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Does Your Golden Parachute Have Holes?

A Practical Guide to Minimizing 280G Exposure

Every year, more and more executives are realizing that their golden parachutes have holes. Although the Treasury Department has attempted through numerous regulations to clarify the confines of Internal Revenue Code (IRC) Section 280G, it is often difficult to predict with reasonable accuracy whether a Change in Control (CIC) reward package is in danger of violating IRC Section 280G.

The tax regime under which the Internal Revenue Service (IRS) attempts to regulate the magnitude of golden parachutes is convoluted and ambiguous. It is often difficult to predict whether a particular executive's CIC reward package is in danger of violating 280G because the calculations that determine whether tax sanctions apply require several unknown variables (e.g., interest rates and stock price on the CIC date). All we can do is run the 280G calculations using various assumptions and hope they are accurate.

This inability to forecast 280G exposure with reasonable accuracy causes many companies to shoulder a perpetual unknown liability, wherein a slight violation can lead to enormous tax penalties (see Exhibit 1 below). There is a very fine line between "no" tax sanctions and "heavy" tax sanctions when it comes to golden parachutes. As a result, more and more executives are taking a hard look at their golden parachutes and repairing the holes before they jump.

This article identifies some of the critical checkpoints that can prevent the launching of a golden parachute with holes. First, we provide some basics on the mechanics of IRC Section 280G. Then we identify some of the more common circumstances that cause golden parachute problems and recommend various measures to prevent the pitfalls of 280G. Finally, we introduce some tax minimization strategies that may enable a safe landing even when it appears to be too late.

280G Basics

In 1984, IRC Section 280G was added to the IRC to discourage companies from excessively rewarding executives upon the event of a CIC. IRC Section 280G accomplishes this by proscribing a threshold amount of compensation and benefits that can be paid to an executive contingent upon a CIC. If this threshold is exceeded, the recipient of the payment will be subject to a 20% excise tax in addition to federal and state income taxes. Furthermore, the company making the contingent payment is limited in the amount that is tax deductible as a compensation expense.

The 280G threshold is determined by calculating three times the recipient's Base Amount. An individual's Base Amount is the average annual reported income over the prior five years ending before the year of the CIC. If the 280G threshold (i.e., three times the Base Amount) is exceeded or matched, the executive pays excise tax and the company loses a deduction on the entire amount that exceeds one times the Base Amount. This distinction is critical. The 20% excise tax is imposed on the amount that exceeds one times the Base Amount, not **three** times the Base Amount. Potentially, a large tax hit could result even in the case where the threshold is matched by the total contingent payments. Consider the following illustration:

Exhibit 1

		Scenario 1	Scenario 2	
Base Amount	(A)	$200,000	$200,000	
Three Times Base Amount	(B)	$600,000	$600,000	
Total Contingent Payments	(C)	$599,999	$600,000	
Difference	(D)	($1)	$0	(B-C)
Excess Parachute Payment	(E)	N/A	$400,000	(C-A)
Excise Tax	(F)	**N/A**	**$80,000**	(20% x E)
Amount Deductible	(G)	**$599,999**	$200,000	(C-E)

The above illustration shows that for 280G purposes, there is a fine line between "no" tax sanctions and "heavy" tax sanctions. The only difference between Scenarios 1 and 2 is the $1 increase in the Total Contingent Payments. However, this additional $1 resulted in an increased tax liability of $80,000 and in $400,000 of a disallowed corporate tax deduction. This shows that it is critical to stay well away from the 280G line of disaster.

It may be very difficult to determine whether a particular CIC reward package will exceed this line (i.e., the three times Base Amount threshold). However, the risks of IRC Section 280G tax sanctions can be managed through a comprehensive review of all documents (e.g., employment agreements, severance plans, deferred compensation plans, benefit plans) that provide for executive remuneration and benefits.

Inconsistent Plan Documents

Some of the most common problems may be avoided by resolving conflicts between plan documents well in advance. Many times, compensation and benefit plans are drafted years apart and by different practitioners, which results in plans conflicting as to what is payable.

For example, an employment agreement might provide that all options will be accelerated upon a 50% change in the Board, while the company's stock option plan may call for the acceleration upon a change in more than half of the Board. Which definition controls? Such inconsistencies are very common and will inevitably cause dissension between high-ranking executives and the Board. In addition to the plan terms and definitions, there are substantive provisions that should also be verified for consistency. For example, it may be provided in the stock option plan that the company will pay the executive's excise taxes, while the employment agreement states the executive is responsible for the excise taxes. Such contradictions have the potential to disrupt the deal and may alter the structure and timing of the transaction.

A well-integrated CIC reward package will have consistent definitions and substance across the various plan documents providing for such awards. The documents will not conflict, and it will be clear what rewards are due to the executive and how 280G violations will be handled.

Failure to Plan Ahead

In many cases, we have found that 280G tax sanctions could have been avoided through advance planning. Most organizations fail to recognize the degree to which they are exposed to IRC Section 280G. By performing periodic test calculations, companies can manage the potential 280G exposure by altering the terms of CIC rewards.

For example, assume that a test calculation indicates that a certain executive will receive CIC rewards barely exceeding three times the Base Amount. This result could be altered by changing the terms of one of the CIC rewards. The company could amend the severance plan to provide that the continuation of salary will be paid monthly over a two-year period rather than in a lump sum. This will lower the amount characterized as a contingent payment because each monthly payment is discounted back to the CIC date.

Although periodic reviews may provide the company with the ability to plan ahead, it is critical to note that any amendments that provide for immediate payments or benefits related to CIC rewards must occur at least one year prior to the actual CIC date. The IRS has made clear that amendments to CIC reward provisions that result in an immediate payment within one year of the CIC will be presumed to be a contingent payment.

Therefore, it is important that the implications of 280G be thought through and addressed as far in advance as possible.

Ineffective Protective Measures

Some companies have attempted to limit their exposure by tying the cash severance to 2.99 times the Base Amount. Unfortunately, cash severance is only one element of the contingent-payment calculation. Other elements that affect the calculations include:

- The accelerated vesting of stock options and restricted stock, even when there is no cash out of the options or the stock
- A "deal bonus" where the executive is paid for selling a company above a threshold price
- The accelerated payout of a supplemental executive retirement plan
- Post-employment company-paid health plan coverage (even if it is not subject to income tax)
- Reimbursement for post-employment financial planning as well as other post-employment perquisites, such as the continuation of payment of country club dues for a fixed period of time

These items are very common in CIC reward packages. A 2.99 cash severance payout can very easily be pushed over the three times Base Amount threshold when combined with any one of the above items. Don't be fooled into thinking your 280G worries are over just because the severance plan was drafted to limit the cash payment to a level below the 280G threshold. It is critical that all compensation and benefit plans be reviewed when performing a 280G calculation.

Another misconception is that employment contracts entered into prior to the CIC will avoid the negative implications of 280G if the executives' services are to be performed after the CIC. For example, companies have attempted to convert severance payments into bonuses to be paid sometime after the CIC. If the value of the employment contract exceeds the amount that can be substantiated as reasonable compensation, the excess amount will be included as a contingent payment. Thus, it is important to carefully determine what constitutes reasonable compensation for the specific services to be rendered following a CIC.

Tax Minimization Strategies

So far, this article has described the mechanics of IRC Section 280G to illustrate the fine line between "no" tax sanctions and "heavy" tax sanctions. We have also identified some of the more common circumstances that lead to golden parachute problems. The final section of this article identifies tax minimization strategies that can be employed when the CIC date is scheduled to occur within the one-year horizon.

Noncompete Agreements

One of the more common strategies to reduce the total contingent payment is to enter into a noncompete agreement with the executive. A noncompete agreement is a contract between the company and the executive wherein, in exchange for compensation, the executive agrees not to work for a competitor or solicit clients of the company. CIC payments received in exchange for the executive's promise not to compete will not be included in the total contingent payments. To be excluded as a contingent payment, the amount received in exchange for a promise not to compete with the company must be reasonable in light of:

- The legality of such covenants under state laws
- The age of the individual
- The availability of alternative employment opportunities
- The likelihood of the employee obtaining such other employment
- The degree of skill possessed by the employee
- The employee's health
- The practice of the employer in enforcing such covenants

However, a noncompete agreement only has substance and economic value to the company if the executive's employment terminates. If the executive remains employed, a noncompete agreement has no substance or economic value to the company and the IRS will not allow the corresponding payment to be excluded from the 280G calculations.

Postponing the CIC Date

Another strategy for tax minimization involves postponing the CIC date to the subsequent year so that the current year's income is included in the executive's Base Amount. This strategy will be effective if the executive and company can marginally increase the Base Amount by including the higher more recent annual income in the five-year average. An increase in the Base Amount will ultimately increase the 280G threshold and may eliminate the negative tax implications.

For example, assume an acquisition is scheduled to close in late November of the current year. By restructuring the deal to close at the beginning of the following year, the acquiree executives may benefit by including the current year's reported annual income in the Base Amount calculation. Additionally, the executive has the ability to increase this Base Amount by exercising stock options. The option exercise will be included in the executive's annual reported income for the current year and increase the Base Amount as calculated in IRC Section 280G.

Tax Gross-Up and Cutback Provisions

One of the most common strategies is to include a provision in the employment agreement or severance plan that identifies how 280G tax sanctions will be handled. These provisions range from the company paying all resulting excise taxes to allowing the executive to choose which payments shall be cut back to reduce the total contingent payments to a level that falls below the 280G threshold.

Without recognizing the potential magnitude, many companies deal with 280G by stating in the plan document that they will pay any and all excise taxes. Before making this commitment, many companies fail to realize that excise tax payments paid by the company on behalf of the executive will also be included as a contingent payment and, as a result, generate additional excise tax, which the company is obligated to pay.

Essentially, what happens is the company pays additional excise tax on the excise tax payments. This is commonly referred to as a "full" gross-up provision.

A less extreme approach is to only obligate the company to pay the first level of excise tax and require the executive to pay any additional excise tax generated from the tax payments paid by the company. This approach, sometimes referred to as a "limited" gross-up provision, can significantly reduce the cost to the company.

Another alternative is a "cutback" provision. This provision requires the executive to cut back certain CIC rewards to bring the total contingent payments to a level that falls below the 280G threshold. The executive chooses which payments will be reduced or eliminated from the CIC rewards based on the after-tax value of each payment. Cutback provisions are very common and are cost neutral to the company.

Contending 280G Inapplicable

One common misconception is that the definition of a "Change in Control" in the severance agreement is the same as that under IRC Section 280G. However, the IRS specifically defines the various circumstances that are considered a CIC and those that are not. The triggers in the severance agreements and other documents may not constitute a CIC under IRC Section 280G, even though payments are due under the plan provisions. Consequently, if there is a significant parachute problem that cannot be cured by other methods, a company should reexamine whether there had, in fact, been a CIC under 280G.

However, this approach can be very costly and time consuming. The identity of the shareholders of the parties to the transaction and the structure of the transaction are keys to determining whether there had been a CIC for 280G purposes. Because the shareholder identification process is costly and complicated for publicly traded companies, it is not typically embarked upon unless there are significant parachute problems.

Summary

As we discussed, it is difficult to predict with reasonable certainty the tax implications of IRC Section 280G. Many of the problems that occur during a transaction can be reduced significantly by a thorough review of the various plan documents and by planning ahead. Using a combination of these techniques, existing holes may be mended. In situations where it is too late for advance planning, we have identified some of the most common tax minimization strategies that may be incorporated to eliminate the negative implications of 280G.

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