PARACHUTE PAYMENTS

September 2009

Introduction

Section 280G of the Internal Revenue Code imposes special tax penalties on employers who make golden parachute payments that are considered excessive in the eyes of the tax law. Section 4999 of the Internal Revenue Code imposes corresponding tax penalties on certain employees and independent contractors who receive such payments. Fortunately, the Internal Revenue Code offers an exemption from the tax penalties to private companies that meet a number of requirements.

Legal Authority

The information below is based on Sections 280G and 4999 of the Internal Revenue Code of 1986, as amended, and Section 1.280G-1 of the Income Tax Regulations issued by the Internal Revenue Service on August 4, 2003. In conjunction with the final regulations, the IRS also issued Revenue Procedure 2003-68, which provides additional guidance on the valuation of stock options for purposes of Sections 280G and 4999.

Definition of "Parachute Payment"

Under the Income Tax Regulations, parachute payments include all compensatory payments or benefits that would not have been paid if no change in control had occurred. This standard is deemed to be met unless it is "substantially certain" that the payments would have been made even in the absence of a change in control. Parachute payments also include all payments and benefits that *accelerate* as a result of a change in control, but in this case only the increase in *present value* counts as a parachute payment. (In other words, if the payment would have been made anyhow sooner or later, only the increase in present value counts.)

Double-trigger arrangements as well as single-trigger arrangements may give rise to parachute payments. Stated differently, it is immaterial whether the payments are made or accelerated immediately upon a change in control or whether the payments are made or accelerated only if the recipient's service terminates after the change in control. In either case, the payments or benefits may count as parachute payments for tax purposes. Likewise, it is not relevant whether the payment is made by the target or by the surviving company.

Examples of Parachute Payments

Some typical examples of parachute payments include the following:

Options

This category includes options where vesting accelerates immediately upon a change in control. In other words, the options become exercisable as soon as the issuer is subject to a change in control, and the underlying shares become vested. This category also includes options where vesting accelerates if the optionee's service terminates within a certain period, such as 12 months, after a change in control. In the latter case, the options become exercisable only if (a) the issuer is subject to a change in control and (b) the optionee loses his or her job within a specified period thereafter. Typically, the optionee would not qualify for accelerated vesting if he or she is terminated for cause or resigns without a good reason. The term "good reason" is often defined as a demotion, a reduction of compensation or relocation.

The Income Tax Regulations attempt to deal with the calculation of the parachute payment derived from the accelerated vesting of an option. The calculation is exceptionally complex. In most cases, only a portion of the value of the accelerated option will count as a parachute payment. This portion reflects (a) the "time value of money" element attributable to the earlier payout and (b) the elimination of the forfeiture risk. The relatively favorable calculation method in the regulations is not available if the grant of the option—rather than accelerated vesting—is contingent on the change in control.[1]

As discussed in more detail below, options granted within 12 months before a change in control are presumed to be contingent on the change in control and, therefore, are presumed to be parachute payments.

Restricted Stock

Shares of restricted stock may also give rise to parachute payments if vesting accelerates upon a change in control, either on a single-trigger basis or a double-trigger basis. However, the Internal Revenue Service describes an exception from this rule in a private letter ruling (which does not constitute binding authority for any taxpayer other than the one to whom it was issued).[2] The ruling applies to a situation where founders purchased fully vested shares of their company. Subsequently, in connection with a debt financing, the lender required that the founders subject their shares to vesting. The new vesting provisions included an acceleration clause triggered by a change in control. The company in fact was acquired, and the founders' shares vested on an accelerated basis. The Internal Revenue Service ruled that no parachute payments came into existence as a result of the acceleration. The rationale was that the shares had been fully vested when transferred to the founders and, therefore, the accelerated vesting did not convey additional compensation to them. Arrangements of this type are not uncommon among private technology companies; if the founders' shares are fully vested, the first outside investors typically insist that some vesting requirements be imposed on those shares. Therefore, the ruling—although it may not be cited as precedent—could be helpful in minimizing the amount of parachute payments.

Severance Payments

An offer letter, employment agreement or severance agreement calls for parachute payments if it provides for special severance benefits to an executive who is terminated after a change in control. In many cases, these payments are also due if the executive resigns for "good reason," i.e. the executive's compensation is reduced, he or she is demoted, or he or she is forced to relocate. This includes an arrangement where an officer has a loan forgiven if there's a change in control. Often, the agreement provides for continuing health care coverage after termination of employment, which would increase the value of the parachute payment.

Under the regulations, it is no defense that the severance payments would have been made upon a termination of employment even if there had been no change in control. As long as the termination of employment in fact occurs within one year after the change in control, it is ***presumed*** to be a consequence of the change in control. Accordingly, even an employment agreement without a change-in-control trigger can result in parachute payments, if the agreement happens to result in the payment of severance benefits within a year after a change in control.

In Cline v. Commissioner, 34 F.3d 480 (7th Cir. 1994), the taxpayer and the target company had entered into a severance agreement. Benefits under the agreement exceeded the threshold of Section 280G and would have triggered the tax penalties. The taxpayer agreed to amend the agreement in order to reduce the severance benefits to a level just below the Section 280G threshold. At the same time, the taxpayer and the acquiring corporation reached an oral understanding that the acquiring corporation would keep the taxpayer whole by continuing his employment for a few months and paying him a bonus roughly equivalent to the loss in severance pay. The Seventh Circuit, affirming the Tax Court, held that the bonus is a parachute payment. It reasoned that the bonus would not have been paid but for the change in control and was not calculated to reflect the value of the taxpayer's services after the change in control.

[1] PLR 9119051 (February 13, 1991).

[2] PLR 200212005 (November 8, 2001).

Sometimes, a separation agreement provides for severance pay but requires the former employee to refrain from competing with the company for a specified period of time. Both the regulations and private letter rulings issued by the Internal Revenue Service provide that a portion of the severance pay may be allocated to the non-competition covenant and, therefore, is not considered a parachute payment.[3] However, the value of the non-competition covenant, and thus the excludable portion of the severance pay, is difficult to ascertain. The private letter rulings state that the Internal Revenue Service will not cover this issue in an advance ruling, since it represents a question of fact.

Retention Bonuses

Acquirers frequently offer the target's key employees cash bonuses if they remain employed for specified periods of time following the closing. For example, $250,000 will be paid if a key employee is still employed on the first anniversary of the closing, and another $250,000 is due if the key employee's service continues until the second anniversary. The present value of these amounts is considered a parachute payment, unless the key employee can prove with "clear and convincing evidence" that the retention bonuses are reasonable compensation for services to be performed for the acquirer after the closing. Whether the incentive payments are considered "reasonable compensation" depends on all relevant facts, including (a) the key employee's total compensation after the closing relative to his or her compensation before the acquisition and (b) the key employee's compensation after the closing relative to the compensation of others who perform similar work but who were not involved in the transaction.

Carve-Out Plans and Transaction Bonuses

If it appears that the proceeds from selling a company will be less than the liquidation preference of the Preferred Stock, the company often adopts a carve-out plan. Under such a plan, employees who have been designated as participants will share in a portion of the sale proceeds before the balance is distributed to the holders of the Preferred Stock. Under less formal arrangements, the target's Board of Directors simply approves cash bonuses for one or more key employees as a reward for completing the sale. In either case, the carve-out distribution or transaction bonus constitutes a parachute payment.

Hidden Parachute Payments: The 12-Month Look-Back

Some agreements spawn parachute payments even though they contain no explicit change-in-control triggers. Any payment under an agreement entered into during the 12 months before the change in control is *presumed* to be a parachute payment—unless it can be proven by "clear and convincing evidence" that there is no connection with the change in control. This means that the officer and the target have a heavy burden of proof whenever a payment is made under an agreement that was entered into during the year before the change in control.

For example, assume that an officer signed a new employment agreement 11 months before an acquisition, before anyone had an idea that the acquisition would occur. The officer and the employer now have to prove by "clear and convincing evidence" that all payments under the new employment agreement are unrelated to the acquisition. If the burden of proof is not sustained, then payments under the agreement are counted as parachute payments, despite the fact that the agreement does not even refer to a change in control.

Under the same rule, shares or options granted within one year before a change in control are presumed to be contingent on the change in control. The Internal Revenue Service has ruled that the presumption is rebutted if the options granted within one year before a change in control are "not excessive when compared to those granted in prior years." But a portion of the value of the options still counts as a parachute payment if the vesting of the options accelerates as a result of the change in control.[4]

"Disqualified Individuals" Affected by the Excise Tax

---

[3] PLR 9314034 (January 8, 1993); PLR 200110025 (March 9, 2001).

[4] PLR 9127016 (April 1, 1991).

The following individuals (called "disqualified individuals" by the IRS) are subject to the tax penalties under Sections 280G and 4999 of the Internal Revenue Code, if they receive parachute payments in excess of the threshold amount:

Officers of the Target

Officers of the target are potentially subject to the excise tax.[5] However, the number of officers that must be counted is limited to the lesser of:

(a) 50 officers, or

(b) A number equal to the *greater* of (i) three officers or (ii) 10% of the highest number of employees that the target employed during the 12-month period prior to the change in control.[6] Employees who normally work less than 17½ hours per week or not more than six months per year may be disregarded.

If some officers need not be counted, then the lowest paid officers are eliminated first.

Highly Compensated Employees or Independent Contractors of the Target

Other employees or independent contractors of the target may also be subject to the excise tax. But the number of employees or independent contractors that must be counted is limited to the *lesser* of:

(a) The highest paid 250 employees, or

(b) The highest paid 1% of all employees.

Employees who normally work less than 17½ hours per week or not more than six months per year may be disregarded. All compensation is measured during the 12-month period prior to the change in control.[7] An employee who earned less than $111,000 per year will in no event be included as a highly compensated employee. (This is the 2011 amount; it is periodically adjusted for inflation.)

Stockholders of the Target

In addition, the excise tax applies to employees or independent contractors of the target who are also stockholders owning stock with a fair market value in excess of 1% of the total fair market value of the target's outstanding stock. In determining how much stock a stockholder owns, the attribution rules of Section 318 of the Internal Revenue Code apply. This means, for example, that a stockholder is deemed to own shares owned by his or her spouse, children, grandchildren or parents. A partner is deemed to own a *pro rata* share of stock owned by the partnership. An optionee is deemed to own the shares that he or she may acquire under an option that is exercisable to purchase vested shares. If option vesting will accelerate as a result of the change in control, then the optionee is deemed to own the shares that he or she may acquire under the option.

Calculating the 20% Excise Tax

Once the parachute payments and the disqualified individuals have been identified, the impact of the tax penalties on the various parties may be determined. First, the disqualified individuals are subject to the tax penalty under Section 4999 of the Internal Revenue Code. Under this provision, they must pay a 20% nondeductible excise tax on excess parachute payments. The 20% excise tax is in addition to the regular income tax, which means that the maximum marginal federal income tax rate increases from about 35% to about 55%. The employer must withhold the 20% excise tax.

The excise tax becomes applicable if the total parachute payments equal or exceed three times the disqualified individual's average annual Form W-2 compensation for the last five completed calendar years. This calculation involves the following two steps:

---

[5] In general, we assume that anyone with the title of Vice President or a higher title will be considered an officer for this purpose.

[6] Whenever the number of individuals is a fraction, that fraction is rounded *up.*

[7] This theoretically means that it may be impossible to identify all covered individuals until the closing date. In practice, projections are usually close enough.

First, determine the disqualified individual's total W-2 compensation for the last five completed calendar years before the change in control. If there are fewer than five years, count all completed calendar years. If this shorter period includes a fractional year, then the W-2 compensation for that fractional year is annualized. However, non-recurring payments (like a hiring bonus) may be counted only on a dollar-for-dollar basis, even if other compensation is annualized. If there is no completed calendar year because the disqualified individual started work in the year in which the change in control occurs, then W-2 compensation for the fractional year is annualized. Otherwise, the year in which the change in control occurs is disregarded.

Note that W-2 compensation includes not only salaries and bonuses but also the ordinary income attributable to the exercise of a nonstatutory stock option or the disqualifying disposition of incentive stock option shares. This may create some modest planning opportunities. If a disqualified individual believes that a change in control will occur in the next calendar year, he or she should consider exercising options in the current calendar year in order to increase W-2 compensation during the base period. On the other hand, W-2 compensation does not include compensation that was deferred under a Section 401(k) plan or another deferred compensation plan and, therefore, not taxed during the base period.

Second, the sum of W-2 compensation is divided by five (or by the number of available years). This provides the average annual W-2 compensation. This is also known as the "base amount." The base amount is multiplied by three. If the total parachute payments are at least equal to three times the base amount, then the disqualified individual is subject to the tax penalties.

Once the penalties bite, they bite hard. They apply not only to the excess over three times the base amount—they apply to the excess over one times the base amount. For example, assume that a disqualified individual's average annual Form W-2 compensation is $200,000. (This is his or her base amount.) Multiplying the base amount by three results in a threshold amount of $600,000. Assume now that the disqualified individual's total parachute payments are $700,000. The tax penalties apply, and they apply to the excess over one times the base amount, or $500,000. The excise tax is 20%, or $100,000. As mentioned above, the excise tax is imposed in addition to the regular income tax. As a result, parachute payments in excess of three times the average annual compensation are very expensive for the disqualified individual.

Loss of Corporate Tax Deductions

Under Section 280G of the Internal Revenue Code, the target loses its entire deduction for excess parachute payments. The loss of the deduction applies to the same amount that is subject to the 20% excise tax. Accordingly, in the example above (where the base amount was $200,000 and the total parachute payments were $700,000), the target would be unable to claim a deduction for $500,000 of compensation expense.

Exemption for Private Companies: Stockholder Approval

In the case of a private corporation, the parachute tax penalties may be avoided altogether if the parachute payments are approved by the stockholders. But this approach is not available to public companies, and a subsidiary of a public company is treated as a public company for this purpose. In order to take advantage of this exemption, the following requirements must be satisfied:

First, a super-majority of more than 75% is required.[8] The record date for this purpose must be within the six-month period preceding the change in control. All disqualified individuals who receive excess parachute payments are prohibited from voting, and their shares are disregarded in calculating whether the 75% requirement has been met. In other words, these shares are eliminated from both the numerator and the denominator when the 75% test is applied. A disqualified

[8] A special rule applies if a stockholder of the target is an entity (such as a limited partnership) and at least one-third of the entity's assets consist of the target's stock. In that case, the entity's voting rights must be exercised on behalf of the entity by owners of the entity who hold more than 75% of the entity's voting interests. The special rule may come into play, for instance, if one of the investors in the target is a venture fund that has liquidated most of its other investments.

individual who receives excess parachute payments is barred from voting on anyone else's parachute payments as well as his or her own, and such an individual is barred from voting even if his or her own excess parachute payments are not being submitted for a vote.

Second, the parachute payments must be approved in a separate vote. It is not permissible to state in the proxy or information statement that a "yes" vote on the merger will be deemed to be a "yes" vote on the parachute payments. However, a separate vote on each disqualified individual is not required; all parachute payments may be bundled as one item.

Third, the vote actually must determine whether the payments will be made. It is not possible to adopt the approach that a "yes" vote will avoid the tax penalties but the payments will be made anyhow if the stockholders vote "no." This raises the stakes, for example, in the case of a disqualified individual who is already entitled to option acceleration and who now must let the stockholders decide whether or not he or she will actually receive the benefit of the acceleration. In general, this requirement is implemented by asking all affected disqualified individuals to agree in writing before the vote that they will waive their parachute payments to the extent that the stockholders fail to approve them.

Fourth, there must be adequate disclosure to the stockholders of all material facts concerning excess parachute payments. Such disclosure typically is included in an information statement. Under the Income Tax Regulations, the disclosure must be delivered to all stockholders entitled to vote; it is not permissible to solicit only a sufficient number of stockholders to obtain more than 75% of the votes. The disclosure must cover *all* excess parachute payments that will be made to *all* disqualified individuals subject to the tax, whether or not the payments are being submitted for approval.

Note that is it not necessary to submit all of a disqualified individual's parachute payments to the stockholders. Instead, a corporation may selectively submit those payments that cause his or her 300% threshold (calculated as described above) to be exceeded. For example, assume that a disqualified individual receives both a severance payment and option acceleration as a result of a change in control. Assume further that each of these benefits alone would not trigger the 20% excise tax, but both benefits together do. The corporation may seek stockholder approval of the option acceleration. If both types of parachute payment were disclosed to the stockholders and if they approve the option acceleration, then the severance payment as well as the option acceleration will be exempt from the tax.

Gunderson Dettmer's lawyers are available to assist in addressing questions you may have regarding the issues discussed in this Alert. Please contact the Gunderson Dettmer attorney with whom you regularly work. Contact information for our attorneys can be found at www.gunder.com.