# Section 280G: The Law and Lore of the Golden Parachute Excise Tax Part II: Mitigating Section 280G

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## SUMMARY

This article is the second installment of a two-part series regarding the "golden parachute" tax under Internal Revenue Code Sections 280G and 4999. Section 280G denies a corporate tax deduction for, and Section 4999 imposes a non-deductible 20% excise tax on the recipients of, payments exceeding a statutory threshold that are made to senior executives in connection with a change in control, and as a result can have a significant, adverse impact on "change in control" payments, penalizing both the employer and the executive.

The golden parachute tax rules are complicated and confusing, and often result in unintuitive outcomes. Enacted in 1984, Section 280G was intended to combat perceived abuses in management compensation practices at large publicly-traded corporations that were viewed as either hindering M&A activity or depriving shareholders of transaction gains. Two sets of proposed Treasury Regulations followed in 1989 and 2002, culminating in final regulations (the "Final Regulations") in 2003.

Many Section 280G rules do not have clear guidance. Both the statutory and regulatory language is broad, in some cases ambiguous, and in many cases at odds with common business practices. Despite multiple Internal Revenue Service ("IRS") notices, dozens of private letter rulings and a handful of published tax court cases addressing Section 280G, many questions about its application remain. As a result, disparate practices have developed and sometimes competing interpretations have evolved. We focus on those aspects of the Section 280G rules that lack clarity and discuss their application in practice, addressing common, as well as less frequently occurring issues.

The first installment of this article ("Part I") focuses on the operation Section 280G, discussing circumstances under which Section 280G may be triggered, the individuals impacted and the composition and valuation of parachute payments. This second installment ("Part II") addresses spe-



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cial issues arising in connection with two significant avenues to mitigate Section 280G, the exclusion for "reasonable compensation" for services performed and the shareholder approval exception available for certain private companies. This Part II should be read as continuation of, and companion to, Part I.

## SECTION IV: REASONABLE COMPENSATION FOR POST-CIC SERVICES

Aggregate parachute payments are reduced by amounts that a taxpayer demonstrates, by clear and convincing evidence, to be "reasonable compensation" for services rendered after a transaction triggering a Section 280G "change in ownership", "change in effective control", or "change in ownership of a substantial portion of a corporation's assets" (each, a "CIC").[1] While often a valuable strategy to eliminate parachute payments, the relevant rules are among the more complex of the golden parachute tax regime and, outside of the Final Regulations, there is little authority on application of the reasonable compensation standards. The absence of meaningful guidance has resulted in a broad range of interpretations and applications in practice, raising questions as to what "clear and convincing" evidence of reasonable compensation actually is.

### General Principles

The Final Regulations provide the following general requirements for post-CIC reasonable compensation for all types of post-CIC services:

- "Reasonable compensation" payments may, in general, be made only for the post-CIC period that an individual *actually performs* personal services;[2]

- "Actually performing" services may include (1) holding out as available to perform services (such as under a consulting agreement) and (2) refraining from performing services (such as under a non-compete covenant);[3] and

- Evidence of reasonable compensation must be "clear and convincing"—the Code's highest standard—determined based on all the facts and circumstances of a particular case.[4]

The same general rules for valuing "reasonable compensation" apply for compensation derived from actually performing services, holding out to perform services (under a consulting agreement) and refraining from performing services (under a non-compete covenant), although special considerations apply to reasonable compensation payments for each. Under a "safe harbor" provision, evidence is "generally considered" to be clear and convincing if a taxpayer demonstrates that either (1) annual compensation for substantially the same post-CIC duties is not significantly greater than before the CIC or (2) annual compensation for duties that are not substantially the same as pre-CIC duties is not significantly greater than that customarily paid by the disqualified individual's ("DI's") employer or comparable employers to persons performing comparable services.[5]

The regulatory list of "facts and circumstances" that may impact reasonable compensation value is not exhaustive, but the valuation must at least consider the (1) nature of services rendered, (2) DI's historical compensation and (3) compensation of individuals performing similar services in a non-CIC context.[6] Other factors may be relevant, however, and should (and in fact must) also be considered. While compensation meeting that safe harbor standard is "generally considered" to be reasonable, that standard is not *exclusive*. Even post-CIC compensation that does not meet the "safe harbor" should not necessarily fail to be "clear and convincing", as long as facts


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and circumstances—in their totality—support the payments.

## The Role of Square D

The case of Square D Co. v. Commissioner, 121 T.C. 168 (2003))[7] provides guidance on "clear and convincing evidence", although it is not clear how broadly *Square D*'s holdings should be applied. In *Square D*, the taxpayer argued that certain severance payments (which would otherwise have been parachute payments under Section 280G because there was a window, free-walk right) were restructured to be reasonable compensation payments conditioned on post-CIC services. On the specific facts of the case, the *Square D* court viewed the reasonable compensation value claimed by the taxpayer skeptically and applied a strict interpretation of the reasonable compensation test under the proposed regulations then in effect, limiting the reasonable compensation value of the payments to less than 10% of the amount claimed by the taxpayer. Evidence of reasonable compensation was restricted to a narrowly-tailored range of historical and comparable compensation, and other potentially relevant factors were rejected by the court.

Outside of its more specific holdings, *Square D* also provides certain generally applicable principles which augment, but do not necessarily narrow, the Final Regulations' reasonable compensation standard under Q&A-40. These include that:

- reasonable compensation should be valued using a "multi-factor test" considering the relevant facts and circumstances be used to value reasonable compensation;[8]
- reasonable compensation should be measured on a DI-by-DI, year-by-year basis (requiring allocation of multi-year compensation over the period during which it is earned);
- annual compensation includes total compensation paid to a DI, including the value of equity grants and non-cash compensation; and
- consistent with the Final Regulations, relevant facts and circumstances include a DI's historical compensation and the compensation paid to similarly-situated employees of the acquirer and other comparable employers.

Certain of the *Square D* court's other findings regarding the appropriate application of the reasonable compensation test appear to substantially constrain the types and range of admissible evidence of reasonably compensation, in contrast to the broad "all the facts and circumstances" standard under the general rule of Q&A-40. For example, the court effectively limited evidence to historical compensation and comparable employer compensation data in a non-acquisition context, ultimately determining reasonable compensation, for some DIs, based solely on comparable-employer compensation.

The court also found that "comparable employers" used for purposes of a market-based compensation check should consider the comparability of the employer's peer group, the comparability of each DI's position and the positioning of compensation along the peer group's range, drawing permitted "comparable employers" narrowly. Under *Square D*, comparable employers are those with a similar business structure, industry and relative lifecycle stage, generally including direct competitors of the acquirer. Broad, off-the-shelf market surveys were viewed as weaker evidence than more customized studies, and the more generic surveys were generally disfavored. A publicly-traded company's peer group as presented in its annual proxy statement is often the starting point to determine "comparable employers", but the selected peers need to be


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specifically analyzed under the *Square D* standard. For comparable employer data, the court found that compensation up to the 90th percentile was acceptable evidence of reasonable compensation.

Given the apparent limitations it places on determining reasonable compensation, there is an open question about how Q&A-40 should be applied in light of *Square D*. In particular, it is unclear whether the stringent *Square-D* analysis should be applied to determine the reasonable compensation value of post-CIC services in all situations, including for new grants of post-closing compensation, or instead whether the more narrow analysis should be limited to where existing entitlements were restructured in connection with a CIC. A framework for analyzing reasonable compensation under a few common scenarios is discussed below.

### *1. Restructuring Existing Change in Control Entitlements*

Under the facts of the *Square D* case, the taxpayer claimed that certain modified-single trigger severance payments (pursuant to which the executive had a window to resign for any reason and collect enhanced CIC severance) amended in connection with the transaction to require post-CIC services were reasonable compensation for post-CIC services and thus not parachute payments. Thus, in its narrow form, *Square D* could be read such that its rigid analysis is appropriate in situations where single-trigger bonus payments or modified single-trigger severance payments are restructured to require post-CIC service. One characteristic of these types of payments is that absent the restructuring, they would (assuming they exceeded the Three-Times Test[9]) almost certainly be paid and would constitute parachute payments. Accordingly, it would be expected that assessments of the reasonable compensation for such payments would be performed skeptically.

The most rigid application of the *Square D* test would appear to be in the case of single- or modified-single trigger payments amended to require post-CIC service. Applying *Square D*, the reasonable compensation analysis would be limited to a review of the grantee's historical compensation and non-acquisition context comparable employer compensation for the DI's position. In many cases, the *Square D* test would likely show limited reasonable compensation value for those payments and in the ordinary circumstance it would be difficult to demonstrate with clear and convincing evidence that such payments were reasonable compensation.

However, when double-trigger severance payments (those that are only triggered in connection with a termination by the company without "cause" or a resignation by the executive for "good reason"), a different analysis may be appropriate to account for the bargained-for aspect inherent in adding a post-closing service condition to the payment. In that situation, it is appropriate to consider other relevant facts and circumstances, such as the duration of the retention period, nature of post-closing role or other factors relevant to the DI's position. The same level of analysis may also be appropriate for newly-granted retention bonuses with a short service period (e.g., less than one year). In each of these situations, however, if payment is made because a DI's employment is terminated within the post-CIC service period under the restructured compensation (even if the termination was after the one-year post-CIC presumption period), the amount would likely constitute a parachute payment based on the premise that it was otherwise not substantially certain that the payment would have been made absent the CIC.[10]


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### 2. *New Entitlements Granted in Connection with a CIC*

Employees are frequently provided new entitlements for post-CIC compensation shortly before a CIC. Common types of grants include new salary or bonus rights, grants of acquirer equity awards (which could be significant) that vest over time after closing and cash retention bonuses. Although these new entitlements may be proportionate to the employee's post-CIC role, when aggregated with the employee's ordinary course post-CIC compensation the payments might exceed the DI's historical compensation. If the payments do not qualify as reasonable compensation, they could be presumed to constitute parachute payments under the Q&A-25 "lookback". In determining the reasonable compensation value of such payments, the more expansive reading of the Q&A-40 "facts and circumstances" test would seem more appropriate than the stringent *Square D* test, because the facts are materially different than under the *Square D* restructuring context.

Although such payments were granted in connection with a CIC, these types of new entitlements are distinguishable from, and lack the characteristics of, CIC compensation arising from existing compensation rights. For example, they do not result from restructured payments that would have otherwise been paid in connection with the CIC, are not otherwise related to past services, are driven by valid, non-280G business purposes and often result from arm's-length negotiations for post-CIC services. And, grants of new compensation do not raise the same potential for abuse of the 280G rules as do payments resulted from existing CIC compensation restructured in connection with a transaction.

As a result, it would seem to be inappropriate to apply *Square D's* narrowed standard, which is biased towards constraining reasonable compensation value in a restructuring context. A more expansive reading of the general rule applied to newly-granted payments would permit the introduction of evidential factors not expressly stated in the Final Regulations or considered in *Square D*. In practice, there generally appears to be the most comfort with and support for this view for regular, recurring annual compensation (such bonuses), and for multi-year commencement grants that are conditioned on long-term post-CIC service and/or performance, which, absent extenuating factors, seem to present the least risk of abuse. A slightly narrower reading may be appropriate for retention bonuses of medium-term duration (e.g., one year), or other similar episodic, less frequent payments than the analysis that could apply for ongoing compensation.[11] In general, the more factors that tie the compensation grant to post-CIC service or the operation of the employer after the CIC, and the less connection there is to the pre-CIC company or services, the stronger the argument appears to be to permit the introduction of additional facts and considerations under the Q&A-40 rule.

Facts that may be relevant to establishing evidence of reasonable compensation under an expanded reading could include: the degree of negotiation involved in reaching an agreement with the DI;[12] compensation granted by the acquirer (or comparable companies) in an acquisition context;[13] the importance of the DI to successful completion of the transaction and post-CIC integration; and concerns that the DI may work for a competitor. Relevant considerations could also include the extent to which the DI's duties and responsibilities change after the CIC, the level of perceived risk involved with a new, unfamiliar employer and the degree to which the acquir-


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er's compensation structure differs from the target's.

The specific facts and circumstances surrounding the grant of an entitlement may also suggest that greater weighting be given to comparable-employer compensation, if higher than historical compensation, in circumstances where the DI's role or employment profile differs substantially after a CIC. Increases in the scope of a DI's duties or responsibilities, decreased stability of post-CIC employment or an acquirer structure that generally provides for higher compensation levels for example, in each case suggest that comparable compensation should be given relatively greater weight than a DI's historical compensation as historical compensation would, in those circumstances become less relevant.

Even under a more liberal reading of the rules, however, there are limits on the amount that can be ascribed to reasonable compensation, since Section 280G provides that parachute payments are presumptively *unreasonable* compensation.[14] Moreover, the 1984 Joint Committee on Taxation's "Blue Book", provides that only in rare cases, if any, will a payment be treated as reasonable compensation based on the argument that the DI was previously undercompensated.[15] If relative historical compensation is viewed as merely one of the relevant set of facts to be considered under the Q&A-40 rule, though, this legislative soundbite should not preclude consideration of any other specific, relevant factors; to do otherwise would ignore the general "all the facts and circumstances" rule.

### *3. Special Case: Covenants Not-to-Compete*

Parachute payments may also be reduced by the amount of reasonable compensation for *refraining* from performance services on or after a CIC, including payments to comply with a non-compete covenant.[16] There is, however, virtually no guidance regarding application of reasonable compensation to a non-compete covenant. The basic inquiry breaks down into three parts: first, is there a valid non-compete covenant; second, what is its reasonable compensation value; and third, are there any limitations on how the reasonable compensation value of the covenant may be "assigned" to reduce parachute payments.

#### 1. Is There a Valid Non-Compete Covenant Under Section 280G?

The Final Regulations require that the corporation demonstrate by clear and convincing evidence that (a) the covenant "substantially constrains" a DI's ability to perform services and (b) there is a "reasonable likelihood" that the corporation will enforce the covenant (typically evidenced by a demonstrable history of enforcement).[17] To "substantially constrain" a DI from performing competing services, the covenant must be legally enforceable. State law requirements regarding enforceability of employment-related non-competition restrictions vary and validity of a covenant under applicable law should be considered. For example, California generally prohibits non-compete covenants; however, under a "sale of business" exception to California's non-compete statute, if the CIC company's executives sell all of their equity or equity awards (including phantom equity awards) in the transaction and the executives were responsible in part for the company's goodwill that is being sold, that circumstance should generally permit an enforceable non-compete under California law. In addition, certain states may prohibit covenants that would prevent an attorney (e.g., a company's general counsel or other member of its internal legal function) from providing services as an attorney, includ-


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ing in an in-house capacity, so the non-compete analysis for these people needs to focus on their ability to compete with the company in a non-legal role. The corporation benefitting from the covenant should also, per the covenant's terms, be able to avail itself of legally enforceable remedies upon the DI's breach, which may be in the form of either a court-ordered injunction or imposition of money damages (which would result in ceasing future payments and/or recouping prior payments).

**2. What Is the Appropriate Standard for Determining the Reasonable Compensation Value of a Non-Compete Covenant?**

Neither the Final Regulations nor *Square D* address how the "reasonable compensation" determination is applied to valuing a non-compete covenant. In practice, one of three primary approaches is typically used to determine the reasonable compensation value of the restriction (with a potential fourth approach as a combination of the others):

*i. Historical Compensation Value*: Reasonable compensation is the amount of compensation the DI would have earned if employed for the duration of the non-compete period, determined under the Q&A-40 "facts and circumstances" test (applying the more stringent *Square D* analysis in certain circumstances). This comports with Section 280G's general guidance for measuring reasonable compensation, although it is not tailored to non-compete valuation. In addition, legislative history suggests that the amount of reasonable compensation used to reduce parachute payments generally should not exceed the compensation the individual would have received if the DI continued to perform services for the corporation.[18] A common rule of thumb among practitioners is that the reasonable compensation for one year of a non-compete covenant is generally "worth" one year of historical total compensation, including salary, annual bonus (at target or most recent actual payment levels), long-term incentives (at target or actual payout amounts, typically allocated to an annual performance period) and in some cases, the annual value of other cash and non-cash benefits.

*ii. "Damage" Value*: Drawn from case law on non-compete appraisal in the business valuation context, reasonable compensation is determined based on the competitive "damage" or economic loss that an executive could inflict upon the corporation upon breaching the non-compete covenant.[19] The damage calculation uses an expected value approach, based on the probability that a DI will compete with the corporation (taking into consideration the DI's ability and intent to do so) multiplied by the monetary damage the DI could cause to the corporation (typically measured as the drop in the corporation's enterprise value based on the DI's competitive impact on the corporation's income stream).

Courts have considered the following nine-factors in valuing (from a "damages" perspective) a non-compete covenant: the (1) DI's ability to compete, (2) DI's intent to compete, (3) DI's economic resources, (4) potential damage to the employer posed by the DI's competition, (5) DI's business expertise in the industry, (6) DI's contacts and relationships with customers, suppliers and others in the business, (7) corporation's interest in eliminating competition, (8) duration and geographic scope of the covenant and (9) DI's intention to remain in the same geographic area. In practice, factors such as the DI's age, position, past employment history, financial resources and heath often are often factored-into the valuation as evidence of ability and willingness to compete.

Certain of these factors, no-


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tably the employer's willingness to enforce and past practice of enforcement and the employee's willingness and ability to compete, could also impact the value of the covenant as measured under the Historical Compensation approach. The absence of an enforcement history or evidence that the employee is unwilling or unable to compete could either result in a discounted non-compete value or, in a more extreme case, suggest that the covenant does not substantially constrain the employee's competition and as such is not a valid non-compete restriction under Section 280G.

The "damage" approach has been accepted as a non-compete valuation method outside of the Section 280G context, but focuses on the DI's competitive impact on the corporation rather than the value of compensation that could be reasonably earned by the DI. As such, the IRS could argue that the damages approach overstates the reasonable compensation value of non-compete covenant. In some cases, such as for non-operational personnel like a corporation's general counsel or chief financial officer, this approach may tend to systematically *understate* reasonable compensation value as compared to the Q&A-40 test, because it may be more difficult to demonstrate that such executives would in fact competitively damage the corporation.

*iii. "Lesser of" Valuation*: A hybrid approach entails performing calculations under both approaches and assigning reasonable compensation based on the lesser of the two amounts, which may, in many cases, result in use of the "historical compensation value".

*iv. Alternative "Hybrid" Valuation*: An alternative and more complex "adjusted damages" approach would involve performing the damage calculation to determine a baseline reasonable compensation value, adjusting upward or (more typically) downward based on the outcome of the facts and circumstances test. The adjusted damages approach is at least conceptually appealing, as it seems to comport with the Section 280G totality of circumstances standard and considers a DI's potential competitive damage as a relevant fact under Q&A-40.

### 3. Are There Specific Facts and Circumstances that Limit the Value of the Non-Compete that May Be Allocated to Parachute Payments?

The Final Regulations do not expressly limit the reasonable compensation value of a non-compete covenant that may be assigned to parachute payments, other than for parachute payments (1) resulting from a "securities violation" or (2) valued under Q&A-24(b) or (c), neither of which are eligible for reasonable compensation reduction.[20] Questions may also arise as to whether the amount of non-compete covenant's "reasonable compensation" value may be limited, either by terms of the agreement or specific facts and circumstances under which the parachute payments arise. Four common circumstances include:

*i. Payments and non-compete covenant are under different agreements*. In general, reasonable compensation attributable to a non-compete should not be limited to payments that arise under the agreement including the non-compete covenant.[21] Payments are generally eligible for reasonable compensation reduction if demonstrated to be "in exchange for" compliance with a non-compete; all payments received by the DI (regardless of whether arising under the same or different agreement as the non-compete) are commonly viewed as provided "in exchange for" compliance unless otherwise excluded.

*ii. Remedies for breach of the non-compete are limited*. If


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the corporation's remedies for breach include the right to an injunction and/or money damages, then the value of the non-compete covenant should not be limited. However, the reasonable compensation value of a non-compete covenant could be limited if the agreement specifies (1) a liquidated damages amount for breach or (2) only permits clawback of certain payments, which would, in each case, have the effect of assigning a pre-determined value to the covenant.[22]

*iii. Non-compete covenant is added shortly before a CIC*. If a new non-compete covenant is added or extended shortly before a CIC (or a post-CIC employment termination) for no consideration, could the amount of parachute payments that are "in exchange for" the non-compete be limited? There may be increased sensitivity that such a non-compete covenant may have been imposed solely to avoid Section 280G, because, it could be argued, the DI's right to the payments giving rise to the parachute payments was negotiated before, and without contemplation of, the later non-compete obligation, so the "value" of the non-compete should be proportionate to the incremental consideration accompanying it. Conceptually, then, the non-compete covenant's value could thus be limited to the accompanying consideration. If no consideration is paid for the non-compete added near the CIC, it does raise a question as to enforceability and intent of employer enforcement, but if the covenant is enforceable and the employer intends to enforce it, the regular Section 280G non-compete valuations standards discussed above should apply.

On the other hand, it could also be argued that the entire reasonable compensation value of the covenant should be assignable to parachute payments if the corporation's remedies include injunction, and, as described above, are not otherwise limited; if the parties did not intend the non-compete covenant to be broadly applicable to payments, they could have taken steps to limit its remedies. Moreover, by agreeing not to expressly limit remedies for breach, it could be argued that the DI essentially waived all payments up to the reasonable compensation value of the non-compete subject to future compliance with the covenant. It is unclear whether the IRS would agree, though, so it is advisable that new non-compete covenants be implemented in circumstances where adequate consideration is provided. In a similar vein, there is a risk of unenforceability if no new consideration is paid for the new non-compete covenant.

*iv. DI continues to work for the corporation after the CIC*. There is also a question as to whether "single trigger" parachute payments may be assigned non-compete reasonable compensation value if a DI continues to be employed with the corporation post-CIC. Consider two DIs, who are each receiving the same parachute payments, are the same age, have the same historical compensation and relative position in the target company, and are subject to an identical two-year post-employment non-compete covenant. Should the value of a non-compete be limited because the DI subject to the covenant continues to be actively employed by the target (or acquirer) after a CIC? Not necessarily.

Both the Final Regulations and legislative history support assigning value to the non-compete even if the DI continues to perform active services. Q&A-42(a) states that "except as provided" in Q&A-42(b) (for non-compete covenants), clear and convincing evidence will not exist if the DI does not, in fact, perform contemplated services (which, for a non-compete, means refraining from performing services).

The broader interpretation is


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consistent the legislative history suggesting that a non-compete covenant has value at the time it is entered.[23] If the covenant was entered into at the beginning of employment (or any other time that post-agreement employment with the employer was contemplated), then the non-compete covenant's value is *necessarily* not dependent on "actually" refraining from services at that time. Accordingly, it does not seem appropriate to assign no reasonable compensation value to the employee's non-compete covenant (and, in fact, the non-compete may be a reason that the DI continues to work for the corporation after the CIC). Consider three common scenarios:

*1. Wear-Away Post-CIC Non-Compete*: Assume a three-year post-CIC non-compete where the employee continues to work for the corporation. Although a zero value for the covenant seems inappropriate based on the principle discussed above, it may be reasonable to discount the value of the covenant since it may not actually have effect if the employee continues to work for three years after the CIC.

*2. Post-Employment Non-Compete*: Assume a covenant that applies for two years after termination of employment. In this case, the value should not be limited at all, since it is likely to apply at some point in the future and its value was presumably bargained for by the employee in connection with the employee's compensation package.

*3. Limited Post-Employment Non-Compete*: Same as the covenant in #2 above, but only applies for a termination of employment within two years after a change in control. In principle, since the non-compete will only have effect within a specified window like the first scenario above, it may be reasonable to discount the covenant's value. The amount of the discount would factor in, among other things, the probability of employment termination. Although in this situation, it is likely that an enhanced severance payment would be paid upon such termination so, alternatively, the non-compete value could be ignored as of the CIC date (when there was no parachute payment) and applied at full value in calculations at the time the DI actually terminated employment.

### *4. Special Case: Consulting Agreements*

Payments made for holding oneself out as available to perform services may constitute payments of reasonable compensation.[24] A typical post-CIC consulting structure might provide for periodic payments in exchange for a DI's agreement to remain available to perform services for a specified amount of time. In general, such payments are subject to the same standards as payments for continued post-CIC services, but case law may provide limits to consulting payments in certain circumstances. The Tax Court, in Balch v. Commissioner, 100 T.C. 331 (1994), for example, limited the reasonable compensation ascribed to a consulting agreement by holding that reasonable compensation was comprised of an amount calculated as the number of days *actually worked* under the agreement during a year times a per diem rate based solely on the DI's historical compensation in the year preceding employment termination.

Like *Square D*, the *Balch* consulting payments resulted from restructured CIC payments with an added post-CIC service condition. Accordingly, the strict *Balch* rule may not apply outside of a higher scrutiny context such as in the case of restructured CIC payments. While a broader reading of *Balch* seems to conflict with the rule that remaining available to perform services in itself constitutes "performing services", it is advisable that companies realisti-


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cally estimate the amount of time that a DI is expected perform services under a consulting arrangement. Arrangements under which a DI spends little time actually performing services relative to the compensation provided may be of concern, as there is a risk that the IRS could assert that an arrangement under which a DI did not actually perform the specified amount of services (notwithstanding being available to do so) could generate parachute payments in excess of the reasonable compensation of the DI's services.

#### *5. Reasonable Compensation for Services Before a CIC.*

Reasonable compensation may also be applied to services performed *before* a CIC, although the reduction is less helpful than post-CIC reasonable compensation in mitigating parachute payments, and is often overlooked (or ignored) in practice. Compared to reasonable compensation for post-CIC services, which reduces parachute payments dollar-for-dollar and is applied before performing the Three-Times Test, pre-CIC reasonable compensation reduces only the amount of an excess parachute payment *after* the Three-Times Test is performed and the excess parachute payment is calculated.[25]

To apply the pre-CIC reasonable compensation reduction, the excess parachute payment is calculated and reduced by (1) the amount of pre-CIC reasonable compensation attributable to the parachute payment (determined in accordance with Code Section 162)[26] *minus* (2) the portion of the Base Amount[27] allocated to that parachute payment. For example, consider a DI who has a $100,000 Base Amount and receives an annual incentive bonus of $500,000 upon the closing of a CIC based on actual performance, and $300,000 of the payment is established as reasonable compensation for pre-CIC services. The $400,000 excess parachute payment ($500,000 minus the $100,000 Base Amount) is reduced by $200,000 ($300,000 minus the $100,000 Base Amount, since it was applied to this payment), for an excess parachute payment of $200,000 (for a $40,000 savings of the Section 4999 excise tax). By contrast, if the $300,000 reasonable compensation reduction were for *post-CIC* services, the excess parachute payment for the bonus would be $0 (for an $80,000 savings of the Section 4999 excise tax), since the parachute payment attributable to the $500,000 bonus would be reduced dollar-for-dollar to $200,000, and there would be no amount exceeding the Three-Times Test.

## SECTION V: PRIVATE COMPANY ISSUES

Payments to a private corporation's DIs may be eligible for exemption from "parachute" treatment under one of two special rules: (1) the S Corporation exemption (see Section I of Part I) or (2) the shareholder vote exemption, under which payments approved by more than 75% of the voting power of a corporation's shares entitled to vote after "adequate disclosure" will no longer be deemed to be parachute payments (the "280G Vote").[28]

### 1. Eligible Corporations.

The 280G Vote is available to a corporation if, immediately before the CIC, none of the corporation's stock is "readily tradeable on an established securities market or otherwise".[29] "Readily tradeable" stock is "regularly quoted" by brokers or dealers making a market in such stock.[30] An "established securities market" is (1) a national securities exchange registered under section 6 of the Securities Exchange Act of 1934, (2) a foreign national securities exchange officially recognized, sanctioned, or supervised by governmental authority, or (3) any over-the-counter market.[31]


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***1. Is a Private Corporation with a Public Shareholder Eligible to Use a 280G Vote?***

A private corporation with a shareholder which has readily tradeable stock will generally be eligible to use the 280G Vote, unless either (1) the FMV of the private corporation's stock held by the corporate shareholder directly or indirectly constitutes one third or more of the total gross FMV of all the corporate shareholder's assets (determined under the Asset Test[32]) or (2) any member of the private corporation's "affiliated group of corporations", within the meaning of Code Section 1504.[33]

***2. Are the "Pink Sheets" An Established Securities Market?***

The "pink sheets" constitutes an established, over-the-counter securities market. Accordingly, if a company's stock is "regularly quoted" by brokers or dealers making a market in such stock on the pink sheets, then the 280G Vote is not available.[34]

***3. Is a Corporation Whose Shares Were Delisted From a Securities Exchange Eligible to Use the Shareholder Approval Exception?***

A corporation's stock trading status is determined as of immediately before a CIC. The 280G Vote is thus generally available to corporations for which stock was delisted (including pursuant to a bankruptcy) before a CIC,[35] unless the corporation's stock becomes "regularly quoted" by brokers or dealers on an over-the-counter market (including through "pink sheets", an over-the-counter bulletin board or inter-dealer quotation service, although an over-the-counter market should exclude trades exclusively among "qualified institutional buyers" through a Rule 144A private placement where securities are not otherwise regularly quoted on an inter-dealer system).

***4. Is a Foreign Corporation Eligible to Use the 280G Vote?***

The "securities exchange" definition includes a foreign national securities exchange, so the rule prohibits a corporation whose shares were traded on a foreign exchange from employing a 280G Vote.

**2. Effect of Vote.**

***1. What Is the Impact of the 280G Vote in Determining the DI's Right to Receive a Payment to Which the DI Has a Legally Binding Right?***

The 280G Vote must determine the DI's right to receive payments, or to retain payments made before the vote.[36] Although the Final Regulations do not address how the vote "determines" the DI's right to receive or retain a payment to which the DI has a pre-existing legally binding right, an approach where a DI agrees to waive payments unless approved is nearly always used. The applicable waiver should be:

- *Legally binding and enforceable*. The DI's execution of the waiver should be knowing and voluntary, so the waiver's purpose should be stated and describe and quantify the relinquished rights. It should describe, at a minimum, the amount being waived, the total of all potential parachute payments and the DI's Safe Harbor amount. If there is uncertainty regarding the precise amount being waived and voted on, one approach is to provide that the DI only has the right to receive or retain amounts up to his or her Safe Harbor in the absence of approval (or alternatively, that all potential payments are being waived subject to approval).

- *Irrevocable*. A DI's waiver of parachute payments must be irrevocable. The waiver's effectiveness, however, could (and should) be contingent on the CIC occurring, such that if the sale transaction is not con-


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summated, the waiver agreement will terminate.

- *Executed Before the Vote*. The DI should execute the waiver not only before the vote, but before distribution of disclosure materials and ballots to the corporation's shareholders.

### 2. Can Shareholders Agree to Vote Shares to Approve Parachute Payments in Advance of the Vote?

The Final Regulations do not expressly prohibit agreements among shareholders to approve parachute payments. However, certain specific facts and circumstances may raise questions about the effectiveness of the vote in actually determining the DI's right to receive or retain payments. There is less concern with nonbinding, verbal discussions between shareholders and a DI that payments will be approved as long as such discussions fall short of legally enforceable assurances.

### 3. How Much Is the DI Required to Waive?

Shareholders may vote on either the full amount of the payments to be made to a DI, or something less than the full amount.[37] The more common approach in practice appears to provide for a waiver limited to payments and benefits to the extent that they would otherwise constitute parachute payments, instead of a broader waiver of all payments, although in certain circumstances, such as where there are difficulties valuing certain payments, waiver of all payments may be appropriate. The risk with the broader waiver is that if the required number of affirmative votes were not obtained, the DI could forfeit more than just the amounts that would constitute parachute payments. As such, corporations (and DIs) often opt to vote upon (and waive) something less than the full amount of payments, under one of two basic approaches. Under the "Safe Harbor Waiver", the DI waives only the right to payments exceeding the DI's Safe Harbor amount, less one dollar. The Safe Harbor Waiver should specify the order in which any disapproved payments would be reduced (much like a typical Section 280G "cutback").[38]

In some circumstances the precise amount of a DI's payments is uncertain, and corporations and DIs elect to subject additional amounts to the vote to build "cushion" into the approval. Where there is significant uncertainty regarding the potential value of parachute payments, DIs and corporations may choose to vote on all or part of an entire category of payments (e.g., accelerated vesting of equity awards, cash transaction or retention bonuses or severance payments and benefits). This approach may be desirable if there could be unaccounted for payments or benefits that could be deemed contingent on the CIC, actuarial assumptions related to retirement or health care continuation benefits could change or the CIC date abuts the date upon which interest rates used for parachute valuation (e.g., AFR) might be scheduled to change. The "categorical" waiver may also be attractive where a benefit reduction might be difficult to accomplish (such as for a partial waiver of accelerated vesting for equity awards or curtailment of retiree health benefits).

### 4. When Should the Waiver Occur?

A DI's waiver of payments may occur at any time up to and before payments are voted on, including at the inception of an agreement that might generate parachute payments in the form of a "cutback" provision. More typically, the waiver is not executed until shortly before the 280G Vote, when a more precise estimate of potential parachute payments is available in connection with a specific CIC transaction.


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### *5. Are There Circumstances Where a Separate Waiver Is Not Necessary?*

If a DI is party to an agreement providing for an automatic cutback to the Safe Harbor limit if any payments would otherwise constitute parachute payments, the DI has effectively waived his or her right to any payments in excess of the Safe Harbor covered by the cutback. A formal waiver is not necessary: shareholders simply vote to "reinstate" the DI's right to amounts exceeding the Safe Harbor. Where a cutback provision is relied on in lieu of a separate waiver, however, it is advisable to review the cutback language to verify that a sufficient amount of payments are in fact waived (or if instead, for example, the cutback was limited to payments under specified agreements).[39]

### *6. Are There Special Considerations If a DI Forfeits a Payment that Has Already Been Made?*

Payments made before a CIC may be deemed parachute payments in certain circumstances (such payments that are contingent on an event that is "closely associated" with a CIC, as more fully described in Section III of Part I). The Final Regulations contemplate that the 280G Vote could apply to payments that have already been made, in which case the vote would be required to determine the DI's right to retain the payments. A post-payment waiver would typically provide that if the payments are not approved, the DI must them to the corporation. Presumably, the amount waived (and repaid by the DI) equals the pre-tax payment received by the DI. There are additional tax considerations related to when (and whether) a DI may get a tax credit for such repayment, especially if the DI's original receipt and repayment of an unapproved amount occurred in different tax years.[40]

### *7. Can a Transaction's Closing Be Conditioned on the Occurrence of a 280G Vote?*

280G Vote requirements are not satisfied if the approval of the CIC is contingent or otherwise conditioned on the approval of payments to a DI that would otherwise be parachute payments. It is permissible, though, to condition the acquirer's obligation to consummate the CIC on the occurrence (but not outcome) of the vote. Such a closing condition might, for example, require that all parachute payments have been irrevocably waived and a vote has occurred and amounts have been approved or disapproved.[41]

Some corporations may be concerned that a closing condition for a 280G Vote could provide DIs with the ability to hold-up a transaction. An alternative to an express closing condition is that if payments are not waived and there is no shareholder vote, there is a specific "first dollar", unlimited indemnity for any lost deduction for parachute payments (although the effectiveness of this could require an extended special indemnification period).

Despite the intent that shareholder approval of a CIC transaction is not contingent on approval of potential parachute payments, occasionally a shareholder ballot combines several shareholder actions into a single line item. To eliminate the risk that transaction approval might be deemed to be contingent on the approval of parachute payments, ballots should clearly separate the 280G Vote from the vote approving the CIC transaction by providing for the 280G Vote as a standalone line item. Some practitioners suggest (although not required as a technical matter) providing for the 280G Vote ballot in a set of documents separate from transaction approval documents.

## 3. Shareholders Eligible to Vote.

Payments subject to a 280G Vote must be affirmatively approved by more than 75% of the voting power of all out-


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standing stock of the corporation entitled to vote immediately before the CIC. The normal voting rules of the corporation apply in determining which shareholders are entitled to vote.

### *1. When Can the 280G Vote Be Held?*

The Final Regulations require that "shareholders entitled to vote" are determined "immediately before" the CIC. A special rule of convenience permits determination of shareholders entitled to vote based on shareholders of record as of "any day" within the six months immediate preceding the CIC date.[42] This rule generally protects votes based on a record date at any time within six months before a CIC, even if there were transfers of shares between that record date and CIC date. It also appears permissible to conduct votes based on a record date outside of the six-month pre-CIC window if there are no changes in shareholders between that earlier record date and the CIC date.

### *2. Who Votes on Behalf of a Shareholder that Is Not An Individual?*

If a shareholder is not an individual (an "Entity Shareholder"), payments must be approved by the person authorized by the Entity Shareholder to vote its shares in other shareholder matters.

*i. Look-Through Rule*. A special "look-through" rule applies if (1) the Entity Shareholder's stock holdings comprise at least one-third of the Entity Shareholder's total assets (determined per the Asset Test) *and* (2) the Entity Shareholder owns 1% or more of FMV of the corporation's stock. In that case, the vote must be "passed through to persons holding, immediately before the CIC, more than 75% of the voting power of the Entity Shareholder's stock that is entitled to vote.

The Final Regulations do not specifically address application of the look-through rule where the Entity Shareholder's stock is itself owned by an Entity Shareholder. A literal interpretation of the rule requires serial application of the look-though analysis until arriving at either an Entity Shareholder not subject to the look-through or individual shareholders entitled to vote. In reality, there might typically only be one or two "layers" of Entity Shareholders looked-through before arriving at a person authorized to vote, so the Entity Shareholder look-through might not necessarily result in significant additional analysis in connection with the determination of the appropriate voting person or persons.

*ii. Partnerships*. The vote is passed through to partners. The partnership agreement or other organizational documents determine voting rights, such that, for example, if limited partners are not entitled to vote on similar matters, then the general partner would have authority to approve or disapprove parachute payments.[43] In addition, any partners who may be DIs of the CIC corporation would not be permitted to vote.

*iii. Trusts*. The "normal voting rules" determining the person authorized to vote shares held by the trust are typically provided by trust documents and applicable law. The result may become more complicated if authorized person (the trustee or beneficiaries) are DIs, and if both are DIs, then shares held by the trust may be excluded from the vote.

*iv. Minority corporate owner is publicly-traded*. Shares are generally voted by the person authorized by the corporation to vote for the corporate shareholder in other matters related to the private corporation.

*v. Bankruptcy*. A corporation for which shares were delisted in connection with a bankruptcy is generally eligible to employ a 280G Vote. Because determining equity holders' continuing interests after a bankruptcy may be difficult, in some cases a bankruptcy court's approval may satisfy


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the shareholder approval requirement.[44]

### 3. How Are Abstentions Treated?

Payments must be affirmatively approved by 75% of the voting power of the corporation's stock entitled to vote, so abstentions have the effect of a "no" vote.

### 4. Are DIs Permitted to Vote?

Stock actually or constructively owned (under the attribution rules of Code Section 318(a)) by or for any DI receiving payments that would, absent shareholder approval, be parachute payments, is not counted as outstanding and not counted in determining whether the 75% threshold has been met. In addition, if a DI is the person authorized to vote for an Entity Shareholder, then the Entity Shareholder can appoint another equity interest holder, or, if a trust, another person eligible to vote for the trust. If all the voting stock is held by DIs, then such stock is counted as outstanding and votes by DIs are counted in determining whether the vote has been obtained.[45]

It is not clear whether this rule would exclude voting stock owned (or deemed owned) by a DI whose payments were not voted on (because, for example, the DI was not a U.S. taxpayer or refused to subject payments to the vote). Q&A-7(b)(4) provides that the exclusion applies to stock owned by a DI who "receives (or is to receive) payments that *would be parachute payments if the shareholder approval requirements*" of the 280G Vote are not met. The literal interpretation—that the exclusion would apply only if a DI's parachute payments were submitted to the vote, is consistent with the rule's thrust, which is to exclude votes of shareholders whose interests may conflict with those of other shareholders. It is uncertain, however, whether the IRS would argue to disqualify votes by DI whose parachute payments are not voted on.

## 4. Adequate Disclosure.

### 1. What Constitutes "Adequate Disclosure" Under Section 280G?

The Final Regulations provide a relatively bare standard for "adequate disclosure", and there is virtually no other IRS guidance on its contents. The Final Regulations require "adequate disclosure" to be "full and truthful disclosure of the material facts and such additional information required such that, at the time the disclosure is made, it is not materially misleading at the time the disclosure is made". "Material" facts are those facts that are substantially likely to be considered important by a reasonable shareholder, and may influence a shareholder's decision to approve payments.

Although the Final Regulations do not require "adequate disclosure" to be made in writing, disclosure almost universally takes the form of a written "disclosure statement" describing both substantive and procedural elements of the vote, including the transaction giving rise to the CIC, the impact of Section 280G on the corporation, the DIs and shareholders, the reason for the vote, the payments being voted on and agreements generating them. Required information includes the triggering event, the total amount of potential parachute payments to each DI and a brief description of each payment that would, but for the vote, be a parachute payment.[46] The disclosure statement must clearly report the total amount of all parachute payments, as well as the amounts being voted on. DIs' base amounts are also typically reported. The Final Regulations require that disclosure of potential parachute payments is made for "each" DI,[47] which is typically read to mean each DI for whom payments are subjected to the 280G Vote (and not *all* DIs, regardless of


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whether parachute payments, if any, are being voted on).

Disclosure must also include additional information so that disclosure is not materially misleading when made. What constitutes "additional information" would presumably comprise information sufficient to permit a shareholder to gain a clear understanding of the source and purpose of the payments at issue. "Additional information" might include a description of consequences to shareholders if the payments are not approved. For example, purchase agreements commonly include purchase price or working capital adjustments and similar provisions that would have the net effect of increasing proceeds to shareholders if parachute payments were not made. The possibility of higher purchase proceeds could impact a shareholder's decision to approve payments, and, if material, would require disclosure. If the vote occurs well before closing, then more disclosure could be required (including how the payments could change if based on a formula, such as the corporation's stock price).

### *2. Are There Limitations on How Disclosure Materials Are Distributed?*

The Final Regulations do not address the means by which disclosure materials are distributed to shareholders, but only state that there "is" or "was" adequate disclosure, or that disclosure must be "made" to shareholders. Moreover, the Final Regulations do not require that the corporation "make" disclosure to every shareholder in the same way. Disclosure transmission means should not matter, as long as the information is reasonably calculated to reach all shareholders. Ideally, the dissemination manner would provide a way to confirm each shareholder's receipt of such materials. State corporate law notice and disclosure requirements, the methods typically used to communicate with shareholders, and the composition of a corporation's shareholder base should all inform the disclosure statement transmittal mode.

E-mail seems to have become the preferred delivery means, and has the advantage of fast, confirmable transmission. If a reliable e-mail address is not available for a shareholder (such as a former employee), more traditional means of distributing the materials, such as postal mail or a private carrier, may be appropriate. Virtual delivery, through an electronic data site or similar means have become more common, although some practitioners have expressed concern that the IRS may assert that the disclosure was not properly "made" if accessing the information is procedurally cumbersome and required substantive affirmative effort by shareholders (for example, if disclosure is posted on a data site that requires multiple steps to register and access disclosure materials). It may also be possible to have a "town hall"-type meeting to vote on parachute payments, with required disclosure presented live and available as handouts (although under this approach it would be important to have all shareholders attend, or otherwise provide disclosure to those shareholders who did not attend).

### *3. Which Shareholders Must Receive Disclosure Materials and Vote?*

Disclosure must be made to "all persons entitled to vote", determined pursuant to the corporation's normal voting rules[48] (and applicable "look-through" rules) as discussed above. Disclosure is not required to be made to holders of non-voting stock, or limited partners where stock is owned by a limited partnership in which the general partner alone is vested with the right to vote. Even though a single shareholder (or group of a few shareholders) may possess more than 75% of a corpora-


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tion's voting power, disclosure must nonetheless be provided to every shareholder otherwise entitled to vote.

The limits on the "entitled to vote" standard pose both strategic and practical challenges. In most cases, the shareholders who will actually vote (determined as described below) will be the same shareholders to whom disclosure must be made, although questions occasionally arise. One is whether state law voting requirements (which might determine the corporation's "normal voting rules") supersede Section 280G's voting requirements. Some states (for example, Delaware) permit shareholder action by written consent of 75% of the corporation's shares. Notwithstanding the fact that the written consent would be effective in approving potential parachute payments, the IRS has informally stated that in such situation all shareholders entitled to vote must *receive* adequate disclosure.[49]

Another question is, where one shareholder has granted another person an irrevocable proxy covering a right to vote shares on all matters (or just on the 280G Vote), whether adequate disclosure must also be made to the proxy grantor (who will not participate in the 280G Vote), or only to the grantee (who will vote the shares). While the grantor may have been entitled to vote under state law, he or she contractually transferred that right to the grantee. If the purpose of adequate disclosure is purely to provide a shareholder with information necessary to make an informed decision, then the requirement should be met if the information were provided to the grantee, only (and assuming that the grantee is also a shareholder, as is often the case, there would not be an additional burden to the corporation). If disclosure was also intended to have a normative, "shaming" effect on a DI receiving parachute payments by publicizing payment information to all shareholders (which does not seem to be an appropriate use of the Code), then it could be argued that it would be necessary to also make the disclosure to the proxy grantor as well. If employee shareholders have not executed a proxy (or have executed a proxy but are entitled to receive disclosure pursuant to the preceding analysis), then it may be desirable to consider delayed distribution of disclosure information until very close to (if not immediately before) the 280G Vote.

### *4. When Must Disclosure Be Made to Shareholders?*

The Final Regulations require that disclosure is made before the 280G Vote, but do not otherwise address timing. Near instantaneous electronic transmission permits delivery of disclosure materials close in time to a 280G Vote. In most cases, disclosure materials should be sent sufficiently ahead of the vote to give shareholders a meaningful opportunity to review and absorb materials and consider their decision. Required deliberation time may vary depending on facts and circumstances, such as the complexity of payment arrangements, the composition of the shareholder base and what, if any, information was previously provided to shareholders.

Given sensitivity about compensation information, strategic concerns could come into play, as it may not be desirable to distribute disclosure materials to employee shareholders until the latest possible moment. In that situation, however, state law and the corporation's governing documents should be consulted for any specific requirements regarding timing or mode of delivering information to shareholders (including whether it may be permissible to use different delivery modes for different shareholders).


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## 5. Voting Procedures.

### *1. Are There Limitations on the Manner in Which the 280G Vote Is Conducted?*

The 280G Vote may be conducted in any manner consistent with the corporation's normal voting rules, as long as it is separate from the vote to approve the CIC.[50] It is not sufficient for the corporation's board to approve or ratify the payments. Shareholders must approve them. State law and the corporation's charter and by-laws might dictate other procedural requirements, particularly for actions by written consent. In some situations state law may increase the voting threshold required to approve payments. For example, certain states permit written consent only if unanimous, in which case the voting threshold for a consent effectively increases from 75% to 100%. Conversely, although state law may permit a valid consent of less than 75% of shares, unless the required 75% approval threshold were actually met, the consent would nonetheless fail to eliminate parachute payments.

### *2. When Must the Shareholder Vote Occur?*

The Final Regulations do not require the 280G Vote to occur at any specific time, and the vote may even occur after a CIC.[51] Adequate disclosure requirements and the "six-month rule" for determining voting shareholders often dictate timing. The vote is typically conducted shortly before a CIC, when parachute payment and related information is available, so that parachute payments can be eliminated before closing. The vote may also occur before signing the transaction agreement giving rise to the CIC, but if the transaction closes more than six months after the vote and the corporation's shareholders have changed, the vote's validity may be at risk.[52] A "front-end" shareholder vote at the arrangement's inception is also possible, although concerns about voting shareholders and disclosure adequacy may be more pronounced.

## CONCLUSION

The golden parachute tax can be expensive for both companies and executives, and, at least for public companies, may result in undesirable SEC disclosure. Proper planning, valuation and implementation of effective mitigation strategies should be a key planning consideration in executive compensation arrangements both before a change in control transaction is contemplated and in connection with transaction planning. Planning is complicated by the fact that Section 280G and the Final Regulations are intricate, complex and in some cases, wrought with ambiguity. Therefore, a thorough analysis and creative approach to Section 280G is necessary in order to effectively plan for and, as permitted, eliminate harsh golden parachute tax consequences.

## NOTES:

[1]Q&A-5(a)(5), Q&A-9 and Q&A-42(a).

[2]Q&A-42(a)(1).

[3]Q&A-40(b). In addition, payments made under a nondiscriminatory employee plan or program (regardless of whether the payments are for services before or after a CIC), generally constitute reasonable compensation (and, importantly are not subject to the valuation inquiry). Q&A-41.

[4]Q&A-40(a).

[5]Q&A-42(a)(2).

[6]Q&A-40(a).

[7]Although *Square D* was decided before the Final Regulations became effective and was based on events that occurred when the 1989 Proposed Regulations were in effect, the operative reasonable compensation rules under the 1989 Proposed Regulations are not materially different than those under the Final Regulations.

[8]The *Square D* test is generally consistent with the standard provided in Q&A-40(a).

[9]"Three-Times Test" means three times the DI's base amount, as described in Section III of Part I, and in Q&A-30.

[10]Q&A-22(e), *Example* 2. In this case, however, it could be appropriate to ratably reduce the amount of the resulting parachute payment for the portion of the post-closing performance period actually worked.

[11]However, if a DI's employment is terminated within the post-CIC ser-


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vice period, under Q&A-22(b) and (e), *Example* 2 (discussed in Section III of Part I), it seems that the more rigorous analysis would likely apply (and any annualized amounts of reasonable compensation would need to be prorated for any portion of the year/ other "retention" period actually worked).

[12]In footnoted dicta, the *Square D* court rejected an argument that payments were reasonable because they resulted from arm's-length bargaining; however, the crux of the court's reasoning was that the parties bargained over restructuring of CIC payments for *past* services, which may be distinguished from bona fide arm's-length bargaining over compensation for *future*, post-CIC services.

[13]Although Q&A-40(a) requires consideration of comparable compensation not contingent on a CIC, and legislative history provides that the "touchstone of reasonable compensation" is the amount paid "outside of an acquisition context", neither *preclude* consideration of comparable CIC compensation in every circumstance (although the weight given to such evidence may be limited in some situations).

[14]*See* Section 280G(b)(4), and 121 T.C. 168, 213–214 for discussion of the Code Section 162 versus Section 280G "reasonable compensation" standard.

[15]1984 DEFRA Blue Book at page 204.

[16]Q&A-42(b).

[17]Q&A-42(b). In addition, although a customer non-solicitation restriction is sometimes viewed as akin to a non-compete covenant, such a covenant may or may not "substantially constrain" a DI from performing services within the meaning of Section 280G.

[18]*See* Senate Committee Report PL 99-514 at paragraph 11,358, p. 10.

[19]*See* Langdon v. Commissioner, 59 F. App'x 168 (8th Cir. 2003), aff'g *Bemidji Distributing v. Commissioner*, T.C. Memo 2001-260 (Oct. 1, 2001).

[20]In addition, under Q&A-44, "severance payments" are not by themselves treated as reasonable compensation (this rule, however, should not prohibit a valid non-compete covenant from reducing the amount of a parachute payment arising from a severance payment).

[21]Q&A-42(b)'s reference to non-compete agreements "under which" a DI must refrain from performing services as resulting in reasonable compensation payments should not be read to limit non-compete consideration to payments under the same agreement including the non-compete; consistent with Q&A-42(a)'s description of payments "in exchange for" refraining from performing services under Q&A-42(b), "agreement under which" is read to refer to payments "in consideration for" or "subject to" non-compete compliance.

[22]It could also be unhelpful if an arrangement specifically identified particular payments made in exchange for entering into the non-compete covenant.

[23]1984 DEFRA Bluebook at page 204.

[24]Q&A-40(b).

[25]Q&A-39.

[26]Q&A-43.

[27]A DI's "Base Amount" is the DI's average annual compensation for the five years preceding the CIC, as determined in accordance with Q&A-34 to -36.

[28]Q&A-7.

[29]Q&A-6(a)(2)(i).

[30]Q&A-6(e).

[31]*See* T.Reg. § 1.897(m).

[32]Any one person, or persons acting as a group, acquires, within a 12-month period, assets from the corporation with a total gross fair market value ("FMV") equal to or more than one-third of the total gross FMV of all of the corporation's assets (measured without regard to liabilities) immediately before the acquisition or acquisitions.

[33]Q&A-6(c).

[34]Rev. Rul. 2004-87 addresses the issue of whether the "pink sheets" constitutes an "established securities market", but concludes that in the bankruptcy context securities may not be "regularly quoted" because trading is "impaired" for a debtor in a bankruptcy case.

[35]*See*, e.g., Rev. Rul. 2004-87; PLR 200212013.

[36]Q&A-7(a)(1).

[37]Q&A-7(b)(1).

[38]Considerations under Code Section 409A may also be relevant in this situation. In general, it is more beneficial to the DI to first reduce non-cash payments with higher parachute value compared to economic value, such as accelerated vesting or payment, with the benefits that would otherwise be received later in time reduced before benefits that would be received earlier in time; a typical order is to first waive double-trigger payments, followed by single-trigger payments, with equity payments not eligible for Q&A-24(c) discount waived first, followed by cash payments, followed by equity payments that are eligible for Q&A-24(c) discount.

[39]A Section 280G cutback may be an effective planning tool in an executive agreement when coupled with a covenant to use good faith efforts to conduct a shareholder approval vote to the extent available (but in no way guarantee its outcome), and could be used to eliminate the "hold-up" risk that a DI will refuse to waive parachute payments in connection with a 280G Vote.

[40]While beyond the scope of this article, taxpayers should be aware that in certain circumstances relief to the DI under Code Section 1341 may not be available to the extent that the DI's return of a payment was deemed to be "voluntary".

[41]Q&A-7, *Example* 2, paragraph (iii) contemplates a similar situation, where the acquisition agreement provides that the CIC is approved only if there are "no parachute payments made to" a DI. In that situation, the shareholder approval vote would be effective to cure the payments as long as the other requirements of Q&A-7 are met.

[42]Q&A-7(b)(2).

[43]Q&A-7(e), *Example* 3.

[44]*See* Rev. Rul. 2004-87.

[45]Q&A-7(b)(4).

[46]Q&A-7(c).

[47]Q&A-7(c).

[48]Q&A-7(b).

[49]*See* ABA Joint Committee on Employee Benefits, Q&A 7, May 4–6, 2006.

[50]Q&A-7-(b)(1).

[51]ABA Joint Committee on Em-


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ployee Benefits, Q&A 8, May 9, 2003.

[52]*See* Section V.3.1, above.


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