Parachute Problem?

The question addressed in the ruling involved a member of the subsidiary's board. His severance

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agreement provided that in the event of a termination of his employment following a change of control, he would receive certain amounts. Under the terms of that agreement, the subsidiary was not obligated to make any payment that constituted an excess parachute payment under Section 280G. In other words, the severance agreement included a savings clause.

The board member resigned and was to receive payments under the severance agreement. The ruling concludes that the payments are not parachute payments under Section 280G because the debenture holders were not acting as a group to obtain ownership or control of the subsidiary. Furthermore, the board was not replaced under circumstances contemplated by the regulations. *See* Reg.§1.280G-1, Q&A 28(a)(2). Accordingly, the threshold determinations necessary for the application of Section 280G simply did not apply.

For further discussion of the golden parachute rules, *see* Wood, "Bonus Treated as Golden Parachute Payment Even Though Agreement Not Enforceable," Vol. 3, No. 4, *M&A Tax Report* (November 1994), p. 2.

Gold or Platinum!

For those who need a reminder that golden parachute payments really are paid, consider the recently reported case of BB&T Financial Corp. According to the reports, in the $1.11 billion merger of Southern National Corp. and BB&T Financial, Southern National's CEO parachutes out with $1,660,000 a year for life. *See* "Banking Firm's Merger Would Yield Retiring Boss $1,660,000 a Year, for Life," Wall Street Journal, November 16, 1994, p. B4.

Likewise, Martin Marietta Corp.'s Chairman, Norman Augustine, is reportedly slated to receive a special payment of at least $2.7 million contingent on the planned merger with Lockheed Corp. *See* "Marietta Chairman to Get $2.7 Million In Lockheed Pact," Wall Street Journal, December 16, 1994, p. A3. In fact, a total of 460 officers and managers at Martin Marietta would receive at least $31 million following the merger. The top five Martin Marietta officers are to receive a total of $13 million in incentive plan payments after the merger, with about $5.8 million being attributed to the change in control. ■

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