

Planning for Golden Parachute Payments

“Golden parachute” arrangements typically provide for large cash payments to a corporation’s top executives if those individuals are terminated due to a change in the control of the company.

Years ago, these payments were fully tax deductible by the employer if they were “ordinary and necessary” business expenses under Internal Revenue Code § 162. Due to controversy over large executive pay packages, the Tax Reform Act of 1984 added § 280G to the Code.

General Rules

Section 280G provides that no deduction is allowed for any “excess parachute payment” paid as a result of a change in control of the corporation or a change in the ownership of a substantial portion of its assets (“change of control”). The payment may be to an employee, independent contractor or other person who performs services for the company and is an officer, shareholder, or highly compensated individual (§ 280G(c)).

In addition to the loss of a deduction for excess parachute payments under § 280G, Code § 4999(a) imposes a 20% excise tax on the recipient of an excess parachute payment. Since an excess parachute payment would be taxed as ordinary income, the total tax on the recipient may approach of 65%. This is because he or she must pay federal income tax, Medicare tax, the 20% excise tax and any state and local income taxes that apply to that income.

If the payment is made while the individual is still an employee, the employer must withhold the full 20% excise tax (§ 4999(c)(1)).

Determining an “Excess Parachute Payment”

The rules for determining an “excess parachute payment” are somewhat complex. The first step is to determine whether a “parachute payment” even exists. A parachute

payment is defined as any payment in the nature of compensation to an officer, shareholder, or highly compensated individual which is contingent on a change of control, if such payment exceeds a dollar figure equal to three times such person's "base amount." For these purposes, the base amount is an individual's average annual compensation for the five taxable years ending prior to the year of the change of control.

If a parachute payment exists (the aggregate amounts contingent on a change of control exceed three times the base amount), the excess parachute payment is the entire portion of such payment which exceeds the base amount.

Notice that if the contingent payments exceed three times the base amount, by even one dollar, the entire amount of those contingent payments in excess of the base amount is an excess parachute payment subject to the loss of deduction and the 20% excise tax.

Example

Pam's average annual compensation for the prior five years was \$400,000. Upon a change of control and her impending termination, she is to receive a parachute payment of \$1,250,000. Since this amount exceeds three times her base (by \$50,000), the entire portion in excess of her base amount is an excess parachute payment. Therefore, \$850,000 is non-deductible by the company. And Pam must pay an excise tax of \$170,000 (20% of \$850,000). Note that if the payment to her had been \$1,200,000, it would have all been deductible and none would have been subject to the excise tax.

Tips and Traps

Section 280G applies primarily to corporations whose stock is readily tradable on an established securities market. (See § 280G(b)(5)(A). Note that this is a different definition of publicly-traded company than the one used in § 162(m).) Although the golden parachute rules were intended to deal with perceived abuses at publicly-traded companies, these rules can also apply to closely-held companies. There are exceptions in § 280G(b)(5) which make § 280G apply to non-publicly traded corporations unless the shareholders approve the payment by a super majority vote of more than 75% and there

was adequate disclosure to shareholders of all material facts concerning all payments that would otherwise be parachute payments.

Also, note that if an agreement to pay was drafted or modified within a year prior to the change of control, it is presumed to be “contingent on a change of control” unless clearly shown not to be.

In the case of stock options which provide for accelerated vesting upon a change of control, the regulations provide a method for calculating the value of such acceleration.

Payments to or from a qualified retirement plan are not considered to be parachute payments (§ 280G(b)(6)).

Any compensatory payment made in violation of securities laws may be treated as a parachute payment (§ 280G(b)(2)(B)).

Code § 280G(e) was added to provide special rules for employers participating in the troubled assets relief program (TARP).

Exception for Services to be Provided

Any amount paid for personal services to be rendered on or after the date of the change in control is not considered to be a parachute payment if the company establishes by “clear and convincing evidence” that the amount is “reasonable compensation.” There is a similar exception for reasonable compensation paid for services rendered before the change of control. For more information on determining reasonable compensation, visit www.ReasonableComp.biz.

Conclusion

There are many potential tax traps to avoid while designing parachute payments. The IRS regulations under § 280G were written in a question and answer format. Although

these regulations are lengthy, they should be perused carefully before any agreement providing for a parachute payment is finalized or modified.

Please Note

This article provides a brief overview of a complex subject. This information is provided only to encourage meaningful discussion and is not intended to be advice for any specific party. The tax laws change often. Please seek professional counsel before making any final decisions. Atlantic Executive Consulting Group, LLC does not provide legal advice or sell any financial products.

Stephen Kirkland is a compensation and tax consultant with Atlantic Executive Consulting Group, LLC. He serves as an expert witness in U.S. Tax Court and other courts on issues involving potentially unreasonable compensation. Stephen can be reached at (803) 477-5973 or Stephen.Kirkland@AECG.biz.